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Public Administration and Constitutional Affairs Committee

After Carillion: Public sector outsourcing and contracting

Seventh Report of Session 2017–19

Report, together with formal minutes relating to the report

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Summary

Government outsourcing and contracting has become a very significant part of the delivery of central and local government services throughout the world. The UK Government spends £251.5 billion per year on outsourcing and contracting. The UK spends 13.7% of GDP on public procurement, which is not significantly different from countries such as Denmark (14.16%) or Germany (15.05%). Despite the UK leading innovation in this field for some 30–40 years, there has been a depressing inability of central government to learn from repeated mistakes and to some extent the collapse of Carillion and the state of the sector reflect this.

The failure of Carillion was one of the biggest commercial challenges the Cabinet Office has ever faced. The Government was right not to bail out Carillion. The Government was prepared for the consequences of this decision, and was able to ensure that public services kept operating as far as possible. However, the failure of Carillion reflects long term failures of Government understanding about the design, letting and management of contracts and outsourcing.

In his recent speech, the Minister for the Cabinet office, Rt Hon David Lidington MP, underlined the importance of rebuilding public trust between government, private sector providers and the public. Carillion's failure reinforced a widespread crisis of confidence in government reliance on the private sector to deliver public projects and services on which the public relies. The Government needs to move quickly to improve public confidence in the competence of its commercial capabilities.

It is unclear how and why the Government decides whether to outsource a particular service. The Government has a process, set out by the Treasury, to make decisions about how it should deliver services and run projects, including evaluating options about whether and how to use the private sector. However, the Government does not always follow its own process. Moreover, the evidence used to support these decisions is thin or non-existent. This report calls for the Government to follow its own processes to decide whether and how to "make or buy", before any public contract is put out to tender, and to publish the justification (including its evidence) on which the decision is based. This transparency is vital for rebuilding public confidence.

Our report finds that government ineffectiveness has contributed to the problems that Carillion and other companies have faced. The Government has deliberately promoted an aggressive approach to risk transfer to the private sector - often even attempting to transfer risks that the government itself has completely failed to analyse or to understand. Government assumed Carillion had accurately estimated its own costs in delivering maintenance for the prison estate, even though it later transpired the accurate cost was £15 million more. Government procurement has been driven by price while failing to appreciate differences in quality that contractors may be offering. We recommend a fundamental change of attitude by the Government towards its partners - ensuring that risk transfer is realistic and that quality, an appreciation of systemic risk and economic impact as well as price drives decision making. The Cabinet Office should also aggregate the risk exposure from across the whole of government to large contractors like Serco and Capita, so there is a better appreciation of how much the public sector as a whole is relying on individual companies.

Government failures in this area have forced government repeatedly to renegotiate contracts with the private sector. Even in the months since the beginning of 2016, departments have already had to renegotiate over £120 million worth of contracts with the private sector. This reflects poorly on government's effective ability to let and manage contracts.

The Government's pressure on private sector partners has encouraged reckless acquisitions and efforts to achieve unsustainable growth. In some markets, diminishing competition and high barriers to entry for new suppliers means there are too few bidders, so the market looks more like an oligopoly. Despite their market domination, many of the major players have had to announce dividend cuts and recapitalisations to address over optimism and tighter margins from government contracts. The Government must also take steps to improve competition and encourage more suppliers into these markets.

The Government must re-examine its due diligence procedures and learn from the Carillion crisis. The Government must develop a deeper understanding of its commercial partners' supply chains and of the risks hidden behind their published accounts and public statements. Share prices, buy, hold or sell recommendations, and public statements are a poor guide to the long term security of these companies. Shareholders can accept higher risks for an equity rate of return and can bale out at short notice. The Government is in for the long term and cannot take such risks with public money or with the security of public services. The Government must better understand the security of their cash flows and the real value of their balance sheets and potential liabilities. Carillion's balance sheet was fatally weakened by high risk construction contracts. It was also puffed up with high valuations of goodwill, reflecting no more than how much it had overpaid for acquisitions and which provided no security. The Government needs to understand better the true quality of leadership and governance of its major commercial partners, whose greed and appetite for risk in Carillion was significantly at odds with public service values.

