House of Commons

Committee of Public Accounts

HM Revenue and Customs: ASPIRE—the re–competition of outsourced IT services

Twenty-eighth Report of Session 2006–07

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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Summary

ASPIRE (Acquiring Strategic Partners for the Inland Revenue) is HM Revenue & Customs' contract with Capgemini for the provision of IT services. The contract initially involved only the Inland Revenue and replaced the contracts it had with EDS and Accenture for IT services and NIRS2 respectively. The change from one supplier to another was the first of this scale in the public sector. Following the merger of Inland Revenue and HM Customs & Excise in 2005, the latter's IT services contract with Fujitsu was incorporated within ASPIRE in April 2006.

The Department was concerned that potential competitors might perceive EDS to be a strong incumbent that could not be easily displaced. To encourage competition the Department contributed £8.6 million towards bidders' costs , and incurred further costs in IT support to allow bidders to demonstrate their capabilities. It also agreed to pay transition costs to any new supplier and exclude these from the bid evaluation.

The procurement took 21 months at a total cost of £27.5 million, against a budget of £29.6 million. Capgemini's bid was £2,830 million for a 10 year term—£32 million higher than RPS (EDS and Accenture)—but the Department considered that their bid better met its future IT needs, recognising that these could change significantly over the 10 year term.

As part of the transition process, the Department paid £37.6 million towards Capgemini's 'unique transition costs', i.e. those costs which would not have been incurred if the existing suppliers had remained. It also paid £5.7 million to EDS and Accenture to facilitate the changeover. There was no major disruption to services during the main transition. The National Insurance Recording System (NIRS2) transition, which was run separately, took longer than expected and Accenture was subsequently retained as a sub-contractor. The Department paid £2 million for the delay.

The bid price was based on the Department's level of demand for IT services in 2003. The forecast cost of the contract has increased as the Department's need for IT services and projects has increased. Actual costs were £539 million in the first year (40% higher than the Department estimated), and £767 million in the second year. The estimate for the third year was £840 million. By late 2006 the Department estimated that the total cost could rise to £8.5 billion. The main reasons for the increase are the inclusion of the Fujitsu contract (£900 million) and additional projects and services relating to the Departmental merger and transformation programme.

The ASPIRE contract provides wider lessons for the public sector in re-competing major contracts, particularly relating to the payment of transition costs. On the basis of a report by the Comptroller and Auditor General,[1] the Committee took evidence from HM Revenue & Customs on the procurement, transition, and performance of the ASPIRE contract.

1 C&AG's Report, *HM Revenue and Customs, ASPIRE—the re-competition of outsourced IT services*, HC (2005–06) 938

Conclusions and Recommendations

1. **The successful bid for the contract was originally £2.83 billion, based on levels of IT demand in 2003; but as its demand for IT services and projects has increased and the former HM Customs and Excise IT contract has been included, the Department's forecast cost has risen to £8.5 billion over the 10 year term.** Before concluding the deal, the Department should have evaluated bids against a range of demands for IT services. To inform its negotiations, it should also have analysed the effect of different scenarios on suppliers' prices and profit margins.

2. **The Department did not conduct a formal evaluation of the work of its consultants, believing that it had obtained reasonable value.** As a general principle, Departments should evaluate the performance of consultants and lessons learned from their use, not only for their own benefit but for that of other departments.

3. **By contributing to bid costs and paying transition costs to secure competition for the new contract, the Department incurred a premium of £51.9 million.** The need to generate competition for a contract of this size and complexity made a defensible case for not expecting the bidders to meet these costs. But the cost was high, and any savings from more competitive pricing remain uncertain. Where exceptionally Departments pay bid and transition costs, they should expect to have to show that there was no other cost-effective way of securing competition.

4. **The Department negotiated the actual costs of transition after the contract was awarded, including a profit margin of 15.5%.** The purpose of paying transition costs was to level the playing field between the incumbent supplier and an incoming supplier. If, exceptionally, departments decide to pay transition costs they should be negotiated before the deal is concluded to benefit from the competitive tension, and should not include a profit margin.

5. **On NIRS2, the Department paid £28.9 million to put a new contract and supplier in place and upgrade the system, though in the event Capgemini retained Accenture as a subcontractor following difficulties and delays in upgrading the new system.** The Department therefore paid for a transition which, in respect of Accenture, effectively did not take place. If departments agree to pay transition costs they need to negotiate terms that allow for the abatement of their contribution if transition does not take place as planned.

6. **Our predecessors highlighted in 2002 the challenge the Department would face in overcoming the barriers to competition when the NIRS2 contract came to an end.** By the time it has to replace ASPIRE, the Department will need to have secured viable alternative bidders to achieve effective competition, for example by making use of the facility it has in the contract to use a range of other suppliers.

7. **Almost 90% of the ASPIRE projects are being delivered on time against the Department's target of 75%.** The target is not rigorous and does not impose sufficient discipline. The Department should set more challenging performance

targets which reflect the demands it faces in improving its business operations, distinguishing as necessary between mission critical projects and other projects.

8. **Forecast spending on ASPIRE has increased significantly as the Department's demand for IT services and investment in new systems continues to grow, the aim of which is to reduce its costs to meet future spending limits.** The Department will need to demonstrate that the benefits of its investment are achieved in practice by establishing reliable baselines and tracking the costs, service improvements and efficiency savings actually achieved.

9. **The higher volumes of work on ASPIRE have increased Capgemini's overall profits on the contract, but profit margins have not reached the thresholds which trigger the profit sharing agreement.** If margins remain at the current level of 10-13%, the overall profit on the contract as a whole could be £1.1 billion compared to the £300 million initially envisaged. In agreeing future prices, the Department will need to undertake rigorous benchmarking of prices and margins, and should aim to get them discounted to reflect the increased volume of work.

10. **In settling its claim against the previous supplier, EDS, for the Tax Credits computer problems, the Department agreed that £26.5 million of the settlement could be paid in instalments dependent on the new business EDS won from government.** Most of the £26.5 million remains to be paid, and it remains to be seen whether and when the Department will obtain payment of the settlement in full. We reiterate that Government should not be placed in the invidious position of having to commission further work from the contractor in order to recover compensation for underperformance.

1 The Procurement

1. ASPIRE is HM Revenue & Customs' contract with Capgemini for the provision of IT services, which came into operation in July 2004. It replaced the former Inland Revenue's contracts for IT services with EDS, and with Accenture for the National Insurance Recording System (NIRS2). In April 2006 the IT services provided to the former HM Customs and Excise under a PFI contract with Fujitsu were brought into the ASPIRE contract. ASPIRE is crucial to the Department in providing the IT services needed to deliver its day-to-day operations, and the projects and programmes to support its business change. The Department plans a transformation programme to deliver more efficient customer-focused services which will depend heavily on new IT systems. It estimates that its spending on the ASPIRE contract may now reach £8.5 billion over its initial ten year term.[2]

Encouraging competition and evaluation of bids

2. The Department decided to replace the contracts it had with EDS and Accenture with a strategic partnership with a single supplier who has overall responsibility for the IT services. The contract also provides the Department with access to a range of other suppliers and technology. To encourage competition, it contributed towards bidders' costs and funded IT support to allow bidders to demonstrate their IT capabilities. The Committee has previously accepted that such assistance can be advantageous to encourage bids where such costs were otherwise likely to be reflected in higher tender prices.[3]

3. The Department also agreed to fund the costs of transition for a new incumbent and to exclude these costs from the bid evaluation. It considered that not to pay these costs would send a signal to the market that it was locked-in to the incumbent supplier (EDS), as the costs of transition would make the competition unwinnable for any other supplier.[4]

4. The bid from Capgemini and Fujitsu was £2,830 million—£32 million higher than RPS (EDS in alliance with Accenture). Both were 21% lower than the Department's forecast in its "Should Cost Model". The initial bids were however much closer to the Should Cost model. These bids and the model changed during negotiations which also took into account updated requirements for services. While the model included some efficiencies over the life of the contract, the Department considered that both bidders were more aggressive in their forecasts of efficiencies. The third bidder, Fusion Alliance, was not taken forward to the negotiation stage. The Department considered that Capgemini's bid better met its IT needs and changing requirements, and its quality more than offset the higher cost.[5]

2 Qq 13,15; Ev 16; C&AG's Report, paras 1–2, 28

3 Q 92; C&AG's Report, paras 17, 1.5, 16; Committee of Public Accounts, Seventeenth Report of Session 2004–05, *London Underground Public Private Partnerships*, HC 446

4 Qq 7, 92; C&AG's Report, paras 17, 1.3

5 Q 12; C&AG's Report, para 18, Figure 5

5. The bids were based on the Department's level of demand for IT services in 2003. The contract has grown in value from £2.83 billion to £8.5 billion as the Department's need for IT services and projects has increased and the HM Customs and Excise's PFI contract has been brought into the ASPIRE contract. The Department could have analysed the value for money of the bids better by using sensitivity analysis to look at the effects of changes in the scale of work on costs and profit margins. The Department considers that the increase would not have affected its original decision to award the contract to Capgemini. Its recent analysis suggested that, with the additional work, Capgemini is now cheaper than EDS would have been on a like-for-like basis.[6]

Managing the procurement

6. The procurement took 21 months at a total cost of £27.5 million, against a budget of £29.6 million. The Office of Government Commerce concluded that the Department had run the competition to a high standard and had maintained an effective competition. The procurement and transition costs were about 2% of the estimated value of the contract, and lower than industry benchmarks for PFI deals.[7]

7. £7.7 million of the procurement costs was spent on funding bidders' costs and studies to demonstrate their capabilities. The Department also contributed £0.9 million towards due diligence costs. The Department justified its contribution towards bidding costs partly on the grounds that there would be outputs which it could use. It did not however make further use of these outputs or evaluate their benefits. It also incurred £11.9 million on consultants during the procurement and transition, but did not evaluate their performance and quality of advice. It believed it had got reasonable value and considered that a formal evaluation would not have been a sensible use of resources.[8]

The previous contract with EDS

8. Under the previous contract, EDS agreed to pay £71.25 million to settle the Department's claim for compensation for the Tax Credit computer problems. The settlement included cash payments by EDS and the offsetting of certain amounts which would otherwise have been due to HMRC. The Department agreed that £26.5 million could be paid over three years, in quarterly instalments which were contingent on the new business EDS won with other government departments. Most of the £26.5 million remains to be paid. The Department suggested that if there were insufficient payments from this source, it could take legal action to secure the sum outstanding; but it has not yet done so. The Committee has previously recommended that Government should not be placed in the invidious position of having to commission further work from the contractor in order to recover compensation for underperformance.[9]

6 Q 5; C&AG's Report, paras 1.11, 1.14

7 Q 8; C&AG's Report, paras 1.19–1.23

8 Qq 51–52, C&AG's Report, paras 1.9, 1.19, Figure 1

9 Qq 24-30; Qq 137–150; Ev 23; Committee of Public Accounts, Thirty-seventh Report of Session 2005–06, *The Inland Revenue Standard Report: New Tax Credits*, HC 782

2 The transition to a new supplier

The costs of transition

9. The transition cost the Department £47.5 million in total (**Table 1**). The Department paid £37.6 million to Capgemini in respect of 'unique' transition costs which would not have been incurred had the existing suppliers continued to provide all or some of the IT. It also paid £5.7 million to EDS and Accenture to facilitate the transition. In addition to the £47.5 million, it paid £14 million to Accenture for the rights to continue to use NIRS2 after the end of its contract and £7.6 million to Capgemini for the upgrade of NIRS2. These costs were necessary to develop and run the new system. As such, they were linked with but not part of the agreement to pay transition costs to the new supplier.[10]

Table 1 Transition costs incurred by HM Revenue and Customs

Category	Main transition (£million)	NIRS2 transition (£million)	Total (£million)
Unique transition costs paid to **Capgemini**	34.2	3.4	37.6
Transition support costs to **EDS**	2.3		2.3
Transition support costs to **Accenture**		3.4	3.4
Staff and IT support costs for NIRS2 transition incurred by the Department for Work and Pensions		0.5	0.5
Departmental staff and running costs	1.3 (1)		1.3
Consultancy advice and support	2.4 (1)		2.4
Total costs of transition	**40.2**	**7.3**	**47.5**
Paid to **Capgemini** for the upgrade of NIRS2		7.6	
Paid to **Accenture** for use of Intellectual Property Rights on NIRS2		14.0	
Total costs of the transfer and upgrade of NIRS2		**28.9**	

Note 1: No separate breakdown between the main transition and NIRS2 for staff and consultancy support.

10 C&AG's Report, para 2.5, Figures 9, 11; Ev 24

10. The Department agreed to pay transition costs to encourage rival bidders, who cited such costs as an obstacle to tendering for ASPIRE against an incumbent supplier. It did not agree the unique costs of the transition until after the contract was signed, and later spent considerable time in negotiating whether a particular cost was unique or not. It also agreed to pay a profit margin of 15.5%. The Department accepted that with hindsight it might have done things differently, so as to obtain better value. The lessons from ASPIRE are that if departments agree to pay transition costs, they should be negotiated before concluding the deal to take advantage of the competitive tension, and they should not include a profit margin.[11]

The main transition

11. The main transition from EDS was completed successfully and on time. 2,811 staff from EDS (96%), 224 key staff (80%), and 219 subcontractors (97%), transferred to Capgemini with no major disruptions to services.[12]

12. The transfer of staff to Capgemini was crucial to the overall success of the transition. The contract with EDS contained exit clauses binding the company to provide support and information to any incoming supplier. EDS also agreed to pay £65 million towards the pension shortfall of staff transferring to Capgemini although it was not legally obliged to do so. Another key factor was the good collaboration between the suppliers, which facilitated the smooth handover while keeping day-to-day operations running as usual.[13]

NIRS2 transition

13. The Committee previously highlighted the challenge the Department would face in overcoming the barriers to competition when the NIRS2 contract came to an end. The NIRS2 system holds the records of 70 million people and is used by HM Revenue & Customs and the Department for Work and Pensions.[14]

14. Under ASPIRE, Capgemini and Fujitsu took over responsibility for running NIRS2 from Accenture in January 2005. But they encountered difficulties in their first attempt to upgrade and replatform the hardware and operating system. They decided to sub-contract the role to Accenture, the previous supplier and rescheduled the work in phases to be completed by September 2005. The upgrade was required so that the system could deal with 1.7 million transactions a day compared to 1.3 million on the previous system.[15]

15. The problems arose because Capgemini was unprepared for the level of expertise required to design and operate the upgraded system. Collaboration between Capgemini

11 Qq 7–8, 97, 108–110; C&AG's Report, paras 1.7, 2.5–2.7

12 C&AG's Report, paras 21 and 2.4

13 Qq 85–88, 111–112; C&AG's Report, paras 2.3–2.4

14 Q 131; Committee of Public Accounts, Thirty-eighth Report of Session 2001–02, *NIRS2 Contact Extension*, HC 423; C&AG's Report, Appendix 2