The Government has been improving its commercial capability but this must not simply be about beating down prices. The Government must improve its skills in the negotiation and management of contracts, so that it best employs the strengths of the private sector while also understanding its limitations and weaknesses. These commercial skills cannot be seen in isolation either but must be integrated with other skills such as costing, project management, IT capability and financial planning, along with deep and relevant subject knowledge and expertise.

The Government admits that its data about contracts internally is poor: we have commented again and again about the lack of useful internal data in Government, which can lead to blind reliance on what companies tell the government, instead of a genuine exchange of information and a continual appraisal of the contractor's performance over the lifetime of the contract. This also depends upon developing a professional atmosphere of verified trust and collaboration between the people in government departments and in private contractors, based on the values attitudes and behaviour which the public expects to be demonstrated in the delivery of public services.

Contracting and outsourcing with the private sector is a permanent feature of governments in mature economies across the world and it will remain so, whichever government is in power. The Government must take the steps recommended in our report and those of our colleagues on other committees so that it can ensure that the public gets the services they deserve from these companies, who themselves must demonstrate values the public can respect.

1 Introduction and context of our report

1. In January 2018, Carillion, a large facilities management and construction firm, entered liquidation. The National Audit Office (NAO) estimates that when Carillion collapsed it had 420 contracts with the public sector.[1] Carillion held contracts with the Ministry of Defence, the Ministry of Justice, Network Rail, HS2 Ltd and various hospitals.[2] The Local Government Association calculated that 30 councils and 220 schools were directly affected by the collapse of Carillion.[3] When Carillion collapsed both the Scottish and Welsh Governments issued statements about their exposure to its failure.[4] By value, Carillion was the sixth largest supplier to the public sector in 2017.[5]

2. Carillion had first issued a profits warning in July 2017. At this point, the Government began contingency planning for the failure of the company. We evaluate this planning in paragraphs 103–4. Carillion announced the award of several large government contracts after its profits warning in July 2017: some of these were awarded before and some after the company's disclosures.[6] In January 2018, the company appealed to the Government and its creditors for assistance. The Government decided not to supply this assistance and the company directors, upon learning the news, put the company into liquidation.

3. The Rt Hon David Lidington MP, the Chancellor of the Duchy of Lancaster and Minister for the Cabinet Office ("the Minister") recently spoke at the think tank Reform about his own proposals for reforming contracting in the public sector. We have reflected on his comments in drafting our report. He thanked "both to the civil servants and contracted workers who rose to that challenge in very difficult circumstances."[7] We endorse the Minister's comments and would like to thank the civil servants and contracted workers, who worked tirelessly to safeguard public services in very difficult circumstances during the Carillion crisis. We would also like to put on record our sympathy for the pensioners, employees, families and subcontractors of Carillion who were caught up in its liquidation through no fault of their own.

4. A number of investigations have since begun into the events which led to Carillion's collapse. These include investigations by regulators into the reasons for Carillion's collapse. In Parliament, the Work and Pensions and Business, Energy and Industrial Strategy Committees launched a joint inquiry which examined the corporate governance and regulatory consequences of the company's collapse. Their inquiry also examined the ramifications of the collapse for small businesses who worked with Carillion and for the company's pension scheme. They reported in May 2018.[8] The NAO published the results of its own investigation into the Government's handling of the Carillion failure

1 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–2019, HC 1002, p. 6
2 House of Commons Library Briefing Paper Number 8206, The Collapse of Carillion, March 2018, p. 35
3 Q305
4 House of Commons Library Briefing Paper Number 8206, The Collapse of Carillion, March 2018, p. 35
5 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–2019, HC 1002, p. 6
6 Ibid. p. 33
7 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
8 Business, Energy and Industrial Strategy and Work and Pensions Committees Second Joint report of Session 2017–19, Tenth Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19 and Twelfth Report of the Work and Pensions Committee of Session 2017–19, Carillion, HC 679

in June 2018.[9] This investigation set out Carillion's role in public sector contracting, the Government's monitoring of Carillion and contingency planning for its collapse, the Government's response to Carillion's request for support and the Government's management of Carillion's eventual liquidation.

5. The Public Accounts Committee (PAC) have begun an inquiry into the Government's approach to its strategic suppliers.[10] Their inquiry looks in detail at the Cabinet Office's approach to strategic suppliers and examines the role of the Crown Commercial Service and Crown Representatives. We have therefore not examined these issues in our report. We look forward to PAC's report.

6. We began our inquiry, before the other select committees, in January 2018. We have sought to examine five important strategic issues arising from the collapse of the company that we believe are essential for the Government to tackle in the aftermath of the failure of one of its major outsourcers:

a) How appropriate is it for particular public sector projects or services to be run by the private sector? (Chapter 2);

b) How successfully the Government has used the Private Finance Initiative to achieve value for money for the taxpayer?; (Chapter 3);

c) Is the Government just the customer or does it have wider responsibilities as the steward of these markets? (Chapter 4);

d) How have companies tended to react to the Government's approach to this market? (Chapter 5)

e) What capability does the Government still lack in letting and managing contracts? (Chapter 6)

We also examine in Chapter 5 the Government's response to the Carillion crisis.

7. We launched our inquiry on 15 January 2018. We held six evidence sessions (including a joint evidence session with the PAC). We received 34 written submissions. We would like to thank all those who gave evidence to our inquiry. We would also like to thank Professor Gary Sturgess, New South Wales Premier's Australia and New Zealand School of Government Chair of Public Service Delivery at the University of New South Wales and Professor of Public Service Innovation at Griffith University in Brisbane, Queensland, who served as our advisor on this inquiry.

9 Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–2019, HC 1002
10 Public Accounts Committee, Strategic Suppliers Inquiry

2 How appropriate is it for public services or projects to be run by the private sector?

The significance of outsourcing

8. The UK Government has always purchased some assets and goods from the private sector. In the 18th and 19th Centuries, governments purchased some public services from the private and voluntary sectors: such as, criminal justice, defence and education.[11] Although governments brought some services in house during the first three quarters of the 20th century, they still purchased a variety of goods and services from the private sector, including construction services and weapons systems.[12]

9. Since the 1970s, the UK has increasingly turned to the private sector to deliver public services.[13] Professor Michael Moran, (University of Manchester), Professor Karel Williams (Manchester University) and Professor Sukhdev Johal (Queen Mary University) argued that current outsourcing is different in nature from what happened immediately prior to the 1970s: "modern outsourcing is more fundamental and more complex; it involves franchising or leasing complex sets of services to private contractors".[14] The CBI agreed that this represents a starting point: "outsourcing, as we have been discussing it today, has been around for 30 or 40 years".[15] There is evidence of this transformation in particular markets. For example, UNISON said that "in the early 1990s just 5% of home care was provided by private companies, today it is more than 80%."[16] There are a number of markets which simply did not exist 30 to 40 years ago including prisons, probation services and support for unemployed people to return to work.

10. Now a wide variety of services and goods are purchased from the private sector. According to the NAO, these include:

- the construction of assets and infrastructure (e.g. the Ministry of Defence's new aircraft carriers);
- services delivered directly to the public (e.g. contracts for probation services);
- support services for Government (e.g. facilities management); and
- the goods required by government agencies to function or by the public as part of some government programme (e.g. pharmaceuticals).[17]

11 Richard Harding and Sergio Solbes Ferri (coords.), 'The Contractor State and Its Implications, 1659–1815', Universidad de Las Palmas de Gran Canaria, 2012, H. Midgley Payment by results in nineteenth century British education: a study in how priorities change Journal of Policy History Vol. 28 Issue 4 (2016) pp. 680–706, G. Sturgess, G. Argyrous and S. Rahman Commissioning human services: lessons from Australian convict contracting Australian Journal of Public Administration Vol. 76 Issue 4 (2017) pp. 457–69, Q404

12 J.F Flower, The Case of the Political Bloodhound Journal of Accounting Research Vol. 4 No. 1 (1966) p. 16. P. Smith, Procurement collaboration in the UK public sector Spend Matters November 2017