15 Qq 78–80; C&AG's Report, paras 2.12–2.13

and Accenture was also not as strong as in the main transition and Accenture's workforce was less willing to transfer to the new supplier.[16]

16. The Department spent in total £28.9 million to achieve the transfer and upgrade of NIRS2 (**Table 1**). Of this, Accenture received, as the outgoing supplier, £3.4 million to facilitate transition and £14 million for the rights to use NIRS2 after the end of its PFI contract. Capgemini received £3.4 million in transition costs and £7.6 million for the upgrade, which included £2 million towards the extra costs of the delayed migration. The Department decided it was not worthwhile to establish and attribute the causes of the problems with the upgrade, since the transition and upgrade as a whole was within its budget. [17]

16 C&AG's Report, paras 2.12–2.14

17 Qq 77, 127–131; C&AG's Report, paras 2.12-2.14, Figure 11

3 The performance and cost of ASPIRE to date

Capgemini's performance

17. The overall value for money of the ASPIRE contract will depend on how well it meets the Department's needs over the lifetime of the contract including how it deals with change. It also depends on how well the Department controls costs and manages performance.[18]

18. Capgemini has provided IT services from the first day of the contract. The Department considers that Capgemini's initial performance has been satisfactory and is improving. It is achieving most of its 500 performance targets—2 to 3% are not met each month. Around 200 of the targets are key performance indicators, which incur deductions in payment if they are not met. Capgemini incurred deductions of £2.67 million in the first year, £1.2 million in the second year and £0.3 million in the first 4 months of the third year.[19]

19. There have been no major system failures in delivering the Department's day to day business. On tax credits, many of the errors arise from wider problems in the design and administration of the scheme and with the IT system itself. Capgemini's main performance measures are availability of the system and successful batch processing. The Department considered that its performance in this area had been good, and there had been only one deduction in 2004. As the system is progressively improved, the Department expects to set more demanding service standards.[20]

20. Capgemini is also responsible for delivering upgrades to existing systems and new projects. Initially there were some delays and cost increases, mainly due to the Department changing its requirements. The Department confirmed that the quality of software releases and delivery of projects were improving. Almost 90% of projects are being delivered on time, exceeding the Department's target of 75%. Delivery of projects will become increasingly important as the Department takes forward its transformation programme between 2007 and 2011. This programme involves a series of projects to deliver more efficient, customer-focused services, such as developing online services, which will depend heavily on new IT systems.[21]

21. Even though the contract continues to grow substantially, the Department and Capgemini considered that it remained manageable, and would provide flexibility and access to wider expertise. In addition to the 2,800 staff taken over from EDS, Capgemini had brought in a further 1,000 staff including additional project management expertise. It could also call on subcontractors to deliver IT services, extra capacity or expertise when

18 C&AG's Report, para 11

19 Qq 31–34; Ev 16; C&AG's Report para 3.4

20 Qq 100–108; Ev 20

21 Qq 13, 39; Ev 16; C&AG's Report, para 3.4

required. Capgemini remains accountable for delivering the overall service even where it is dependent upon another supplier.[22]

Managing the contract

22. Compared with the previous contract, the ASPIRE contract focuses more on service delivery and productivity. Similarly, the Department has sought to change the way it manages the contract. A series of OGC Gateway Reviews have recommended improvements, including improved skills and better programme and project management. The Department is reviewing the performance measures it uses to monitor the contract to identify gaps and align the measures to business targets and outcomes. To improve skills, it has brought in fixed term appointees, but is also seeking to develop the skills of its own staff through outward secondment to work alongside the contractor.[23]

23. The Departmental staff involved in ASPIRE include finance and contract management teams and subject matter experts who manage and assure the contractor's activity. The Department has been reducing the number of its own IT staff, and aims to achieve a ratio of its own staff to contractor staff of 20:80, along the lines of accepted IT industry business models.[24]

The cost of ASPIRE

24. In letting the contract the Department recognised the need for flexibility to meet its IT needs which could change significantly over time. Spending on the contract in the first year (July 2004 to June 2005) was £539 million compared to an estimate of £384 million. It increased to £767 million in the second year and the Department expects to spend around £840 million in the third year. The Department estimates that it may now spend up to £8.5 billion, including inflation, over the ten years of the contract.[25]

25. Around £900 million of the increase stems from bringing into the ASPIRE contract the IT services provided to the former HM Customs and Excise under a PFI contract with Fujitsu. The remainder is largely due to extra demand for IT services and additional projects, including projects to support the integration of the two former Departments into HM Revenue & Customs. The projected further growth relates to work needed to deliver the Department's Transformation Programme including, for example, the further development of on-line services.[26]

26. The higher volume of work has increased Capgemini's overall profits. The profit for the first year of the contract was £52.8 million compared to an estimate of £38 million. The forecast profit for the second year of the contract was around £90 million.[27] Profit margins however remain at around 10–13%, which are within the range that have been used on PFI

22 Qq 2–4, 19, 115

23 Qq 68, 71, 116; C&AG's Report para 3.17

24 Qq 16–17, 44, 126

25 Qq 5, 20–22, 120; Ev 16; C&AG's Report, Appendix 2

26 Qq 5, 20–22, 39; Ev 16

27 Qq 6, 15; Ev 16; C&AG's Report paras 3.5–3.8, 3.13

deals. These margins are below the thresholds which trigger the profit sharing agreement the Department negotiated in the contract. If profit margins continue at this level, Capgemini could make £1.1 billion profit on the contract as a whole compared to the £300 million initially envisaged. [28] The Department can review contract prices if the volume of services changes and if benchmarking suggests the prices no longer represent value for money.

27. The 2006 Budget set future spending limits for the Department which involve a 5% real terms cut in funding in each of the three years 2008–09 to 2010–11. The settlement also gives the Department access to a modernisation fund of £300 million.[29] Its transformation programme is aimed at achieving these efficiencies whilst also delivering more customer-focused services.

28. The Department was drawing up more detailed business plans for its transformation programme, specifying the financing and benefits realisation for individual projects. Its aim was to develop a robust plan and budget, which enabled it to accommodate the planned increase in IT costs within its expenditure limits and to achieve reductions in overall running costs from the investment. [30]

28 Q 6; Ev 16

29 Qq 23, 44–48

30 Qq 23, 39, 123–25, 132–33

Formal Minutes

Monday 14 May 2007

Mr Edward Leigh, in the Chair

Mr Philip Dunne
Mr Austin Mitchell
Mr Alan Williams

Draft Report

Draft Report (HM Revenue and Customs: ASPIRE—the re-competition of outsourced IT services), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 28 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-eighth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 16 May at 3.30 pm.

Witnesses

Monday 18 December 2006

Mr Paul Gray CB, Acting Chairman, and **Mr Steve Lamey**, Chief Information Officer, HM Revenue and Customs, and **Mr David Boulter**, Chief Executive Officer, Capgemini ASPIRE. Ev 1

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Oral evidence

Taken before the Committee of Public Accounts

on Monday 18 December 2006

Members present:

Asterisks in the oral evidence denote that part or all of a document has not been reported, at the request of HM Revenue and Customs and with the agreement of the Committee

Mr Alan Williams, in the Chair

Mr Richard Bacon	Helen Goodman
Mr Ian Davidson	Dr John Pugh

Sir John Bourn KCB, Comptroller and Auditor General, National Audit Office, **Mr Tim Burr,** Deputy Comptroller and Auditor General, National Audit Office, and **Jane Wheeler,** Director, National Audit Office, were in attendance and gave oral evidence.

Ms Paula Diggle, Treasury Officer of Accounts, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

ASPIRE—the re-competition of outsourced IT services (HC 938)

Witnesses: **Mr Paul Gray CB,** Acting Chairman, HM Revenue and Customs, **Mr Steve Lamey,** Chief Information Officer, HM Revenue and Customs, and **Mr David Boulter,** Chief Executive Officer, Capgemini ASPIRE, gave evidence.

Q1 Mr Williams: Welcome to you again, Mr Gray. It is good to see you. I shall wish you a merry Christmas at the start, to show that we are starting with good will.

Mr Gray: I am pleased to hear that the season's good will is abounding in the Committee.

Mr Williams: We are here today to consider the Comptroller and Auditor General's Report entitled *ASPIRE—the re-competition of outsourced IT services*. Mr Gray, would you introduce your two colleagues?

Mr Gray: Yes. On my left is Steve Lamey, who is one of the Directors General on my board and the Department's Chief Information Officer. On my right is my partner, I think it is fair to say, David Boulter, who is the Chief Executive of ASPIRE, our outsource partner.

Mr Williams: Thank you. Is this your first appearance before the Committee, Mr Boulter?

Mr Boulter: It is.

Q2 Mr Williams: In that case, we will catch you before you learn any of the tricks of the trade.

This is a mammoth contract, is it not? It is a giant of a contract, which has shown a remarkable tendency to obesity. There has been a 40% increase in profits and in spend. Are you sure that you have the managerial capability to cope with it?

Mr Gray: Are you asking the Department or—

Mr Williams: No, I am asking Mr Boulter.

Mr Boulter: You are absolutely right. Over the last couple of years, the contract has clearly grown, not only in size and scale, but in terms of the nature of the contract—the type of work that we have to do—and we have indeed been hiring significant capacity, both in terms of the number of people and technology and in terms of management capacity from the rest of the Capgemini Group.

Q3 Mr Williams: But is that rate of growth a single spurt, do you think, or will it be sustained? As I said, it is big enough to start with. If you sustain that rate of growth, it will be very hard to keep control of it, will it not?

Mr Boulter: From our perspective, it is manageable. Clearly, working in partnership with the department is about keeping aligned as to how that will change over a period.

Q4 Mr Williams: Yes, but do you see the growth as an initial spurt that will rapidly settle down, or as something that still has a way to run?

Mr Boulter: We have certainly seen a spurt over the last 18 months, since the contract started, and I think we will continue to see a spurt on the back of the five-year change programme in the Department.

Q5 Mr Williams: So, you have already had your Christmas present in the unexpected profits that come to you.

Mr Gray, why was the incredible rate of growth not anticipated, or even partially anticipated, and used as leverage to get a better share of the profits?

Mr Gray: Obviously, it is several years now since the initial contracting was done. A number of factors have come into play since the negotiations including, notably, the creation of the combined merged Department—Her Majesty's Revenue and Customs. The contract was initially let by the former Inland Revenue and a number of things have grown and developed since then. The major factor I would point to is that, as we have been putting HMRC and its change programmes in place, in a number of areas we have sought to build up the amount of change with planning, which needs IT support and enablement.

We have reflected on whether the fact that the size of the contract has grown over time has impacted on ability to deliver, which David Boulter has just commented on, and on whether, if we had known the scale to which the contract would grow, that would have affected the original decision. We are clear from the benchmarking work and the sensitivity analysis that we have done that the original decision seems to be reinforced by the change in the composition of the work that has happened over the last couple of years.

Q6 Mr Williams: May I put an unfair question to you? If you had anticipated the rate of growth, would you have expected a different share arrangement on the profits?

Mr Gray: I do not think that we would. In drawing up the contract, we agreed specific levels of profit margin in relation to each of the different types of work covered by the contract. We are satisfied, as the National Audit Office Report brings out, that the margins that we are paying on those types of work are well within margins on other similar contracts. As you will have seen from the Report, the margins that we are paying seem to fall well within the so-called should cost model that had been developed at the time of the procurement. Had we known that the figures would be at the level that they are at the moment, I would not have expected that to have any material effect on the profit margins or on the profit share arrangement that we came to.

Q7 Mr Williams: Let us switch, then, to the transition costs. Why did you feel that you needed to pay those costs? It would not be normal to pay, would it?

Mr Gray: We simply paid what are termed the unique transition costs. If we go back to the position before the contract was re-let, we were facing the sort of issues that long-serving Members of this Committee will recall considering as a Committee a few years' ago. Those issues relate to how to ensure that in re-letting a major 10-year contract—the original EDS contract was for 10 years—the incumbent bidder, which was EDS/Accenture, was not in a preferential position. Part of our consideration, which I think was in line with the Committee's recommendations from its earlier Report, was that, in order to encourage other bidders to come forward, it was right to offer to pay the transition costs. If we had not done that, the incumbent bidder would have had a very strong advantage in relation to any newcomer in the competition.

Q8 Mr Williams: But why, then, did you choose not to negotiate the transition costs before you signed the contract? It seems a strange situation to get into to say, "I have signed up in the contract. Now we will haggle over how much I have to give you." That does not seem a particularly businesslike way of going about things, does it? What led to that?

Mr Gray: There were a number of factors. We were anxious to ensure that any new bidder in the competition was not put off by the negotiating approach that we took. With the benefit of hindsight, one of the lessons that emerges from the NAO Report is that in any future competition we would consider whether there were some changes that we could make in relation to that arrangement. As the record has rolled out, the NAO has assured itself that the transition costs that we paid were all legitimately and appropriately incurred. The overall margin that we paid under the new contract for procurement and transition costs came to about 2% of the original estimated total value of the contract. As the NAO Report brings out, that is significantly lower than the prevailing industry benchmark of about 3%. Given those figures, it is not fair to imply that we have ended up paying over the odds for the transition costs.

Q9 Mr Williams: Saying 2% makes it sound quite small, but it is a small percentage of a very large animal, is it not?

Mr Gray: Indeed it is.

Q10 Mr Williams: So that small percentage, in money terms, was what?

Mr Gray: The absolute figure for transition costs was, I think, £37 million[1].

Q11 Mr Williams: That seems incredibly high.

Sir John, what is your impression of the argument you have just heard? Does it alter in any way what you have said in your Report?

Sir John Bourn: It certainly was a legitimate payment in the way that Mr Gray says. At the same time, of course, it is an odd way for the Government to do business—to pay people to enter the competition. The Department makes the case for why, in those circumstances, that was perhaps the only way in which it felt that it could have a competition. It is a matter for careful analysis and not something that the Government drift into as a matter of course.

Q12 Mr Williams: Mr Gray, you chose Capgemini, which cost you more than you needed to pay. What do you think that it brought to the contract that no one else could bring?

Mr Gray: We were extremely keen to ensure that in the new contract we had a partner who was able to respond extremely flexibly to the likely demands within the change programme. In evaluating the bids, we felt that the Capgemini bid offered a significant advantage in that respect. The pure financial gap between the two bids, as the Report showed, was extremely narrow. We felt that that would be more than offset by the higher quality and

[1] *Note by witness*: The absolute amount paid to Capgemini was £37.6 million.

overall higher value for money offered by the Capgemini bid.