13 C. Hood and R. Dixon, *A Government that worked better but cost less? Evaluating three decades of reform and change in UK central Government* (Oxford 2015), p. 2; A. Bowman, I. Erturk et al. *What a waste: outsourcing and how it goes wrong*, Manchester University Press, 2015, p. 2

14 S. Johal, M. Moran and K. Williams Breaking the constitutional silence: the public services industry and the Government The political quarterly Vol. 87 Issue 3 (2016)

15 Q330

16 LCC0013 (UNISON)

17 National Audit Office, A Short Guide to Commercial Relations, December 2017, p. 8

Local Government similarly purchases a diversity of services, ranging from contracts for IT to the provision of children's services.[18] The diversity of service provision leads to a diversity of suppliers: George MacFarlane, Sectors Director at the CBI, told us that around 200,000 companies and charities now deliver services to or for the public sector across the country.[19] Consequently, the Minister argues that "the private sector has a vital role to play in delivering public services".[20]

11. In 2015–16, central and local government spent a combined £251.5 billion with external suppliers of goods and services.[21] The Government spends roughly as much on purchasing goods and services from the private sector (£192 billion in 2015–16) as it does on paying its own staff (£193bn).[22] Most public services now include some element of outsourcing: Michael King, the Local Government and Social Care Ombudsman, told us "there are few areas now where we do not see some sort of externalisation through contracts".[23] Often this will involve the public, private and voluntary sectors working together to deliver a social outcome. For example, in probation services, a public sector prison might release a former prisoner to a private sector community rehabilitation contractor who commissions a service for the prisoner from a charitable provider.[24]

12. The UK is not alone in this regard. The practice has "become commonplace across most EU countries".[25] According to the OECD, government procurement accounts for "approximately 12% of OECD GDP".[26] In 2015, the UK spent 13.7% of GDP on government procurement. This proportion has been consistent over the last ten years, with the UK spending at least 13% (2007) and at most 15.6% (2009).[27] Internationally, this compares with 20.2% of GDP spent on government procurement in the Netherlands, 17.5% in Finland, 15.05% in Germany, 14.6% in France, 14.16% in Denmark and 9.4% in the United States of America.[28] Professor Sturgess told us that different countries take very different decisions about what to purchase, based on cultural factors: in Denmark emergency services like the Fire Service are provided by a private firm which in the UK, he said, would be politically "unacceptable", whereas he said the UK has long contracted out the operation of its lighthouse service which would be "confounding" in countries such as the United States.[29] It is not confined to the public sector only: as the Minister said recently "outsourcing is standard practice within the private sector".[30]

18 Q239 (David Simmonds)
19 Q333
20 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
21 National Audit Office A Short Guide to Commercial Relations December 2017 p. 4
22 HM Treasury, Whole of Government Accounts 2015–16, p. 13
23 Q239
24 Ministry of Justice Transforming Rehabilitation A revolution in the way we manage offenders, January 2013, p. 11
25 J.M. Alonso, J. Clifton and D. Diaz-Fuentes, Did new public management matter? An empirical analysis o the outsourcing and decentralising effects on public sector size, MPRA Paper No. 43255 (December 2012), p. 6
26 OECD Government at a glance 2017 Highlights p. 10
27 OECD Government at a glance 2017 edition public sector procurement (2017)
28 OECD Government at a glance 2017 edition public sector procurement (2017)
29 Qq 403–404
30 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018

13. Despite this, recently public trust in outsourcing has declined. Margaret Stephens said that "trust has been lost in PFI" and warned the same lack of trust could extend to outsourcing in general.[31] Paul Davies said that the public "simply do not trust that private ownership is in their interest."[32] In the Minister's view, the Carillion failure has "crystallised issues which have, at times, informed that breakdown of trust".[33]

14. **Government outsourcing is now more important than ever. This is true not only of the UK but also of most other advanced economies. The Government purchases almost as much from external providers as it spends on its own staff. There are few public services where the Government does not rely, to some extent, on some sort of contractual relationship.**

The case for outsourcing

15. Despite the extent and importance of the UK's use of the private and voluntary sectors to deliver public services, it has been controversial. This section lays out the arguments that we heard in favour of and against outsourcing.

16. Numerous witnesses told us that purchasing services from the private sector reduced costs for the taxpayer by as much as 10–30%.[34] The Minister justified this claim by referring to economies of scale resulting from the use of the same company to serve different clients, greater freedom to access specialist knowledge and the imposition of cost discipline.[35] His arguments were supported elsewhere by Serco and Mitie.[36] These arguments have academic support: John Manzoni, the Chief Executive of the Civil Service, supported the Minister's claim by pointing to studies which say that savings of "about 20%" are achieved when a service is first exposed to competition.[37]

17. The Global Sourcing Association told us that purchasing services allows the government to access "talent on a global basis".[38] Serco agreed, saying that outsourcing enables the Government to bring in new talent with "new ideas" about how to run services.[39] Mitie mentioned that bringing in private sector expertise enables the Government to take advantage of the "innovation and leading-edge technology" which companies bring with them.[40] The Minister agreed, citing the "range of specialist skills, world class expertise and deeper knowledge" the private sector can bring to problems.[41] Paul Davies, an independent infrastructure advisor, said that private companies bring "cost skills and project management skills for implementation" as they are "often doing the same job

31 Q569
32 P. Davies Private Finance: Press Reset Rebuilding Trust and Strengthening Partnerships (March 2018) p. 3
33 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
34 Q240 (David Simmonds), Q333 (George MacFarlane)
35 Q742
36 Mitie LCC0039, Serco LCC0022
37 Q743. S. Domberger and S. Rimmer, Competitive tendering and contracting in the public sector: a survey International Journal of the Economics of Business Vol. 1 Issue 43 (1994) pp. 439–53. DeAnne Julius, Public services industry review: understanding the Public Services Industry: How big, how good, where next? July 2008. Confederation of British Industry Open Access: Delivering Quality and Value in Our Public Services, September 2012
38 Q329
39 LCC0022 (Serco)
40 LCC0039 (Mitie)
41 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018

outside of the public sector”.[42] Peter Smith, a former government procurement director, argued that it is important to remember that the state often failed to deliver the services that companies now successfully deliver.[43]

18. The points raised in favour of outsourcing have not gone without challenge. Professor Haslam (Queen Mary University) told us that purchased services could sometimes be more expensive.[44] Local Authorities have recently argued that providing services themselves is both cheaper and produces better quality services.[45] The Unite Union argued that far from reducing costs, these contracts give “public assets and resources to private individuals or companies that make huge profits”.[46]

19. Critics argue that where there are reduced costs, these “come from driving lower pay, worse terms and conditions”.[47] The TUC said that private contractors offer worse terms to workers than the public sector for similar jobs.[48] This is contested. Rupert Soames, CEO of Serco, “vigorously” denied that they offered worse working conditions than the public sector and said that they “specialise in organising our people well” and hence run services with fewer staff.[49] Phil Bentley, CEO of Mitie, said that while some conditions such as pensions might not be as favourable to the employee in the private sector, there might be more career progression.[50]

20. There is a consensus that the private sector should be able to provide some goods to the public sector. Even opponents of the private sector’s involvement in the public sector acknowledge that the public sector should buy goods from the private sector.[51] On the other hand, supporters of using the private sector acknowledge that there are some areas (for example, policy analysis by the civil service or decision making) which should not be outsourced and that some contracts have gone badly wrong in the past.[52] Opponents of using the private sector tend to extend this boundary. For example, the Scottish Refugee Council “question whether outsourcing to non-public or charitable bodies or the possibility of profit can ever be appropriate in complex services” such as immigration centres.[53]

21. Public sector capacity limits what can immediately be brought back in house. We were told that it would be difficult to bring services back in house, at least in the short-term. Sir Amyas Morse, the Comptroller and Auditor General, told us that “there are a lot of areas where Government does not have the capacity to do anything else but outsource” and that in some parts of government, “the capability of even acting as a prime contractor is not necessarily there.”[54] David Walker, a Guardian Journalist and former Audit Commission official, agreed that “within the short run many services could not overnight