To go back to your earlier question about the increase in the value of the contract over the past couple of years, it is also worth saying that our sensitivity analysis shows us that the major increase in work, compared with the original forecast, is in the particular areas of work where Capgemini's bid price was lower than the competing price. If we were to recalculate the purely financial figures on the basis of the latest estimates of work volumes, it would be the cheaper contract. Our main reason at the time was that we thought that the overall quality of the bid was higher and that it more than offset, in percentage terms, the small differential in pure price.

Q13 Helen Goodman: Would you begin at the beginning and explain what you are paying Capgemini to do? How do you divide responsibility for the work between the Revenue staff and the private sector?

Mr Gray: I might ask Steve Lamey to add to my answer, if I may. There are two primary things that we are asking Capgemini to do for us. First, there is the whole range of the day-to-day provision of IT services that were originally contracted out to EDS, so there is a lot of routine operation of IT systems. Secondly—this has become an increasing proportion of the total work load—we are looking to Capgemini to help us to develop innovative solutions and proposals to roll out our change programmes. Steve may want to add to that.

Mr Lamey: Yes, if I may. We looked at this as a demand and supply model, in that our suppliers would be responsible for all the supply-side activity and HMRC civil service staff would be very much on the demand side in terms of measuring what was required, ensuring that it was being delivered and ensuring that the appropriate strategic architectures were being shaped.

We used very much a business standard model, the Gartner information systems light model, to determine the roles on the civil service side and on the supply side. There is quite a well defined structure of activities, but essentially we are there to ensure business engagement, to identify what the business wants from IT systems, to work with our partners to deliver that, and to ensure that what they are delivering to us, both in live services and in programmes and projects, is to the standards that we expect and meets all the surrounding commercial and contractual obligations. We have a well defined model.

Q14 Helen Goodman: Thank you; I understand. Mr Gray, I want to pursue the line of questioning that Mr Williams was following. Is there not a risk with large contracts that looking at things in percentage terms means that big increases in costs are not addressed sufficiently rigorously?

Mr Gray: There is clearly a risk in that, but we do not just look at things in percentage terms. Percentages are clearly sometimes relevant for some comparisons, but we certainly look extremely closely at the absolute costs, and my accountability to the Committee and the House more generally is to ensure that I account appropriately for the absolute sums that we are spending. My budget is not set in percentage terms; it is set in absolute terms. I would regard that as the primary focus of attention.

Q15 Helen Goodman: You wrote to us a few days ago to tell us that your top estimate now—we are nearly in January 2007—is £8.5 billion.[2]. That compares with an estimate only three years ago of £3.5 billion. You have agreed a profit margin of 15%, which means that over the 10 years of the project Capgemini's profits will have increased from £600 million to £1.2 billion. With profits as high as that, would it not be better value for the public sector to develop the expertise itself, rather than continuing to shell out in that way? Would it be possible to do that for £1.2 billion?

Mr Gray: May I comment first on the figures? As our note of a few days ago said, the total value of the contract is now £8.5 billion, but the right like-for-like comparison is with the earlier estimate of £6.6 billion. None the less, I accept that it is a very big increase.

What we need to do in terms of value for money is regularly to assess how to derive best value in the running of those services. The view was taken more than 10 years ago by the Inland Revenue, in parallel with the former Customs and Excise, that the services that Steve and I have described should be procured by going to the external market.

Q16 Helen Goodman: I understand that, but I am asking you whether it is worth re-examining that assumption, given the great increase in costs.

Mr Gray: It is certainly worth re-examining from time to time, but I do not accept that the fact that the estimated volume of work has increased is sufficient to justify us suddenly saying, "Okay, we're now going to bring the contract to an end and seek to develop this very sophisticated skill set wholly in-house."

What we have done as the new contract has rolled out is ensure that the in-house staff become more appropriately skilled not only in contract management, but—to use the jargon slightly—in being an intelligent customer to ensure that we buy in only the services for which we can get the best value for money.

Q17 Helen Goodman: What is the cost of the in-house staff working on this?

Mr Gray: I am not sure that I have a money figure in my head, but we have about 1,700 members of staff in Steve Lamey's directorate in the Department. That has been reduced somewhat over recent years. The ratio of those staff to the number of staff employed by ASPIRE and its partners is roughly 20:80. So, about 20% of the staff are in-house and 80% are contracted out in ASPIRE and elsewhere.

[2] Ev 16–18

Q18 Helen Goodman: But if each of those members of staff cost the Revenue £50,000, that would be only £50 million. So, are you telling us that you cannot upskill staff at a cost of less than £1.2 billion to carry out the work?
Mr Gray: What we are doing is not just incurring staff costs. We are also purchasing major systems, where we are talking about not just the staff costs involved, but significant capital procurement programmes.

Q19 Helen Goodman: Mr Boulter, may I ask how different you really are from the people with whom you were competing, given that you have taken on, initially at any rate, their work programmes and a large number of their key staff? Why are you different from EDS?
Mr Boulter: There are several things that we do differently and that we have added. Mr Williams asked earlier what we have added in new staff. We have added about 1,000 new members of staff to the 2,800 whom we took over from EDS, so we have basically augmented that number by a third. We have also brought in significant project management expertise.
We talked earlier about the nature of the work that we are doing, a very significant amount of which, now and going forward, is in project management. So, bringing great project management to the table is one of the things that Capgemini does, compared with some of the competition.

Q20 Helen Goodman: Mr Lamey, if the people working in the Revenue are good at commissioning and are intelligent customers, how come they underestimated so drastically the quantity of work in this project over such a very short period?
Mr Lamey: I think that this contract was originally looked at for reworking in about 1998, which was about six years before we let it. When I joined in October 2004, what was on the order books was a fairly modest amount of growth. You have to look at the reason for the growth in the light of components such as Lord Carter's review, which has added £350 million, and the departmental transformation that resulted from the comprehensive spending review 2007 period, which would not have been known back then.
The investments that we are making to produce the cost reductions and the performance increases that we have to introduce are probably quite substantial. Looking back, but not having been there at the time, I honestly do not think that it would have been reasonable to assume this £3 billion-plus increase, when most of that work has probably been generated within the past 12 months.

Q21 Helen Goodman: That is the point—the increase has happened very swiftly.
Mr Lamey: But at that time the Department had some 2,700 civil servants working in the IT organisation, doing a mixture of different work. The 1,700 to whom Paul referred earlier are now absolutely working on predicting the work ahead and governing the work that is in progress. That was not what the model of two or three years ago was doing, so we are in a much better place today to look forward and make predictions, and to control the work that is leading to the £6 billion-odd total investment pot.

Q22 Helen Goodman: Mr Gray, one reason that the project is now estimated to be much more expensive than it was three years ago is the bringing together of the two Revenue departments. Were Ministers told about the potential cost of bringing them together when they took that decision?
Mr Gray: Ministers were clearly aware that there would be additional cost pressures when the department was created, but by far the greatest part of the increase reflects decisions that have been taken since the merger about the appropriate work programme for the department. Ministers have taken a number of decisions and said that they wish us to deliver more than we were delivering before. One consequence of that is the figures to which you referred.

Q23 Helen Goodman: But is there not a difference between thinking that it is a good idea to join the departments at a cost of £50 million and then being told later that the cost will be X hundred million pounds more if they are to work together effectively? That is the point we are trying to get at.
Mr Gray: Yes, I understand the point. The numbers that you are talking about are controlled within the overall resources that the department is given, and those resources are being reduced during the current three-year period up to 2008. As you know from an earlier hearing, we now have a settlement up to 2011 that points to a further 5% a year real reduction in overall resources.
The amounts for IT procurement are part of the overall cost envelope, and this particular element of our costs is increasing because we are making major investments over this period, some of which involve important IT enablement—Steve referred to online services, for example—for a more efficient model going forward. The investment will generate cost reductions down the line.

Q24 Helen Goodman: Another thing that we discussed at an earlier hearing was the money that EDS will pay to the Government and the fact that it could not afford to pay it without winning further business. Having given the contract to Capgemini, where are you on recovering the money from EDS?
Mr Gray: At the HM Revenue and Customs Standard Report hearing in October, some of your colleagues asked questions about that. We indicated that a number of further quarterly payments had been made following the initial major payment under the contract.
What I indicated then, and think that I need to indicate today, is that the confidentiality undertakings that we gave in the agreement with EDS mean that I am constrained in public from giving the amounts that were received in the last quarterly payments. We owe the Committee a note—I apologise for you not having received it

yet—in which we will provide you with the numbers, privately and confidentially. I am sorry you did not receive it before today.
Helen Goodman: Thank you.

Q25 Mr Williams: Perhaps we can have five minutes at the end of the hearing in a closed meeting. If the information is available, we could get it then, rather than just a note.
Mr Gray: I can certainly give you some information.
Mr Williams: We will do that at the end, if that is acceptable.
Mr Gray: I would need to ask Mr Boulter and a number of others to leave for that occasion, as they are not covered by the confidentiality position.
Mr Williams: Of course, we understand.

Q26 Mr Bacon: I will come to the questions about the quarterly payments later, Mr Gray, although is it not true that some facts are in the public domain, including the total quantum?

Mr Gray: The total quantum is in the public domain.

Q27 Mr Bacon: It is £71 million.

Mr Gray: It is £71.25 million, and at the last hearing I put in the public domain the fact that £48 million had already been paid.

Q28 Mr Bacon: I remember that £44 million was paid up front, as part of the initial settlement. I suppose that the remainder is £26 million or £27 million.
Mr Gray: Sorry, I misquoted the figure of £48 million. There is £27 million to come.

Q29 Mr Bacon: And that is in quarterly payments.
Mr Gray: That is the provision of the agreement that is governed by the confidentiality arrangement.

Q30 Mr Bacon: Yes, but those were basically quarterly payments over a period—
Mr Gray: Over a three-year period. If they are insufficient to discharge the full payment of £71.25 million, as I explained at an earlier hearing, we have the right to pursue that money in other ways.

Q31 Mr Bacon: But the £27 million was the basic balance that had to be settled by the quarterly payments. Paragraph 11 states that the department "has yet to evaluate the new supplier's overall performance." How would you characterise Capgemini's performance overall? Are you happy with it?
Mr Gray: Yes, generally I am happy with it. I think that the transition between the old contract and this contract, which was always an extremely high-risk operation, was managed extremely successfully. As we have moved forward over the past two years, Capgemini's performance as our partner in the change programmes has worked out extremely well and now on our mission-critical projects its performance on delivery, time and price significantly exceeds the target that we set. Overall, I am happy. I am never a satisfied man—

Q32 Mr Bacon: Has Capgemini met 100% of its service level agreements?
Mr Gray: Not quite 100%.

Q33 Mr Bacon: Which ones has it not met?
Mr Gray: I might ask Steve to add to this in a minute. We have some 500 measures and in each quarter a handful of those have not been met.

Q34 Mr Bacon: Mr Lamey?
Mr Lamey: There were two specifics over the period. One was our IDMS—our integrated debt management system—which was very complicated. The other was a testing service that we provide for third-party agents. There are 38 that we regularly measure, and of those 34 exceed and four do not. The other two are in the customs world, so they are not necessarily as applicable yet. In general, I would support Paul—I think that they are doing an excellent job.

Q35 Mr Bacon: When you first took over, Mr Lamey, you made a speech at an IT conference in which you said that millions of letters were going astray. I see that you are smiling; I know that there was a frantic operation by the HMRC press office to say, "What Mr Lamey actually meant was—" and that there was a lot of backing and filling.
Mr Lamey: I think the statement stood, but you are right.

Q36 Mr Bacon: How many millions of letters do you think you are misdirecting?
Mr Lamey: Nowadays, much much fewer. When we had those numbers, we were getting accurate addresses for about 60%.

Q37 Mr Bacon: And inaccurate ones for 40%? So, of the £35 million that you spent on postal services in the 2005–06 Resource Accounts, you reckon that 40% was spent on postage to the wrong place?
Mr Lamey: That was the statement at the time, yes. We are now about—I cannot tell you an exact figure—96% accurate.

Q38 Mr Bacon: You did not get into trouble with your masters for telling the truth?
Mr Lamey: No. Allan Leighton at the Post Office was very worried, because if I had it right, spending on it would go down seriously—as it has. I notice that I have not received a Christmas card from him this year.

Q39 Mr Bacon: You could have been sent one, Mr Lamey; it just may not have arrived. *[Laughter.]* I want to move on the question of the rising costs. If there is any justification for such automation and expenditure on IT, surely one reason should be that it is not only more efficient and effective but more economical. It is supposed to save cost. In 1994, the EDS contract for the Revenue had a total value of

about £1 billion. You have added on to that this other contract, but we are now talking about £6 billion—except that we are not, because we know from your letter that it could be £8.5 billion. How is it that the costs are going up and up when IT is supposed to be saving us money?
Mr Lamey: I think that there are two parts to that equation. The business as a whole will be spending a huge amount of money on delivering paper processes that do not have the required level of automation. The challenges that have been given to the department mean that we need to be much more efficient in how we process information, and most of that improvement will come through the application of IT systems.
Two years ago, something like 80,000 employers submitted online; transactions for the other nearly 1 million employers involved going through bits of paper. The year after, 950,000 employers were submitting online, so there was a much smaller amount left. You will see an increase in IT costs, but you will see, as we have been tasked to do, a reduction in the overall cost of delivering HMRC. IT is an investment to enable us to reduce the overall running costs of HMRC.

Q40 Mr Bacon: I would like to pursue the subject of online services. You are receiving many complaints, are you not, from firms that are being pursued to make payment by the recovery office, which claims that they have not filed, although those clients have an electronic record—a receipt from you—that they have filed online. You have somehow lost the file. I have an e-mail which states, "it seems a little over the top that the first our clients or we should hear about it is from the recovery office." How many people do you estimate are filing online in that way whose online files are being lost, with the recovery office chasing them for payments and claiming that they have not filed?
Mr Lamey: I can answer part of the question. I know that we have 1,040,000 employers filing online. I am not aware of the defect numbers that you report.

Q41 Mr Bacon: Is it possible for you to send us a note about that? It is the case, is it not, that people are being pursued by the recovery office for not having filed who it turns out have filed and who have an electronic record of doing so?[3]
Mr Lamey: It is true that we pursue people who we believe have not filed.

Q42 Mr Bacon: But if it turns out that they have filed—I have another e-mail on the subject—the best solution when filing electronically is always to keep evidence to safeguard against HMRC alleging later that it has not received it and so making money from a penalty.
Mr Lamey: I assume that the incident to which that e-mail refers—

Q43 Mr Bacon: It is incidents in the plural. It is happening quite a lot, is it not?
Mr Lamey: It is happening on some occasions. I assume that the context is the delays we had in bringing to account the online filing of payments by employers in 2004–05. I am certainly aware that some demands have gone out when the payment has been registered, but I think that it is a rather small proportion of the total.

Q44 Mr Bacon: I return to the question of costs. In the 2005–06 Resource Accounts, the operating cost statement says that you spent £2.657 billion on staff costs and £1.815 billion on other administration costs. What has happened to those costs over the years? What does the trend line look like?
Mr Gray: If you go back to before the former Inland Revenue contracted out that part of its IS/IT services and its estate management costs, although I do not have the figures in my head, the internal staff proportion would have been significantly more because a lot of that cost was incurred in-house. As we go forward, now that we have major contracts for our estate management and for our IS/IT costs, I would expect, for the reasons that Steve gave, the level of staff costs to go down relative to the costs of procuring the contracts.

Q45 Mr Bacon: Under "Other administrative costs" is a line item for IT services and consumables, which is £495.5 million, and for consultancy, which is £63.5 million. Do the IT services and consumables include your payments to outsource contractors?
Mr Gray: Yes, it does.

Q46 Mr Bacon: It is possible that you could send us a note? I would like to see the trend over a good long period. Could you get someone to go back through it?[4]
Mr Gray: We could certainly do that, although we would need to be careful to ensure like for like.

Q47 Mr Bacon: I fully accept that, but, for that reason, could you go back say 15 years and explain the items for staff costs and other administration costs, with the breakdowns that have been given in the accounts each year, and, if necessary, explain any changes as you go along?
Mr Gray: We will certainly see whether we can do that on a consistent basis, but I am conscious we will have to go back to the accounts of the two former departments.

Q48 Mr Bacon: I understand that, too, but it might be helpful if you could do it on, as it were, an inconsistent basis and on a consistent basis and explain the difference. To see the difference with the raw data would be helpful.
Mr Gray: We will certainly do our best.

Q49 Mr Bacon: May I ask you to turn to page 25 of the Report? Figure 9 shows that "Total costs of transition" were £47.5 million, £2.4 million of which was for "Consultancy advice and support". If you turn back a few pages to page 20, you will see that

[3] Ev 20

[4] Ev 20–22

paragraph 1.19 says at the fourth bullet point, "The total cost of advisers during the procurement process was just over £9 million." What is the difference between the £9 million referred to on page 20 and the £2.4 million referred to in the chart on page 25?
Mr Gray: I think I am right in saying, off the top of my head, that the figures on page 24 in the table that you have referred to—

Q50 Mr Bacon: Page 25—figure 9, headed "Transition costs". The first item is "Unique Transition Costs".
Mr Gray: Yes, so it is the figure of £2.4 million. That relates to the transition period—that is, from EDS transferring the delivery of the contract to Capgemini and its partners. I think the figure you are referring to from a few pages before relates to the cost of consultancy through the whole process, which includes costs that were incurred for consultancy advice during the procurement process.

Q51 Mr Bacon: So that £9 million includes the £2.4 million?
Mr Gray: It probably does, but I need to check that.

Q52 Mr Bacon: Why did the Department not evaluate the consultants' performance and the quality of the advice?
Mr Gray: We have done a certain amount of evaluation. There was particular value in the project that was looked at—the construction industry scheme. We reflected carefully on whether it was sensible for us to spend significantly more money in commissioning somebody to evaluate something when our sense was that we had got pretty reasonable value out of that consultancy advice, so we have not incurred extra expenditure in doing a formal evaluation, but we are pretty satisfied that it was a good use of money.

Q53 Mr Bacon: May I ask you to turn over a couple of pages from figure 9 to figure 11? That chart shows another £14.9 million of costs, including £7.3 million of "Transition costs". I am not quite clear—perhaps the NAO can help—on whether that £7.3 million of transition costs is completely different from the £47.5 million of transition costs on the other page. I am referring to pages 27 and 25.
Jane Wheeler: If you look at the note to figure 9, you will see that included in the transition costs paid to Capgemini is £3.4 million, which related to NIRS2—National Insurance Recording System 2—and there is £3.4 million that is paid to Accenture as part of NIRS2, so the transition costs of £37.6 million at the top of figure 9 include something for NIRS2.

Q54 Mr Bacon: So the two £3.4 millions—Capgemini transition costs and Accenture's support costs—are the same money?
Jane Wheeler: They are part of the £37.6 million.

Q55 Mr Bacon: But the Capgemini costs for NIRS2—£7.6 million—are not. Is that right? This is in figure 11.
Jane Wheeler: That is right; that is separate.

Q56 Mr Bacon: So what were the total transition costs?
Jane Wheeler: The total transition costs, in terms of what was paid to Capgemini and Fujitsu, are the figures in figure 9, which relates to the £37.6 million.

Q57 Mr Bacon: Say that again.
Jane Wheeler: The transition costs in the first line of figure 9 are £37.6 million.

Q58 Mr Bacon: But figure 9 says that "Total costs of transition" were £47.5 million.
Jane Wheeler: That is right.

Q59 Mr Bacon: You just said that the two £3.4 millions are, as it were, double counted, but the other £7.6 million is not. I want to be clear: should I be adding the £14.9 million in figure 11 to the £47.5 million, or should I be adding part of it?
Jane Wheeler: I think you should be adding part of it.

Q60 Mr Bacon: How much? When it says at the bottom of figure 9 that the "total costs of transition" are £47.5 million, is that accurate or does that exclude the costs to the department?
Jane Wheeler: What we have tried to portray in figure 9 are the total costs of transition. We have tried to separate out what was transition on NIRS2 in figure 11, but part of the figures in figure 11—the £7.3 million contract costs for NIRS2—are about running NIRS2 during transition.

Q61 Mr Bacon: That is on top of the £47.5 million. So that we are not double counting, I would like to see in one chart the total transition costs—whatever they were for. Could we be sent a note along those lines?[5]
Jane Wheeler: Yes.

Q62 Mr Bacon: Finally, I would like to ask Mr Gray a question about secondment from HMRC to Capgemini, although this might be a question for Mr Boulter. Is it right that you have some civil servants seconded across?
Mr Boulter: We have one person, yes.

Q63 Mr Bacon: That is Mr Ian Pretty, is that right? Is it correct that he wrote the part of the contract that allows and encourages civil servants to "broaden their horizons by working for Capgemini"?

[5] Ev 22

Mr Boulter: I am not familiar with that quote.

Q64 Mr Bacon: Did he write that phrase?
Mr Boulter: I do not know.

Q65 Mr Bacon: My information is that he did. Would it surprise you that, if that is true, the author of that phrase then decided to, as it were, broaden his horizons by working for Capgemini? It is correct that he is working for Capgemini, is it not?
Mr Boulter: He is seconded to Capgemini, yes.

Q66 Mr Bacon: May we have a note confirming that that is the case and that he was the author of the contract, as well as outlining the terms of the secondment? Is he employed by Capgemini, or is he still employed as a civil servant?
Mr Boulter: He is still employed as a civil servant.

Q67 Mr Bacon: What is the purpose of having a civil servant working for Capgemini?
Mr Lamey: That is very interesting. He must be very good, because I was the one who suggested to Ian that he broaden his horizons and work elsewhere.

Q68 Mr Bacon: And he scribbled down what you said as is faithfully reflected in the contract?
Mr Lamey: No. I am referring to many years after the contract was signed. The purpose of any civil servant going out to work in industry—Ian had been in the civil service all his career and had been very successful—is to broaden their horizons over a two year period and to see how a private sector organisation works on a global basis. Ian has been learning an awful lot from the experience and we are expecting him back in the Department some time next year. His experience so far has been very good value for the Department. We will come back and answer on whether he wrote the quotation you gave from the contract.[6]

Q69 Mr Bacon: Is the assessment of his personal reporting targets done by Capgemini or HMRC? Who monitors it?
Mr Lamey: Capgemini sets him the challenge and obviously he and I review how well he is doing on a six-monthly basis. In fact, I met him just recently and we had an update. He is doing very well.

Q70 Mr Bacon: Many people leave the civil service and go and work in the private sector; indeed, some people leave the private sector and go and work in the civil service. Why could he not have just done that—others have done it?
Mr Lamey: I think that Ian has had a very successful career. He started as a tax officer and worked in IT. He has a lot of potential for us to leverage in HMRC.

Q71 Mr Bacon: Sorry, to leverage what?
Mr Lamey: To leverage in HMRC. I have 1,700 IT staff, who can benefit from the experience that Ian has gained during his time at Capgemini, and that will be very useful for us in going forward.

[6] Ev 22

Mr Gray: May I add, Mr Bacon, that I am keen to follow a mixed economy? Some people decide that it is the right thing for them and the organisation they work for to make a permanent move. I am generally very keen within the Department to encourage appropriate secondments from HMRC to external organisations, and externally into HMRC, as that is a good way of building and broadening experience. It is equally very important to me to ensure that that is done in an appropriate way that observes all the necessary formalities and proprieties. I am satisfied that that is what is happening in this case and in any others I authorise.

Q72 Mr Bacon: Your two predecessors were from the private sector, were they not? Sir David Varney and Sir Richard Broadbent, as I think he is now known.
Mr Gray: Sir David Varney was a predecessor in HMRC; Sir Richard Broadbent was, of course, just Customs and Excise.

Q73 Mr Bacon: Yes, one was Shell and the other was Schroders—I am not sure they intended to alliterate in that way when they successfully applied for their jobs.
Mr Gray: But they were both appointed following open and competitive processes overseen by the Civil Service Commissioners in accordance with the established procedures.

Q74 Dr Pugh: My first question is rhetorical. What I glean from the NAO Report is that you went for the higher bidder rather than the lower, that your spending could be £6 billion rather than £3.4 billion when the project is finished, and that you spent £47.5 million in transition costs and £7 million to £8 million in bidding costs alone. Company profit in the first year is £53 million, not £38 million. Your spend was £539 million, not £383 million. You do not have any estimate of the final costs, and there have been at least 15 systems failures so far. Is that a good deal? If so, what would a poor deal look like? If a local authority had a bid deal structured like that, the district auditor would be called in and the local press alerted.
Mr Gray: I am not sure that I accept that conclusion, although I recognise all the figures you quoted. The profit that was secured by Capgemini in the first year was below the target specified in the contract. As we sought to bring out in earlier comments, the issue is about assessing the value that the department is getting out of the expenditure, relative to the other options at our disposal, and I am satisfied that the arrangement offers good value for money.

Q75 Dr Pugh: Okay, let us go to one of the sources of the added transition costs. One problem that you have is the issue of intellectual property, which is highlighted in the Report. You do not have control over that and you wish to avoid being locked into large suppliers in future, and so to reduce your transition costs.

I understand all that, but would not a solution be for the Treasury to insist on a greater degree of intellectual property when it starts the deal—in other words, sharing the resource code and stuff like that—and so reduce the transition costs when it moves on?
Mr Gray: That is certainly an issue that I am happy to look at.

Q76 Dr Pugh: An open-source solution would suit you very well, would it not?
Mr Gray: It would, but we have built a very large number of aspects of transparency and openness into the contract. I am certainly happy to look at how we might be able to learn even more lessons for the future as we move forward, but I am happy about the overall arrangement on intellectual property.

Q77 Dr Pugh: What struck me was that there was a re-platforming job for the National Insurance Recording System, with new hardware, a new operating system, a new database—the lot. Was the cost about £29 million? Have I got that figure right?
Mr Gray: For the total cost incurred by the both the department and Capgemini, that is probably right. The total cost to the department was about £15 million[7].

Q78 Dr Pugh: What surprises me is that the project was such a radical reshaping, when clearly half or most of the work had been done and the system prior to that kind of worked as well. Was all the work entirely necessary?
Mr Gray: Yes, but I will let Steve add something in a moment. Yes, there was a NIRS2 system in place and yes, it did lots of things, but the replatforming has added major areas of additional functionality that were not there before.
Mr Lamey: The hardware and the operating system, which you quite rightly referred to, had not been upgraded for seven years.

Q79 Dr Pugh: So you might have replaced it anyway.
Mr Lamey: We would absolutely have had to replace it. There were 11 applications on it. Typically, the system would be set up seven years before that and just added to, without any of the hardware being changed. You should look at what the system was required to do and the fact that we had to add in 20,000 new users to it. The batch processes were taking so long because there were so many records on the old system, so we have reduced the number of batch times from 30% to 100%. During the day, we now do 1.7 million transactions, where we could do only 1.3 million on the previous system, and we have far more scope to go further, so the change was absolutely justified.

Q80 Dr Pugh: So it was not just replacement of like for like, simply because you had a different company?
Mr Lamey: No.

Q81 Dr Pugh: Okay. Under the Gershon savings—I think that Mr Bacon was trying to get at this—I would expect you to spend more on IT and possibly less on staff, but the staff whom you do not want to lose are obviously those with appreciable in-house IT expertise. Do you know what percentage of your staff at, say, the top five grades have appreciable IT expertise?
Mr Gray: I cannot give you a figure off the top of my head, I am afraid. Increasingly, it is a requirement for senior management people in the Department to be not IT experts, but IT literate.

Q82 Dr Pugh: It is useful for us to know that. I have asked the question of other Departments. I asked the Department for Work and Pensions how many staff it employs in the top five grades who have a graduate qualification or previous employment in IT, and it gave me a fair answer. The Home Office did not have an answer, but few of us would trust it on a trip to PC World. But you do have an answer.
Mr Gray: I do not have the answer with me, but I will ensure that you get it.[8]

Q83 Dr Pugh: You can provide the answer.
On previous contracts, one of the difficulties that you had was not so much with the contractor—say, for example, difficulties with EDS—but with some of the data entry, which was subcontracted as part of the contract or ancillary to it. It was very badly done, was it not? For example, data entry in respect of Tax Credits created part of the problem. Have you assessed how much outsourcing of data entry will or is likely to occur under your new arrangements?
Mr Gray: The great majority of our data entry is being done in the first instance by our own staff as information comes into the Department. As we move to more sophisticated systems and the online environment, a clear distinction between our staff and contracted staff as to who is doing the data entry will increasingly get a bit more artificial, as a lot of data are being entered directly.

Q84 Dr Pugh: But you are confident that the mistakes that were made in respect of Tax Credits will not be repeated in this case.
Mr Gray: That is certainly my firm intention.

Q85 Dr Pugh: EDS has been rather good to you, has it not? It paid for a £65 million pensions shortfall. Were you surprised by that?
Mr Gray: No, that issue emerged during the negotiations. It was discussed with EDS and an agreement was reached that it would meet that bill. I am slightly surprised by your comment about EDS being very good to us. That is not usually the line of questioning that I get.

Q86 Dr Pugh: It surprised me that EDS is helping out with the £65 million pension shortfall. I wondered why. Was it a *quid pro quo*?

[7] *Note by witness*: The total cost to HMRC to complete re-platforming was £14.9 million.

[8] Ev 22

Mr Gray: As Mr Boulter's evidence brought out earlier, we are talking about a TUPE arrangement—that is the jargon. Initially, the great majority of the staff were contracted out from the Inland Revenue to EDS.

Q87 Dr Pugh: But would EDS be legally obliged to pay the £65 million?
Mr Gray: I am not sure that it was absolutely legally obliged to do so, no.