42 Q561
43 LCC0007 (Peter Smith)
44 Q402)
45 G. Plimmer, How outsourcing fell out of fashion in the UK, Financial Times, February 9 2018
46 Unite LCC0011
47 Unite LCC0011. See also David Walker Q707
48 TUC LCC0018, Q707 (Matt Dykes)
49 Q650
50 Q652
51 Q685 (David Walker), We own it LCC0038
52 Q563 (Margaret Stephens); Q568 (Paul Davies); Q744 (David Lidington MP), LCC0007 (Peter Smith). The Government in 2012 did consider outsourcing some policy development. HM Government The Civil service reform plan (2012) p. 16
53 LCC0016 (Scottish Refugee Council)
54 Q496

be switched back".[55] As the Institute for Government (IfG) said in advance of the 2015 General Election, "however desirable it might be to act quickly, switching from in-house to outsourced provision (or vice-versa) is not a trivial undertaking".[56]

22. Most of the witnesses to our inquiry endorsed the conclusion of Professor Simon Wren-Lewis of Oxford University that the right answer to whether the Government should purchase services or goods from outside companies or charities is "it depends".[57] Nick Davies from the IfG said that "there is broad agreement that there is probably not a hard line about what should be insourced or outsourced, but there are certain services that are more likely to be able to be outsourced successfully".[58] David Walker, from a different perspective, agreed: he told us that, while "public-facing services" should always be in the public sector, it would be "dogmatic to say at any given point that there is a hard and fast division".[59]

23. **At different times, private, charitable and public providers have both succeeded and failed to contribute to successful public services. All the witnesses to our inquiry accepted that the public sector should buy in some goods or services from the private sector, and should insist on providing others internally. The public sector should not contract out the final decision making about policy. The public sector always retains responsibility for the entitlement of individuals to benefits or services. Whether ordinary services should be outsourced though will depend upon the capacity of the public sector, private sector or voluntary sector to deliver them, the comparative cost, and ultimately, the value that each provider can produce.**

The Decision to outsource

24. Consequently, most witnesses to our inquiry argued that decisions to outsource or not should be made on a programme-by-programme basis. Serco advocated "a robust, rational, documented … 'make-or-buy' decision-making process" for each potential outsourced or insourced contract.[60] John Tizard, a former executive at Capita, called for this process to be mandatory across the public sector.[61] Sir Amyas Morse said that "there should be a business case" explaining the rationale for purchasing a good or service, rather than producing it internally.[62]

25. The IfG has set out ten questions which it considers should guide public sector managers in making decisions about whether to procure or not from the private sector. These include questions about the complexity, uncertainty and supply of provision.[63]

26. The Government has also advocated a pragmatic, evidence-based approach. John Manzoni reaffirmed to us the principle set out the Civil Service Reform Plan in 2012 that "Departments will commission services from others where this achieves a better service

55 Q714
56 Institute for Government, Getting a better deal in outsourced services, 2015
57 Simon Wren-Lewis, What Carillion's collapse tells us about public sector outsourcing, London School of Economics British Policy and Politics, January 2018
58 Q408
59 Q685
60 Serco LCC0022
61 (John Tizard) LCC0005
62 Q497
63 Institute for Government LCC0040

to the public or better value to the taxpayer”.[64] The Minister said that “what matters is that the service works for the people who use it in their everyday needs. While at the same time providing value for money for the taxpayer”.[65]

27. The Treasury issues guidance to departments on this evaluation in a document called the Green Book. The Green Book sets out the Government’s approach to evaluation and appraisal of projects. The process for approving new projects covers what the Government describes as the strategic case, the economic case, the commercial case, the financial case and the management case for the project.[66] The Government supplies supporting detail of what it means by each of these cases: in the analysis for the economic case, for example, the Government says it analyses whether “the spending proposal optimises public value (to the UK as a whole)”.[67] During this process, a proposal goes through various checkpoints. At one of those checkpoints, the Outline Business Case (OBC), the department is supposed to set out a “’preferred option’ which demonstrably optimises value for money”, including a strategy for procurement.[68] The department does not just evaluate in deciding on this preferred option between a public and private sector route: but also evaluates what kind of public or private sector arrangement it needs to deliver services. The Government told us that it is currently updating the Green Book guidance on business cases to reflect changes in legislation and “better thinking about how we do the things that we are doing”.[69]