Q88 Dr Pugh: Would you confirm that in a note? It is quite important to know that.
Mr Gray: I will confirm it.[9]

Q89 Dr Pugh: You could not realistically have given the work to EDS this time, could you? Not after the tax credit fiasco. It was difficult politically, and there were contractual reasons.
Mr Gray: In running the competition, we sought to come out with the appropriate value-for-money answer, and I think that we have done that.

Q90 Dr Pugh: So you are saying that there were no political considerations in the background.
This is my final question. One advantage of not going through EDS relates to the requirement to pay people for their preparatory costs. The sum for EDS was relatively small—millions, but still a relatively small sum—but it would have been some £33 million for Capgemini. Is that correct? Had it not got the contract, you would have paid it money that would have been dead money, in a sense.
Mr Gray: We would have had to pay that money if the decision had gone the other way.

Q91 Dr Pugh: But the sum was much smaller for EDS because of various matters of due diligence. The process was simpler for EDS, was it not?
Mr Gray: A decision was made that we should pay transitional costs to any new bidder coming into the equation, in order to encourage competition. Inevitably, that means that whether or not the new bidder is successful, a cost is incurred as part of the price of ensuring that there is effective competition.

Q92 Dr Pugh: That seems to be an odd feature. Had there been a third contractor in the frame, you would have had to pay it out as well as EDS, which was quite cheap to pay off in many respects. That would have added appreciably to the transition costs, would it not? It would have almost doubled them.
Mr Gray: That would have depended on the point at which the competition moved from multiple players to two. Basically, we are talking about a commitment to pay transition costs if the contract is being transited. It is not a commitment to paying transition costs to people who are unsuccessful and do not have to pay them. The commitment is to meet a certain proportion of the bidding costs involved.

[9] Ev 22

Q93 Dr Pugh: I think that you would accept that it is a less than ideal solution. In this case, you went for the higher bidder, but the one that you would have to pay the most to, because it would have been dead money had you not appointed them. That is not an ideal bidding situation. It is not one in which you would want to find yourself.
Mr Gray: I do not see how we can avoid that difficulty.

Q94 Dr Pugh: You cannot avoid it?
Mr Gray: In line with all past recommendations from this Committee and elsewhere it is important, if you have an incumbent bidder, to create the conditions for effective competition in order not to give the incumbent an unfair advantage. So that will be an inevitable consequence of the overall arrangements.

Q95 Dr Pugh: My final question is what would you do to ensure that that rather strange bidding environment does not exist next time round?
Mr Gray: We will seek to learn the lessons from this process.

Q96 Dr Pugh: What would you do?
Mr Gray: If we have an incumbent bidder as opposed to new competition, it would be appropriate to go through the same issues.

Q97 Dr Pugh: You will be staring at the same kind of numbers.
Mr Gray: As I said to the Chairman earlier, I am certainly open to learning that in the future we might seek to negotiate paying transition costs slightly differently from the way in which they are at the moment. However, I do not think that it would be possible to avoid paying any transitional costs.

Dr Pugh: You always pay transition costs: the question is whether they are £33 million or £66 million next time. They will certainly inflate.

Q98 Mr Davidson: May I clarify one point. Do the IT systems we are talking about have anything to do with tax credits?
Mr Gray: The tax credits operating system is one of those operated under the contract, yes.

Q99 Mr Davidson: Oh I see, right. The new contract that is now running is responsible for the mistakes in the tax credits that my constituents are receiving. Is that correct?
Mr Gray: All our major IT systems operate within this contract and, therefore, are covered by it.

Q100 Mr Davidson: I see, right. I thought—obviously erroneously—that the IT systems and the operator thereof were part of the difficulty with tax credits. I had assumed—obviously foolishly—that when it was transferred to a new supplier, the service would improve. Why has that not happened?
Mr Gray: I believe that the service has improved and over the past two years some of the major problems that were experienced on the introduction of the new

Tax Credits system in 2003–04 have been significantly improved. As we have discussed in previous hearings, that process is far from complete, but we and our supplier are on an improving trend in operating that very difficult system.

Q101 Mr Davidson: I still get constituents in tears about Tax Credits, so I am not entirely convinced that the system is improved. Will you clarify something? Presumably, the fact that I and many other Members of Parliament are still having substantial difficulties with the Tax Credits system means that the contract is not operating to the level that it ought to be. Are substantial penalties accruing to Capgemini as a result?
Mr Gray: There are performance standards in relation to that system, as there are in relation to others, that we expect Capgemini to meet. That is not the same as saying that no individual difficulties are being faced. As we have discussed in previous hearings, there clearly are still some difficulties that we are trying to handle.

Q102 Mr Davidson: I know that there are difficulties. I am seeking clarification. Ideally those difficulties would not exist, but since they do, something is obviously wrong somewhere in the system. Does that mean that penalties are accruing to Capgemini as a result of the fact that I and many other MPs continue to have difficulties with tax credits?
Mr Gray: At the moment, they are not, but we set service standards for the Tax Credits system, along with others. If those standards are not met, that will obviously be reflected.

Q103 Mr Davidson: Right. So at the moment Capgemini's contract allows for a certain level of mistakes and misery in the Tax Credits system, but over time that level will be reduced and if it is not penalties will accrue?
Mr Gray: It has been reducing. It needs to reduce further, but each year we will set the appropriate service standards to be met.

Q104 Mr Davidson: What level of mistakes and misery is acceptable at the moment before penalties fall on Capgemini?
Mr Gray: It is important to bear in mind that that some of the mistakes that happen in relation to individual tax credit recipients might reflect difficulties in the IT system and others might reflect difficulties arising from other players in the equation. Sadly, I am conscious that, on occasion, members of my staff might make mistakes.

Q105 Mr Davidson: I understand that, but with respect that was not quite the point that I raised. I am trying to get at the extent to which improvement is expected and what level of error in the IT system is currently considered acceptable for the contractor.
Mr Gray: With each of the system releases where we seek to improve functionality or add to it, we set expectations and parameters that we expect the contractor to meet.

Q106 Mr Davidson: That is right. I know that—you have explained that before. I am asking you to say what level of error is within an acceptable parameter before penalties accrue to Capgemini.
Mr Gray: I do not think that I can collapse that into a single figure or statement. If it would be helpful, I can certainly let you have a note.[10]

Q107 Mr Davidson: But you understand what I am driving at? I am no wiser.
Mr Gray: Yes, I do understand. I am sorry that I cannot boil down for you to a simple figure what is a complicated story.

Q108 Mr Davidson: It would be helpful if you could give us a note telling us what level of IT error is acceptable at the moment before penalties accrue and what the curve is in terms of driving that downwards—depending on which direction you look at the graph.
I am interested in the whole question of transfer. Do you think that any mistakes have been made or that there are lessons that we ought to be drawing for other cases? If we are letting substantial contracts, we clearly should consider how we have genuine competition. Yours seems to be one of the first and was well-handled, in general terms. Do you think that there were any omissions of which the Committee ought to be aware?[11]
Mr Gray: I do not think that there is anything in addition to what the NAO brought out in the Report. Part 4 talks about lessons learned, and I think that I am accurately reflecting its assessment when I say that by and large we have done a pretty good job of implementing the process and that we adopted previous lessons. I think that a number of the points that we have already touched on in the hearing are the areas where I would happily accept that there might be further learning that one might deal with through slight modifications.

Q109 Mr Davidson: Okay. Can I pick up three particular points? First is the issue of transition costs. I understand the argument for that but to what extent do you think that it is reasonable for the successful candidate to get a profit at 15.5% on the transition costs? Is that not just a bit greedy?
Mr Gray: That is one of the areas where it is appropriate to seek to draw lessons from our experience. We reached the judgment in negotiating the contract that in order to set the right incentive to manage the transition, where it was in our interests to ensure that Capgemini put its maximum efforts in, that a profit should be charged.

Q110 Mr Davidson: Does it not smack a bit of cost-plus?

[10] Ev 23
[11] Ev 23

Mr Gray: I would not put it like that, but I think that there is a lesson to be drawn, which I quite accept, about whether it will be appropriate in future to do that in precisely the same way as we did it. That is the issue that the NAO is raising, and it is an entirely reasonable lesson.

Q111 Mr Davidson: The next point I want to raise is about collaboration, as it were, from the loser, which is important. Are you satisfied that the loser behaved properly throughout the entire transition process?
Mr Gray: Yes I am. As you say, a successful transition required both parties to tango. Just as I am pleased about the way in which Capgemini took it on, I think that EDS behaved professionally on its side of the equation. We have had and no doubt will continue to have other conversations in which I might express a lower level of satisfaction with EDS's performance, but in respect of the basic transition of the contract, all parties performed well.

Q112 Mr Davidson: Okay. The third point is about the work force. Some of the people involved will originally have worked for the Government; they were transferred to one company and they are now being transferred to another; and if Capgemini loses the contract, they may be transferred again. Do you think that that has been handled as well as it might have been, or would you draw any human resources lessons that we ought to take account of in future?
Mr Gray: I think it has been handled pretty well. I would not point to any major failing or lessons to be drawn.

Q113 Mr Davidson: So the work force are happy? If I go and see them, they will be noticeable by the fact that they are skipping down the street? Indeed, as we speak, at twenty minutes to six, some of them will be halfway home by now. Right? Is that fair?
Mr Gray: Steve and David can add their comments on this, but my sense is that staff feel generally happy about the way in which the process has been handled.

Q114 Mr Davidson: Right. Presumably, they remain represented by the Public and Commercial Services (PCS) union. When was the last time you discussed this with PCS?
Mr Gray: I have regular discussions with PCS. I met its representatives only a couple of weeks ago, and on that occasion, we did not get into specific discussions about this. Since PCS usually brings its problems liberally to me, if it thought there were major issues, I would expect it to have put them on the table, but such issues were notable by their absence.

Q115 Mr Davidson: That is fine. That is very helpful.
Can I ask about one other issue to do with the nature of the contract? When I read through the document I was surprised at the number of third parties to which EDS had subcontracted. To what extent in the circumstances does a company such as Capgemini or EDS become a virtual company, in the sense that they just bid and badge, and the work is actually put out to everyone else? To what extent can anybody be held accountable for anything in those circumstances? People can say, "It wasnae me; it was him," and, "Oh, it wasnae him either; it was somebody else."
Mr Gray: I recognise that point, and there is an important balance to strike. We are extremely keen that Capgemini should bring in experts from other companies to deal with our world-scale problems. Given the size and sophistication of our requirements, it would be amazing if any one company could provide everything that we need. One good factor of the contract is the operation of a so-called ecosystem, under which Capgemini brings in other players, but it does not do so in a way that enables it to say, "Nothing to do with me, guv; it's down to somebody else." Frankly, we would not allow it to do so. We hold it responsible and accountable for delivering the overall service, and we ensure that the position is not such that Capgemini or anybody else in the supply chain can say, "It's nothing to do with me."

Q116 Mr Davidson: In terms of the Department as an intelligent customer, I take it that the phrase quoted earlier, "people should broaden their horizons and go and work elsewhere," is not quite the same as a Minister going "to spend more time with his family", but that it is a genuine effort to ensure that people are rotated. In terms of the sub-suppliers, the main supplier and the Government, do you intend to foster that process, or is the example that was quoted just a one-off?
Mr Gray: I would seek to foster it in appropriate circumstances. I do not think there is a general rule either in the case of a particular individual or in relation to general skill sets. I go back to some of the points raised by Helen Goodman. If we recognise in our current work force certain skills that we do not have that we think it would be appropriate to have as an intelligent customer, then we have a choice of ways to go about procuring them. We can go to the market and recruit people directly, but that is not always the easiest thing to do; we can bring in consultants or short-term contractors, but there are sensitivities around that; or we can look to identify people in our own staff who we think could have those skills developed, which we can do via outward secondments and other methods. At the moment, we are bringing in fixed-term appointees or interim managers, but we are deliberately seeking to put one of our own members of staff to work alongside them in order to develop their skills, so that in future we will be less reliant on outside support. As a general rule it is to be encouraged, but I do not think there is some formula to be followed.

Q117 Mr Davidson: I am interested in that response. One submission that I received from some members of the work force was that you were making undue use of consultants and that although you had some specialists within your service, they were being told that you did not intend to use them, but that you would buy in those talents. It seems to me that you

are going to have difficulty maintaining your position as an intelligent customer. If it is acceptable, I shall clarify that point and if necessary come back to you.
My final point arises from discussions that we had with the Ministry of Defence on other issues. What percentage of the top 100 or so people in your Department went to public schools? If you do not know, could you find out?
Mr Gray: I honestly do not know; and it is not a statistic that I regard as being a particularly important bit of management information.[12]

Q118 Mr Davidson: I must say that I do, in terms of whether you are an equal access, equal opportunity employer. I presume that you have statistics on gender, race, religion and the rest of it; we would be interested in seeing whether or not you have that information too.
Mr Gray: I will see whether we can collect the information. If it helps, I think that neither of the two civil servants here today went to public school.
Mr Davidson: That is interesting.
Mr Gray: And neither did the contractor.

Q119 Mr Davidson: That says something for you compared to the military, but we shall have to wait and see. If there is a suitable level taking in 40 to 100 people, will you draw the line and let us have it?
Mr Gray: I will let you have the data for our staff in the two senior civil service levels, if that will help. It will probably be about 50 or so.
Mr Davidson: That will be helpful. Thank you very much.

Q120 Helen Goodman: Mr Gray, the overall increase in the contract in the last two years was about £2.5 billion. What was the increase in 2005–06, and what will it be in 2006–07?
Mr Gray: The increase in the estimate? In those two years, we would have had a significant increase as a result of the integration of the Fujitsu contract.

Q121 Helen Goodman: Yes, but you wanted to strip that out. What would it be on the stripped out basis?
Mr Gray: I am not sure that I have that immediately to hand, but I can obviously let you have a year-by-year breakdown of when it occurred. I would think it was roughly equal across those two years. That would be my expectation, but I shall check the figures.

Q122 Helen Goodman: So it would be about £250 million?
Mr Gray: Yes.

Q123 Helen Goodman: Are you telling us that it was possible to accommodate the increases in that work within your cash limit, or departmental expenditure limit?
Mr Gray: That is what I was seeking to say earlier. This is not a special category of expenditure that gives me a free ride. It has to be accommodated within my overall spending settlement, which is going not up, but down.

Q124 Helen Goodman: And you did not have recourse to the contingency reserve?
Mr Gray: No. We have access during the next three years to a modernisation fund within our settlement for that period—

Q125 Helen Goodman: That is within your internal settlement. You do not have to go back to the Treasury?
Mr Gray: Well, in the jargon it has a dual key—I am not allowed to spend that part of my budget without getting approval from the Treasury. But you and I, as former Treasury colleagues, will recognise how the Treasury does these things.

Q126 Mr Williams: Paragraph 3.11 says: "The Department is seeking to reduce the ratio of its own information management staff compared to the supplier team from 30:70". That is, 30 of yours to 70 of theirs, which is a ratio of virtually one to two. Why does it take one person in your management team to manage two people in a contractor's team, and how long will that last?
Mr Gray: What we are seeking to get to is 20:80, as I was saying earlier, and we have almost got to that figure. This is about not just managing the work, but, as Steve was explaining, the appropriate roles of staff within the Department and outside it. Steve, do you want to add anything about the key roles that the in-house staff are providing?
Mr Lamey: Yes, sure. The 20:80 ratio is fairly well established industry best practice in spaces of this sort. At the current rate, we will end up with about 1,500 civil servants to about 6,500 contractors. Those civil servants are not directly managing all 6,500 contractors. With the civil servants, we will have business solutions engagements—working with the business to identify business process opportunities.
A lot of the benefits that are going to come out of the IT work over the next couple of years to benefit the business will come through those routes. We have solutions architects who are mapping the future architecture and the technologies that we require, as well as ensuring that we get the best value for those. We have contract people who are managing the contract—it is a very big, complex contract, as I am sure you have become aware—and we have staff ensuring that we get value for money on that. We have a finance team, because we are spending a lot of money. My overall budget every year is obviously hundreds of millions of pounds, and I need to ensure that it is spent in all the right ways, so I have staff managing that.
In all, we have 1,500 civil servants, 800 of whom—to return to what one of the other Members of the Committee mentioned earlier—are subject matter experts and managing all the programmes and activities that Capgemini currently undertakes.

[12] Ev 23

They are crucial, because they are our experts. They are the people who know how the molecule of a tax receipt flows through our internal systems. It is absolutely vital to retain that as one of the key civil servant roles.

A lot of the roles that we keep internally are for subject matter experts, and they are managing the activities of our partners, as I think you would expect me to ensure. That is why the organisation model is changing quite seriously from very much doing a bit all together to very much saying, "That's our role as intelligent buyers." We expect those concerned to perform intelligent supplier roles, and that is the model that we have been working to build. I think that 1,500 staff is where I am targeted to get the right balance for my organisation, and I think that it is currently about 6,500 on the supply side.

Q127 Mr Williams: Mr Gray, when you were dealing with NIRS2, you spent £14.9 million on transition costs and another £14 million for the right to use it. That is £28.9 million, when a previous supplier is still running NIRS2. What value did you get? Did you get £28.9 million value out of that?

Mr Gray: I am not sure that I recognise those figures. The total that we spent was the £14.9 million. I think that some of the other costs to which you are referring were probably incurred by Capgemini.

Q128 Mr Williams: Does the C&AG have a comment on this?

Jane Wheeler: Yes. There were costs of transition, but there were also costs associated with acquiring intellectual property rights, so those were the two elements.

Q129 Mr Williams: They say that they do not recognise the figures, but the figures in our briefing are quite specific.

Mr Lamey: The £14.9 million is the transition cost, as was mentioned. There was an earlier payment of £14 million, which gave us the intellectual property rights to, as such, use the work that Accenture had done back in the '80s at some point, which created the National Insurance system in the first place. I am not sure exactly what the timing was, but note 2 on page 5 refers to that £14 million. I think that is accurate.

Q130 Mr Bacon: That is separate from the £14.9 million, is it not?

Mr Lamey: I believe so, yes.

Q131 Mr Bacon: Making the figure £28.9 million, which is the figure given by Mr Williams.

Mr Gray: I apologise. We do recognise those figures. My memory failed to spot them.

Mr Lamey: May I help with the second part of the question, which is about whether we got value? The National Insurance system is absolutely huge; it is probably the largest computer system in the UK and in Europe. Let us consider the scale of what it does. Every day, 60,000 to 70,000 civil servants use that system across the DWP and HMRC, and local authorities are starting to use it now, too. It does a massive number of transactions. There are 70 million records on the system and it has to be available, as it is, 99.9% of the time.

I do not know what the value for money judgment is, because this system is outside most of the leagues for what a big system does, but it is a hugely important system to the tax and the benefits systems of the UK. Making it available every day for those 60,000 to 70,000 staff and protecting the records of 70 million people, whose pensions will rely on much of the source information that comes out of the national insurance system, makes it a very good investment.

I cannot comment on whether the £14 million figure was right, because I was not there at the time, but I think the transition charges, which I have been through, and the transition process should be seen as one of the biggest successes that we have had so far in IT. It was a huge programme and very successfully implemented by all the people involved at the time, even though it seemed to take slightly longer. That helped to make it an even bigger success.

We do not talk about great IT successes, especially in HMRC, but we do have them, and this is one. It went live with better than 6-Sigma accuracy rates, which is astounding, so I think it is a success and the money was well spent, although I could not justify where the £14 million came from.

Q132 Mr Williams: Again to Mr Gray, your Department, like others, faces a 5% real cut over the three years coming up. How difficult will it be for you to control your costs in such a growth situation when your department faces cuts?

Mr Gray: I would say that is challenging but manageable. Part of the reason, as I sought to explain earlier, for us consciously increasing the planned investment spending on new systems, including new IT support, is to support us in building more efficient systems in future where we are able to reduce our other costs.

We are drawing up a detailed plan as to how we will deliver the overall spending allocations that we have been given, together with the things we are expected to provide. That is challenging, but I am confident that we are capable, first, of putting a plan in place to do that and, secondly, of delivering it.

Q133 Mr Williams: In what sort of time scale would you hope to devise that plan?

Mr Gray: Different years of the period are at different stages. We are finalising our detailed budgets for the year ahead for all the major investment programmes. We are going through an intensive process of challenging the propositions that have been put forward to my top team in the department. We are looking, early in 2007, to draw up more detailed business cases for all those investment programmes to see whether, first, we can finance all that investment and, secondly, on robust assessment, they look likely to deliver the benefits downstream over the following three or four years of the period. I think that, by next spring, we will be in a firmer position than we are now to say that we have a robust plan in place.

Q134 Mr Williams: Thank you. That almost ends our deliberations. I thank the three of you, because this has been a very detailed and intricate exchange, and it has been very informative. It will take a lot of absorbing and analysing when we look at the record. Having thanked your colleague, Mr Gray, we now need to go into private session. Is Mr Lamey staying for the private session?
Mr Gray: Yes. May I make one request if you wish to go into private session? May I be joined as a witness by my Finance Director?

Q135 Mr Williams: Of course. Would it be helpful for anyone else to be present?
Mr Gray: It would be appropriate for David to leave because he is not covered by this arrangement, but if Stephen Jones, my Finance Director, could join me, that would be helpful.

Mr Williams: That is great—no problem whatever. I would be grateful if everyone else left now. Thank you for joining us.

On resuming, in private—

Q136 Mr Williams: We do not mind who answers the question. It is information that we want. This is a closed session, but I have to warn you that a closed session with us means that we reserve the right to use information in our public Report if it appears necessary to do so. However, we always try to observe confidentiality.
Mr Gray: I understand that, Mr Williams. I have to repeat that I have signed up to a confidentiality provision and that that is the basis on which I am operating, but I understand your point.
Mr Williams: I am grateful for that. Helen, do you want to start?

Q137 Helen Goodman: The question was: how will you get the money out of EDS now that it is not doing the work for you?
Mr Gray: The agreement that we reached with EDS had a provision, which I believe was discussed in an earlier hearing, whereby after the immediate payments that Mr Bacon spoke about earlier were made—he gave the correct figure of £44 million in up-front payments—we would aim for the remaining £27 million or so to come out of payments by EDS to us financed by additional contracts that EDS gets with other parts of the Government. That would be the first source, but we were very careful in the agreement that we drew up fully to retain our right, if sufficient money were not forthcoming from such contracts, to take appropriate legal action to secure the remainder of the £71.25 million. We entered into a belt-and-braces arrangement, if you like.
At an earlier stage, the Committee was a little critical of us for having entered into an arrangement that might be seen to provide an incentive to other Government Departments in respect of the letting of their contracts. I am clear that that is not the case simply because we have a braces arrangement as well as a belt. I can assure the Committee that neither I nor David Varney, my predecessor, have had, nor do I intend to have, any discussion with any other permanent secretary about the process under which they may be letting new contracts for which EDS is a bidder. I do not wish to know about that; it would clearly not be appropriate for me to be part of that. I know that I have a fallback arrangement to secure the money if I need it.

Q138 Mr Williams: Is there anything the Treasury or the Comptroller and Auditor General would like to ask in this context?
Sir John Bourn: No.
Ms Diggle: No.
Mr Bacon: Mr Jones said on 23 October that you had received two quarterly payments so far. If you have been paid £44 million out of the £71.25 million that leaves £27.25 million, which was to be paid over three years.
Mr Gray: The aim was to do it over three years.

Q139 Mr Bacon: Can I take it that £27.25 million divided by 12 gives the size of each quarterly payment?
Mr Gray: No, it does not because it was not an agreement that EDS would pay us that amount each quarter. The agreement was that it would pay us a specified percentage of the value of any new Government business that it obtained, which as I recall was ****. So, the rate of the cash flow that we get depends entirely on the value of any new business acquired by EDS.

Q140 Mr Bacon: Right. How much are the two quarterly payments you have had so far?
Mr Gray: They were relatively small. The first quarterly payment was £******.
Mr Bacon: And the second one?
Mr Gray: The second was £*******.

Q141 Mr Bacon: Mr Jones said you were negotiating the third quarterly payment. That was on 23 October. Is the negotiation now complete on that?
Mr Gray: Stephen, is that complete or is it still in process?
Mr Jones: No, it is not complete. We are still in the process of discussion.

Q142 Mr Bacon: Do you know roughly what it is going to be?
Mr Jones: EDS has suggested to us that the correct quantum is £******.

Q143 Mr Bacon: So if you take £***** million and subtract £****** and £*******, and then subtract £******—
Mr Gray: I think, to save you the trouble, that you are still left with a large amount.

Q144 Mr Bacon: Exactly. You are still left with more than £27 million. Have you worked out—I am happy to do it—by which year of which century if payments continue at that rate, you will have finally got the money.

Mr Gray: That is why, Mr Bacon, I said that I can save you the trouble of using your calculator.

Q145 Mr Bacon: I gave a spreadsheet with some sums worked out on it to the Chief Executive of the National Health Service, but unfortunately I do not have time now to nip back to my office to work this out. But, basically, the payments are not making a lot of difference.
Mr Gray: I do not accept the premise of your question, which is how many years will it take us to recover the sum. We have an agreement under which the aim would be to secure it in three years. If we do not secure it in three years, we will obviously need to have recourse to our fallback option.

Q146 Mr Bacon: Is it not the point that £27.25 million divided by 12 gives a payment of just over £2,270,000 per quarter?
Mr Gray: On a *pro rata* basis.

Q147 Mr Bacon: Well, £2,270,000 per quarter does not sound like the sort of sum of money that it would be impossible for a firm such as EDS to find. It could probably do so relatively easily. Would it not actually be in your interest if this were all in the public domain from the point of view of EDS feeling the pressure to get on with paying you what it owes you? After all, you originally asked for £209 million and you settled for £71.25 million, but so far it is still £27 million short of the much lower figure which you and the company settled for.
Mr Gray: We entered into an agreement, which I think was an extremely good agreement from the Exchequer's point of view. That included the provision of aiming to collect the money in the way I have described over three years. If, as we get deeper into the three-year period, things are looking no better than they do at the moment, I will take action. Within the first year of the agreement I do not think it would be appropriate for me to take precipitate action, but I can assure you that in the light of the figures for the first two quarters and taking into account the prospective figure for the third quarter, we are engaging in serious conversations with the company about what is going on.

Q148 Mr Bacon: Because this is taking the Michael, is it not?
Mr Gray: It is not taking the Michael in terms of the specification of the arrangement.

Q149 Mr Bacon: You mean that this is an accurate reflection of how much business EDS has won from Government Departments?
Mr Gray: That is why we are going through the process of making sure that we validate the figures. Obviously, we wish to do that.

Q150 Mr Bacon: Every time EDS walks in, someone says, "Your reputation precedes you," do they?
Mr Gray: The key point that I want to emphasise is that we have the alternative option, and I will not hesitate to use it. It would be precipitate for me to trigger my second course of action now, but I am triggering serious conversations with the company about what is happening and what is in prospect.

Q151 Mr Williams: Thank you. This is our last sitting before the recess, so I wish the visiting team, the NAO team and our colleague from the Treasury a very happy Christmas and new year. We look forward to seeing you again early next year.
Mr Gray: Are we allowed to reciprocate, Mr Williams, and wish the Committee a very happy Christmas? I think that we will meet again in January.

Q152 Mr Williams: I should add that Chris Randall our Committee Assistant is leaving us after all this time. She has got tired of monoglot interrogation and is going into a bilingual field with the Select Committee on Welsh Affairs. She is abandoning us for areas Celtic, but we wish her well.

Memorandum submitted by HM Revenue and Customs

We thought it would be helpful to provide the Committee with an update on some of the key facts and figures, and a note on some key developments since the Report was published in July, in advance of the Hearing on 18 December.

Contract Costs

Overall

The contract was originally valued at between £3 billion and £4 billion over its 10 year lifespan. Our highest assessment now is that the contract will cost about £8.5 billion over its lifetime.

Excluding inflation, so making the comparison at base prices, the cost is about £8 billion.

Stripping out assumed reductions from our Enterprise Infrastructure Foundation programme and assumed changes driven by HMRC staff reductions, the cost becomes about £7.5 billion.

And with the impact of ISA removed the current estimate is about £6.6 billion. [The services previously provided to HM Customs and Excise by Fujitsu under the ISA agreement have been accommodated within ASPIRE at an overall additional cost to the Aspire contract of around £900 million.]

The increase in value is mainly because of the merger of the departments and a reflection of the work that will be needed to deliver HMRC's Departmental Transformation Programme.

Annual

The spending on ASPIRE in the second year of the contract [July 2005 to June 2006] was £767 million. [NAO reported our then estimate of £800 million.]

This is broken down to spending under these main headings:

Contract Expenditure	*Actuals Year 2*
Operational Service Charges	£374 million
Service Credits	(£1.2 million)
Business Application Development and Enhancements	£243 million
Integration	£12 million
Desktop Applications	£10 million
Rate Based Services	£129 million
Total	**£767 million**

We estimate the spend in the current, third, year of the contract [July 2006 to June 2007] to be £840 million.

The increase in spending for Years 2 and 3 of the contract, compared with the spend in Year 1, is because there is a continuing high demand for IT services, and by two new initiatives in particular: STRIDE, a project to introduce a common desktop environment to support the integration of HMRC's two former departments; and the development and implementation of a major new Enterprise Resource Planning system for our internal HR and finance processes. Also, the merger of the two main IT contracts [Aspire with ISA] has added to the spend on the ASPIRE contract.