28. However, we have received evidence that this is not the process that the Government currently follows. The Trade Union Congress criticised the Government for not following the IfG’s guidelines.[70] Nick Davies said that the Government “has tended to rush into outsourcing approaches” without evaluating whether they are appropriate or how to mitigate any risks if they are not appropriate.[71] There are examples in which decisions about whether and how to procure were made before a formal business case process was concluded.[72] Sir Amyas Morse agreed that “there are, no doubt, cases where I would not be happy with the amount of logic or consideration that had gone in” to the decision.[73] The CBI and David Walker both criticised this decision making.[74]

29. The Government rejected this criticism. John Manzoni told us that all decisions to purchase a good or service “go through that scaffolding, they go through those decision points and they are examined and scrutinised and a decision is taken.”[75] Rupert Soames said that while the Government might assert it did this well, “we never see the grounds for that—it is shrouded in opaqueness, on what grounds the Government decide to put something out or not. I think that that should be a transparent process”.[76] When asked whether the Government should be more “open about… [its] logic” on this kind of decision, the Minister replied that he could see “no objection to that in principle”.[77]

64 Q746, (John Manzoni); The Civil Service Reform Plan, June 2012, p. 8
65 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
66 HM Treasury, Public Sector Business Cases: using the five case model. Green Book supplementary guidance on delivering public value from spending proposals, 2015, p. 11
67 Ibid. p. 12
68 Ibid. p. 19
69 Q748 (Gareth Rhys Williams)
70 LCC0018 (Trade Union Congress)
71 Q414
72 National Audit Office, The introduction of the Work Programme, 2012, p. 7
73 Q498
74 Q333
75 Q747, LCC0002 (David Walker)
76 Q625
77 Q804

30. **There was a consensus among the witnesses to our inquiry that the Government should be taking a reasoned, evidence based make-or-buy decision. The Government has set out criteria for this in its Green Book guidance. This decision is not binary between private provision and public provision but should include a number of alternative methods of provision, several of which might involve commissioning the service or providing the service in-house. We heard conflicting evidence about whether the Government consistently follows its own guidance in this respect. It is impossible to tell from the outside whether decisions have been made appropriately.**

31. ***It is intolerable that the Government is spending £250 billion with little evidence that it is currently following its own procedures to secure value for money. The business case procedure set out in the Treasury's Green Book provides a suitable basis for making decisions about whether and how to let contracts. However, we are concerned by the evidence of the Comptroller and Auditor General that this is not always followed. The Cabinet Office and Treasury should ensure that all contractual decisions are based on a sound business case and in accordance with the guidance laid out in the Green Book.***

32. ***Public trust in outsourcing has been seriously damaged recently. This is due to a number of high profile failures–including most recently the failure of Carillion. The Government needs to rebuild trust in the process by which it makes decisions about outsourcing. The Government can only achieve this by being transparent about how and why it decides to purchase a good or service. Especially in cases where private sector involvement or the type of commissioning is novel, the Government should publish its rationale for the decision and notify the relevant select committee. This might take the form of a published business case, for example.***

Evidence Base

33. The Government's lack of evidence about when and whether using the private sector or voluntary sector will be more successful than using the public sector underpins this lack of a structured business case. Nick Davies told us that, while evidence on buying goods was unambiguous, on purchasing services it was "a lot patchier".[78] Margaret Stephens told us that "there is a case for gathering much more evidence to inform better decision-making."[79] The union UNISON complained about a "lack of hard data".[80] Professor Sturgess noted that, while some research had been done on the merits of purchasing goods or services externally, it was "nowhere near enough".[81]