Profits

The final ASPIRE profit figure for the first year of the contract [July 2004 to June 2005] was £52.8 million, marginally lower than predicted [noted provisionally at £53.9 million in the NAO Report]. At around 10% this is lower than the target profit margin of 13%.

The current forecast for Year 2 profit is around £90 million and a margin of around 13%. This remains below the target margin for Year 2 (over 14%). The Year 2 figures are under review.

As a result, there has been no profit share so far as ASPIRE has not made its target profit margin.

Performance

Overall

ASPIRE performance has been good. For example, the bulk of our mission critical IT services are achieving availability results in excess of their targets. And while we are delivering added functionality in software releases, the quality of those releases is improving. We are also seeing an increasing trend in the delivery of projects on time, with close to 90% now doing that, well in excess of our target of 75%.

Performance Indicators

We use over 500 performance measures to monitor the Aspire contract; some 200 are key performance indicators (KPIs) and carry service credits for underperformance.

As both a percentage of the total measures and an absolute number, the trend for failures is falling.

PERFORMANCE INDICATORS

	Total Measures	*Measures Failed*	*Measures Failed as a %*
Apr 2006	531	9	1.7
May 2006	533	13	2.4
Jun 2006	534	24	4.5
Jul 2006	542	17	3.1
Aug 2006	537	12	2.2
Sep 2006	540	10	1.9

The table below shows performance against the KPIs since Q1 2006, which was the latest figure included in the NAO Report.

KEY PERFORMANCE INDICATORS

	Total KPIs	*KPIs Failed*	*Measures Failed as a %*
Q2 2006	205	5	2.4
Q3 2006	210	9	4.3

Note: The Quarters are for calendar not financial years.

The figure for Q3 2006 reflects one incident which impacted a number of major services and caused all nine of the KPI failures.

Service credits

The NAO Report noted that ASPIRE had paid HMRC £2.67 million in service credits for failure against KPIs in the first year of the contract.

In Year 2, a further £1.2 million service credits were received.

In Year 3, there have been £0.3 million service credits received to end October 2006.

The failures occurred due to low-level technology problems and did not result in major business disruptions. The problems were primarily concerned with loss of availability of Departmental systems to HMRC staff.

OGC Gateway

The NAO Report [3.17] referred to an OGC Gateway 5 review of Aspire in May 2006, to evaluate whether ASPIRE is delivering the benefits identified in the original business case and how well the contract is responding to changing circumstances. This was an Amber report. We are taking action on its recommendations.

Paul Gray

12 December 2006

Memorandum submitted by Xansa

XANSA BRIEFING PAPER FOR THE PUBLIC ACCOUNTS SELECT COMMITTEE

Xansa welcomes the Public Accounts Select Committee's scrutiny of the ASPIRE IT outsourcing procurement process and thanks Paul Gray, Acting Chair of HM Revenue and Customs for what we are sure will be a fair appraisal of this issue. Xansa would like to take this opportunity to offer its own appraisal and its own suggestions of the lessons that can be learned in the aftermath of its award and negotiation.

About Xansa

Xansa is a UK-based outsourcing and technology company with over 8,000 people in the UK and India.

With a 44-year history of sustaining long-term relationships and pioneering better ways of working, Xansa drives real and long-term cost reductions and performance improvements. Committed to delivering guaranteed business outcomes through a combination of technology and process expertise, Xansa gives clients across the private and public sectors the freedom to do more.

Xansa has a long-standing success record of working with the public sector including:

— NHS Shared Business Services—Our 50:50 joint venture with the Department for Health, the first of its kind is freeing up £244 million for frontline care—enough to pay the annual salary of 12,000 extra nurses.

— Financial Services Authority—Our partnership will enable the FSA to deliver a large portfolio of business applications more effectively and companies regulated by the FSA will benefit from greater simplicity when submitting compliance-related information.

— The Club—Xansa has launched and will manage a single internet platform for three government departments known collectively as "The Club" (Directgov, the Department of Health and the Department for Education and Skills). This platform pre-empts one of the key recommendations in the Varney Review—that Directgov acts as the online portal for all frontline public services.

Other Public Sector clients include: Department for Work and Pensions; The Office for National Statistics; Department for Communities and Local Government (formerly ODPM); Learning and Skills Council; Rural Payments Agency; Solihull Metropolitan Borough Council; HM Revenue and Customs (formerly HM Customs and Excise).

Recommendations

Xansa is keen to operate in a healthy and vibrant market sector where innovation and competition are encouraged. We retain concerns about potentially detrimental precedents that the size of the contract and the size of HMRC may have on future tendered contracts. Xansa has been monitoring the HMRC contract with Capgemini and the purpose of this briefing paper is to outline some key concerns that may lead to future suboptimal procurements within the Public Sector. These concerns are outlined below:

1. *Post Contract Negotiation*

Xansa is concerned to learn that the negotiations Capgemini and HMRC undertook on transition costs were not able to benefit from competition, and took place post-contract. The recommended practice is to undertake due diligence and transition planning, including costings, as a workstream within the wider contract—when potential exit prejudices are minimal. Xansa agrees with NAO concerns that Intellectual Property Rights were lost as EDS (the previous contract incumbent) exited the contract. It is possible, through the specification of Referenced Documents within the contract, to reduce the risk of this at exit.

Xansa recommends that the Select Committee encourages future procurement contracts to incorporate detailed provisions for exit/transition planning including due diligence and IPR retention, at the start of the contract.

2. *Contract Governance*

In relation to all previous ICT contract standards, the value of this particular contract (£6 billion over 10 years with extension opportunities for up to a further eight years) and the resource magnitude (involving an employee population of 2,000) is both huge and unprecedented. There is a considerable risk of any contract or operation of this size being or becoming unmanageable. There is a trend in Government ICT contracting to under specify and under resource the retained function resulting in the loss of focus on managing a supplier. Xansa firmly believes an ICT outsourcing contract should be forward looking in order to ensure that:

- technology can be applied to business processes in order to deliver efficiency and effectiveness improvements; and
- services will deliver required future business outcomes set by the Treasury.

Xansa recommends that governance of the Capgemini contract is strategic and focused on business outcomes in order to ensure the paid-for services are delivered. We would also recommend that these perspectives are included in any on-going OGC advice and guidance to the wider public sector.

3. *Outcomes*

The NAO Report only contained limited reference to outcomes as a driving force for the contract (three times) and there is no discussion as to how these outcomes are identified, what they are and how they relate to HM Treasury objectives. This is a significant disappointment as output based specifications are a normal procurement approach to specifying systems and solutions. Third generation outsourcing best-practise advocates greater use of Balanced Scorecards to specify the business objectives of a contract and then link this to remuneration arrangements.

Xansa would encourage the Select Committee to promote the use of outcome-based outsourcing and procurement approaches that will enable a step change in people orientated services.

4. *Value for Money*

Whilst it is likely that a contract of this nature will be value for money at the Day One mark (with the procurement process being designed to demonstrated this), we do not believe that it is guaranteed that such value for money will be preserved over the course of the contract, given its size and duration. Benchmarking, open book accounting and profit share are useful tools but are only effective at a level of granularity that is quite tactical, ie the cost of a body, the price of a function point, the cost of a raw PC. Value for money comes from how these components are put together to produce ICT solutions that work. This means internal contract practices and procedures have to be effective and efficient.

We believe, and have evidence that, true value for money comes from organisations that are not so large they are internally inefficient and not so small economies of scale are not achieved.

Xansa recommends that the Select Committee needs to be satisfied that Capgemini internal practices and procedures, and the way these interact with those of the retained HMRC function, are efficient.

Although the NAO report does indicate the initial sourcing options did include multi-sourcing, the HMRC cannot be sure it is securing value for money without competition. Xansa advocates that the single partnership sourcing model of this size cannot secure value for money and does in fact distort the market, stifle innovation and can increase complacency.

Going forward the Select Committee should ensure that large service contracts are not the norm and should encourage more agile forms of contracting to ensure competition, a healthy market and value for money after Day One.

Supplementary memorandum submitted by HM Revenue and Customs

Questions 41 and 42 (Mr Richard Bacon): *Electronic filing*

Richard Bacon asked how many employers are filing online whose returns are then lost and as a consequence are chased by the Recovery Office.

HMRC is not aware of any returns being lost. HMRC thoroughly check each case individually before contacting employers about outstanding returns. A very small proportion of employers whom HMRC contacted told us that they had filed their return when this was not apparent from our records. In these cases we asked for copy of the acknowledgment e-mail that is automatically issued when the return is filed online so that we could investigate the matter. When we did further checks we found that the returns in question had been received, but because of errors in their completion, they could not be processed correctly.

Question 46 (Mr Richard Bacon): *Operating Costs*

Richard Bacon stated that in the most recent Resource Accounts, £2.675 billion is shown as a staff cost and £1.815 billion is shown as being spent on other administrative costs (including £499.5 million on IT and £63 million on consultants). Mr Bacon asked for a note going back 15 years showing the trend for those two figures comparing like for like and using the breakdown given in the Resource Accounts.

What follows shows the consolidated figures for the former Inland Revenue and Customs and Excise Departments from 1998–99 and HMRC from 2004–05. The notes at the beginning of the document provide an explanation of significant events that have impacted on the various costs involved.

Analysis of Staff Costs and Other Administrative Costs

Background

The first resource accounts published in 1999–2000 provided detailed reporting of expenditure on a consistent basis. Prior to this the only requirement was to publish the cash based Appropriation Accounts which reported the high level total figures of running cost and capital expenditure.

During the period 1993–94 to 1998–99 the Inland Revenue published Financial Statements within the Board's Annual Report that provided greater analysis of expenditure, but HM Customs and Excise did not make a similar publication. As a result it is not possible to compile detailed analysis representing HMRC, from published accounts, prior to the Resource Accounts. The Inland Revenue information for this period has not been included in this paper as it is only reports on part of the new Department.

As the first Resource Accounts for 1999–2000 contained un-audited comparable figures for 1998–99, it has been possible to include this year also. As a result, the figures reported in this paper provide information for the past eight years.

Explanatory Notes

1. The figures for 2004–05 are as published in the 2005–06 HMRC Resource Account, being re-stated to reflect the merger of the two old Departments and the transfer out of the Revenue and Customs Prosecution Office which had effect from 1 April 2005.

2. All figures for 1999–2000 to 2003–04 are a simple aggregation of the separate HM Customs and Excise and Inland Revenue published accounts.

3. In April 1999 the Contributions Agency transferred into the Department followed by the Tax Credit Office in October 1999. The 1998–99 figures reflect this merger as they were prepared as comparable to the 1999–2000 position.

4. April 2000—PFI contract with Fujitsu to provide IT services for HM Customs and Excise caused the increase in PFI Off balance sheet contracts to £60.0 million reported in the 2000–01 account, from a previous £8.5 million. The increases of £21.7 million in 2003–04 and £23.6 million in 2004–05 also primarily arose from commitments under this IT service contract.

5. April 2001—PFI contract involving the sale of property assets to Mapeley and the provision of serviced accommodation. This caused the reduction in rentals in other operating leases reported in the 2001–02 account to £35.9 million from £126.8 million and an increase in PFI Off balance sheet contract charges to £342.1 million from £60.0 million. The additional expenditure reflects the change to occupation of leased property rather than freehold ownership.

6. Expenditure for this category was not reported separately in previous financial years and was included in the heading of "Other miscellaneous expenditure".

7. April 2003—Child Benefit services transferred into the Department. This transfer of function required the 2002–03 account figures to be restated reflecting all the staff and other costs relevant to this service.

8. During 2002–03 the Department exercised its rights under the contract with EDS to buy out future obligations under a finance purchase arrangement for IT hardware; this caused the finance lease payments to fall from £9.1 million in 2001–02 to £0.2 million in 2002–03 and the payment of discount on asset purchases to cease.

9. In 2003–04 a significant write down of value of assets was necessary in accordance with Modified Historic Cost Accounting requirements. The majority of the £98.2 million loss related to IT hardware where the Office for National Statistics reported a large reduction in the index applicable to IT hardware. They reviewed this index during 2003–04 and rebased the index producing significantly different values. As a result the overall revaluation of assets made in 2003–04 saw the loss being reversed by £30.2 million.

10. April 2004—The transfer of Tax Policy to HM Treasury: although small, the effect can be seen from the re-statement of 2003–04 compared to the original publication.

11. (not referenced in the annex) July 2004—The Inland Revenue IT service contract with EDS finished and following a tender process was transferred to a new partner, Capgemini.

12. 2005–06—The £8.1 million reduction in "Other operating lease charges" primarily results from a reduction in accommodation rental charges paid outside of the estates contract with Mapeley.

13. 2005–06—The increase of £10.1 million in interest charges arising from on-balance sheet PFI contracts and £2.8 million in service element on balance sheet contracts reflect the full annual impact of the 100 Parliament Street refurbishment.

CONSOLIDATED EX IR/EX CE AND HMRC FIGURES

	1998–99	*1999–2000*[3]	*2000–01*	*2001–02*	*2002–03*[7]	*2003–04*[7]	*2004–05*[10]	*2005–06*
Staff Costs								
Wages and salaries	1,599.9	1,666.6	1,733.4	1,820.5	1,964.5	2,123.3	2,221.3	2,240.1
Social Security costs	118.3	117.5	121.8	123.5	125.3	152.1	159.1	165.2
Other pension costs	205.4	227.4	242.8	244.8	257.9	277.7	295.6	399.7
Early retirement								
Total staff costs	1,923.6	2,011.5	2,098.0	2,188.8	2,347.7	2,553.1	2,676.0	2,805.0
Other administrative costs								
Rentals under operating leases								
Hire of plant and machinery	4.4	4.6	4.3	4.4	4.0	4.2	3.7	3.0
Other operating leases	118.7	126.3	126.8	35.9[5]	12.3	25.9	22.6	14.5[12]
Total operating leases	123.1	130.9	131.1	40.3	16.3	30.1	26.3	17.5
Interest charges								
Finance leases	11.1	9.7	8.9	9.1	0.2[8]	0.0	0.0	0.0
On-balance sheet PFI contracts	0.0	0.0	0.0	0.0	0.0	0.0	3.1	13.2[13]
Total interest charges	11.1	9.7	8.9	9.1	0.2	0.0	3.1	13.2
PFI service charges								
Off balance sheet contracts	8.3	8.5	60.0[4]	342.1[5]	352.0	373.7[4]	397.3[4]	408.5
Service element on balance sheet contracts	0.0	0.0	0.0	0.0	0.0	0.0	1.0	3.8[13]
Indexation of PFI liability	0.0	0.0	0.0	0.0	0.0	0.0	3.0	4.9
Total PFI charges	8.3	8.5	60.0	342.1	352.0	373.7	401.3	417.2
Non cash items								
Depreciation of fixed assets	148.2	149.3	160.4	156.3	132.4	172.7	152.5	156.5
Amortisation of fixed assets	0.0	0.0	0.0	0.0	0.0	0.0	6.1	6.3
EDS share of discount on asset purchase	0.0	7.3	0.4	0.9	0.0	0.0	0.0	0.0
Barter deal prepayments	0.0	0.0	2.2	6.3	6.9	8.3	12.3	21.7
Profit on disposal of fixed assets	0.0	0.0	0.0	0.0	−1.1	−0.6	−0.1	−0.2
Loss on disposal of fixed assets	6.0	27.4	48.1	8.1	5.4	1.8	8.5	17.2
Net (profit)/loss on revaluation	16.2	28.0	2.4	4.4	98.2[9]	−30.2[9]	21.2	5.6
Transfer from donated asset reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cost of capital charges	48.5	42.5	52.1	41.3	42.3	23.9	22.3	20.1

	1998–99	*1999–2000*[3]	*2000–01*	*2001–02*	*2002–03*[7]	*2003–04*[7]	*2004–05*[10]	*2005–06*
DWP/NISSA internal charges	0.0	0.0	0.0	0.0	64.8	0.0	0.0	0.0
Auditors remuneration	0.4	0.6	0.5	0.5	0.5	0.5	1.0	1.9
Provisions for liability and charges	0.0	11.9	11.5	9.6	38.8	20.9	−8.8	19.7
Amounts provided for early departure costs	−5.9	−3.3	7.9	9.5	5.3	8.1	50.5	21.0
Unwinding of early departure discounting	0.0	0.1	1.2	0.5	0.5	0.7	0.6	2.4
Total non cash charges	213.4	263.8	286.7	237.4	394.0	206.1	266.1	272.2
Other expenditure								
Travel, subsistence and hospitality	71.1	76.8	79.0	88.3	91.6	94.8	93.5	98.3
Accommodation expenses				115.3[6]	140.2	141.6	141.7	143.6
Administrative staff related costs				2.1[6]	6.0	7.7	5.1	3.6
Printing, postage, stationery and office supplies				96.3[6]	114.6	116.3	128.0	127.3
Telephone expenses				29.6[6]	37.5	38.1	30.2	20.9
IT services and consumables				345.3[6]	307.6	356.9	442.8	507.2
Legal costs	53.7[6]	87.7	92.8	82.7	89.4			
Shipbuilders Relief			5.7	5.3	6.2	9.1	4.2	2.3
Lorry Road User Charge							30.7	32.8
Transfer to World Customs Organisation			0.3	0.4	0.4			
Consultancy					49.3[6]	60.6	76.9	65.3
Contracted out services					16.5[6]	17.0	16.3	19.2
Publicity					25.1[6]	20.7	24.1	30.3
Post Office services					16.5[6]	65.0	38.1	35.4
Bank charges					5.2[6]	17.3	16.4	17.4
Other miscellaneous expenditure	840.9	836.3	885.0	215.1	164.2	100.9	66.3	96.2
Total Other expenditure	912.0	913.1	970.0	951.4	1,068.6	1,138.8	1,197.0	1,289.2
Total Operating Costs	3,191.5	3,337.5	3,554.7	3,769.1	4,178.8	4,301.8	4,569.8	4,814.3

Questions 62–73 (Mr Richard Bacon): *Secondment of Civil Servants*

Richard Bacon asked for a note confirming whether or not Ian Pretty wrote the section of the contract relating to the secondment of civil servants to industry.

Ian Pretty was not the author of the contract. All detailed contract development was handled by the Inland Revenue's commercial and legal teams. Mr Pretty was responsible for negotiating the Human Resources (HR) elements of the ASPIRE contract and as such led the negotiations of the HR Schedule contained in the ASPIRE Contract on behalf of HMRC. Secondment arrangements are contained as annexes to the HR Schedule and govern only the terms for secondments of HMRC staff to the ASPIRE Account and ASPIRE Account staff to HMRC. The secondment arrangements simply mirror the standard terms HMRC applies to all secondments of its staff to another organisation. These Standard Terms were drafted by the Inland Revenue's HR Department. They also broadly mirror the secondment terms set out in the previous contract with EDS.

At the express insistence of the Inland Revenue's HR Division, the terms of the secondment arrangements contained in the ASPIRE contract were not open to negotiation; bidders were expected to accept them as drafted and indeed did so. HMRC actively encourages its staff to take responsibility for their own personal development, including private sector experience where this provides both business benefit to HMRC and personal benefit to the individual. Mr Pretty's secondment was in line with this policy and was formally approved by HMRC's Senior Appointment Board, which is chaired by the Chairman of the HMRC Board. Mr Pretty's secondment to the private sector is not to the ASPIRE Account and therefore the terms of the ASPIRE Contract form no part of his secondment. His secondment is, like all secondments, governed by HMRC's standard secondment terms and conditions.

Questions 81–82 (Dr John Pugh): *IT Expertise*

John Pugh asked what percentage of the top 5 grades in HMRC had "appreciable IT expertise" (graduate qualification in IT or previous employment in that area).

Out of the 28 Senior Civil Servants working to manage and provide the IT for HMRC and VOA, 16 hold an IT qualification or have previous experience in another part of the IT public or private sector.

Questions 85–88 (Dr John Pugh): *Payment from EDS*

John Pugh asked whether EDS were legally obliged to make up the £65 million pension shortfall.

EDS was not under a legal obligation to make up the pensions deficit. This was agreed through high-level discussions between EDS and the Inland Revenue in the later stages of ASPIRE bidding. With regards to a quid pro quo for the New Tax Credits (NTC) settlement, the Memorandum of Understanding that gave effect to the arrangement on pensions transfer was signed on 23 October 2003, over two years before the NTC Settlement was concluded and before the scale and quantum of possible NTC liabilities was apparent.

Questions 106–108 (Mr Ian Davidson): *Level of IT Error*

Ian Davidson asked for a note indicating what level of IT error is acceptable within the Tax Credits system before Capgemini incurs penalties.

The main measure of performance is the availability of the Tax Credit System to its users. The level of error that will trigger liability for Capgemini will depend on the nature of the error. There are specific provisions in the Aspire contract that allow HMRC to deduct monies from Capgemini for performance related issues. For Tax Credits, deductions are made if the Tax Credit system is unavailable for more than nine hours in total over a three month period. In addition, if there are more than five Tax Credit batch processes failures over the three month period deductions will be made.

The performance of Capgemini in this area has been good and there has only been one instance in December 2004 when the tolerance has been exceeded and deductions applied for loss of availability. There has been 100% availability for 18 months of the last 24 months. There are also provisions in the contract that allow HMRC to claim monies from Capgemini where the Department suffers loss. Specific indemnities cover losses arising from the incorrect issue of tax repayments. Losses could also relate to additional staff costs incurred in dealing with system errors.

Questions 117–119 (Mr Ian Davidson): *Education Background*

Paul Gray agreed to provide Ian Davidson with a note outlining what percentage of HMRC's top two SCS levels went to public school.

Within the two most senior civil service levels in HMRC, 80% attended state schools and 20% attended public schools.

Q120–121 *Contract costs*

Given that the overall increase in the estimated size of the contract in the last two years was about £2.5 billion, Helen Goodman asked what the increase was in the estimate in 2005–06, and what would it be in 2006–07, with the integration of the Fujitsu contract stripped out?

The figure of £2.5 billion relates to the increase in the 10-year contract price between the amount included in the bid and the like-for-like comparison projected to the end of the contract. This figure already excludes the effects of the integration of the Fujitsu contract in April 2006. The increase from the original contractual bid model to the actual amounts recorded in the HMRC resource accounts, excluding the effects of the integration of the Fujitsu contract, for the financial year 2004–05 is £109 million and for 2005–06 is £312 million.

Figures for 2006–07 are not yet available but the latest forecast shows an increase of around £331 million. This gives a total of £752 million, or an average of approximately £250 million per annum to date.

Letter from Acting Chairman, HM Revenue and Customs

When the Public Accounts Committee went into closed session on Monday 18 December, I gave evidence about the ongoing payments from EDS as part of the settlement with HMRC in respect of its claim for compensation for the problems that arose with the introduction of IT support for tax credits.

As you know, the settlement contract contains a confidentiality clause designed to protect information that is commercially sensitive for EDS. The contract also provides for ongoing quarterly payments based on new public sector contracts won by EDS. So far those quarterly payments have been lower than expected and that is a real concern for HMRC. But with the percentage of turnover on new Government business payable to HMRC having been made public by the Committee, I am very concerned that by also making public the quarterly payments made to date EDS' government turnover would effectively be laid bare in a way that would be interesting to their competitors without being of any help to HMRC in recovering the outstanding balance of the contracted settlement. I am sure the Committee will recognise that public disclosure of that sort will make it much harder to obtain settlements in future from suppliers where contracts have not delivered what is expected.

I hope the Committee will find it helpful to know that early in the New Year HMRC officials will be meeting with EDS to discuss the settlement terms, look again at their pipeline of future Government work and ask them to make an immediate payment with a view to ensuring that the settlement is delivered within the anticipated timescale.

The Committee will also recall that, until such time as EDS pays in full, HMRC's original legal claims against EDS are not relinquished—and this remains the ultimate sanction to make sure that EDS pays what it owes.

I will write to you again to let you know what progress is made in those discussions.

Paul Gray CB
Acting Chairman

21 December 2006

Letter from Chairman, HM Revenue and Customs to the Chairman of the Committee

PAYMENTS FROM EDS

I wrote to Mr Williams on 21 December[1] following the hearing he chaired on 18 December in that letter I said that I would write again about progress we are making in discussion with EDS to ensure that they pay what they owe in relation to the settlement made with HMRC. This is in respect of our claim for compensation for the problems that arose with the introduction of IT support for tax credits.

Since I wrote, HMRC officials and our legal advisers have met with EDS on several occasions. EDS have assured us of their intention to pay the outstanding sum within the planned timescale and said that the speed of payment is likely to be ramped up with several million pounds to be paid during 2007, and a greater sum paid in 2008. EDS say they would face significant legal and accounting issues were they to pay a lump sum now—the contract terms do not oblige them to do that—but we are exploring with them whether the number of contracts in which HMRC receives payment and the proportion of each contract paid over to HMRC can be increased.

Paul Gray CB

4 April 2007

Supplementary memorandum submitted by the National Audit Office

Question 61 (Mr Richard Bacon): *Transition costs*

1. The total transition costs incurred by the Department were £47.5 million as set out in the table below.

2. Within this total sum, the Department paid £37.6 million to Capgemini in respect of "unique" transition costs which would not have been incurred had the existing suppliers continued to provide the IT services. It also paid £5.7 million to EDS and Accenture to facilitate the transition (£5.3 million in support costs and £0.4 million in retained staff costs for EDS). These figures are shown in Figure 9 of the C&AG's report.

3. Of the total £47.5 million transition costs, £7.3 million related to the NIRS2 transition. This comprised £3.4 million paid to Accenture, "3.4 million paid to Capgemini to support the NIRS2 transition, and £0.5 million of costs incurred by the Department for Work and Pensions, as shown in the first part of Figure 11 in the C&AG's report.

4. On NIRS2, in addition to these transition costs the Department paid £7.6 million to Capgemini in contract costs as part of the ASPIRE contract. It also paid £14 million to Accenture for use of Intellectual Property Rights on NIRS2 which was effectively a closing payment relating to the former 1995 PFI contract with Accenture. Both of these costs were necessary for the NIRS2 replatforming, but were not an intrinsic part of the transition process. These are reflected in Figure 11 of the C&AG's Report.

[1] Ev 23–24

TOTAL TRANSITION COSTS INCURRED BY
HM REVENUE AND CUSTOMS

Category	*Amount (£ million)*
Unique transition costs to Capgemini (1)	37.6
Transition support costs to EDS/Accenture (2)	5.3
Retained staff costs for EDS	0.4
DWP IT support costs for NIRS2 transition (3)	0.5
Departmental staff and running costs	1.3
Consultancy advice and support	2.4
Total costs of transition	**47.5**

(1) Includes £3.4 million paid to Capgemini for NIRS2 transition.
(2) Includes £3.4 million paid to Accenture for NIRS2 transition.
(3) Relates to NIRS 2 transition.
Source: C&AG's Report, figures 9 and 11.

Supplementary memorandum submitted by Xansa

Further to the evidence session held on 18 December 2006, I would like to thank you for the interest that the Committee of Public Accounts have taken in this ground breaking contract. You may recall that I sent a short briefing paper to your office prior to the evidence session[2] outlining some of the key concerns that Xansa has with the award and the negotiation of the contract.

Xansa has 44 years experience of sustaining long term relationships with both the public and private sector, through the provision of efficient and pioneering ways of delivering technology and outsourcing solutions. We have existing public sector partnerships with NHS Shared Business Services, the Club and the Financial Services Authority amongst a number of other departments and agencies. We also provide client side advice and guidance to many public sector organisations in support to their sourcing, procurement and contract management activities.

Having attended the open session of the Committee meeting, I was impressed with the range and depth with which the Committee conducted its questioning of Paul Gray (HMRC), Steve Lamey (HMRC) and Richard Boulter (Capgemini ASPIRE) under limited time constraints. However, there were a number of important issues that I feel, in hindsight should be re-emphasised:

Contractual Value for Money

The answers given by the witnesses were unconvincing and did not answer legitimate concerns about the efficiency of Capgemini's internal contract management procedures, given the size and duration of the contract. Xansa has evidence that true value for money comes from companies that are not so large they are unable to perform their function efficiently.

Size of the Contract

During the evidence session, there was no consideration of the overarching impact of the unprecedented size and duration of the contract on the market and the precedents that this will set for future contract awards. Xansa believes that there are alternative sourcing models which would be just as effective, not distort the market and maintain optimal value for money.

Transition Planning and Office of Government Commerce Review

Transition planning must be part of the procurement process, including due diligence and intellectual property rights retention. Xansa believes that the OGC should make it recommendations accordingly.

Risk Transfer and Renumeration Aligned to Outcomes

Xansa believes that a contract of this size and duration must take on performance risk and the service provider should be partially regarded for the business outcomes achieved not just service levels achieved.

[2] Ev 18–20

Governance Arrangements Aligned to Strategic Planning

Intelligent customer function is not the same as the IT staff retained by HMRC. Although the Committee did touch on the size of HMRC's in-house team, the Committee did not explore the size and nature of the team directly responsible for managing the contract, how their performance is measured and how value for money going forward would be assured. Xansa believes that a clear governance function and arrangements must be in place and aligned to HMRC strategic planning. This will allow both HMRC and CapGemini to make decisions based on informed knowledge drawn from each other's perspective and be able to more effectively forecast implications on the contract's budget, programme, resources and HMRC's capacity to change.

Gavin Hall
Principle Consultant, Government Consulting Services
Xansa

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