34. Professor Sturgess told us that, given the complexity of each decision about purchasing services, more work should be done in evaluating case studies of contracting.[82] In the Government's manual for handling money, *Managing Public Money*, it endorses the principle that programmes should have evaluations designed into them at the start.[83] There are examples of evaluations within central government that examine novel procurement structures. For example, the Department for Work and Pensions commissioned an evaluation of the Work Programme in 2014 which pointed out that incentives to help the hardest-to-help claimants had "a limited impact in driving provider behaviour."[84]

78 Q399, see also Q412
79 Q572
80 LCC0013 (UNISON)
81 Q395
82 Q398
83 HM Treasury, Managing Public Money, Box 4.8
84 Department for Work and Pensions, Work Programme evaluation: operation of the commissioning model, finance and programme delivery, December 2014, p. 218

35. Professor Sturgess recommended that, in addition to evaluations published by departments, the Government should consider the "establishment of a centre of excellence for the study of applied public service contracting, and the design and operation of public service markets."[85] In other areas, the Government has established what it calls "What Works Centres": these currently focus on issues like educational attainment or local economic growth.[86]

36. ***The Government must produce evidence about the advantages and disadvantages of purchasing from the private or third sector in different public services. This should include an assessment of the cost and quality advantages and disadvantages of purchasing services. The Government should establish a centre of excellence for research into applied contracting (for example, through establishing a new "What Works Centre").***

85 Professor Gary Sturgess LCC0023

86 For a full description of "What Works Centres" and description of their function see Government What Works Network (2018)

3 The Private Finance Initiative: time for honesty

37. The Private Finance Initiative (PFI) is a distinctive form of purchasing assets from the private sector. In a PFI contract, a company called a Special Purpose Vehicle (SPV) is set up by private sector investors. The SPV is responsible for the financing, construction and maintenance of an asset such as a school or hospital. The SPV borrows from banks and others and contracts with construction and facilities management companies (who will often also be investors in the SPV). Once the asset is constructed, the public sector then pays back the SPV over the period of the contract (typically 25 to 30 years). This payment covers the cost of the construction, the cost of the maintenance of the asset and the costs of financing the SPV. The profits made after all these costs are distributed to the shareholders of the SPV. This structure is the same for a PFI deal and for the Treasury's replacement for PFI-PF2 (see paragraph 43).

38. There are currently around 700 operational PFI and PF2 deals with a capital value of around £60 billion.[87] Annual charges for these projects amounted to £10.3 billion in 2016–17 and future charges which continue until the 2040s will amount of £199 billion.[88] The number of PFI or PF2 deals has declined since 2010.[89] However, Highways England recently announced that they would use PF2 to finance the £1.3 billion A303 Stonehenge tunnel and roads and the £1.5 billion approach roads to the Lower Thames Crossing.[90] Also, in June 2018, the Minister for Justice, Rory Stewart MP announced that the new Glen Parva prison "will be funded through PFI".[91]

39. The Government claims that there are benefits to using external finance for projects such as "the discipline and rigour" that lenders apply to projects.[92] Sir Amyas Morse agreed that PFI was not "undilutedly a bad thing" as "independent financial bodies … will not let you have the money unless you have done a reasonable job of evaluating the cost of the contract".[93] Taking a different view, Paul Davies told us that one of the motivations behind PFI was "to make a lot of those projects off balance sheet."[94]

40. The Government has been clear in the past that PFI or PF2 "should be used where—and only where—it offers better value for money than other means of procurement".[95] However in evidence to us, John Manzoni agreed that the off-balance sheet structure was a key motivation behind using PFI or PF2. He told us that "the entire PF structure is to keep the debt off the public balance sheet. That is where we start."[96] The Treasury Select

87 The Treasury launched PF2 as a replacement for PFI in December 2012. We consider the differences between the two contractual mechanisms in paragraph 33 of this report. All figures are from Comptroller and Auditor General PFI and PF2, p. 4
88 All figures are from Comptroller and Auditor General PFI and PF2, p. 4
89 PF2 is the Government's new revised version of PFI. Report by the Comptroller and Auditor General, PFI and PF2, session 2017–19, HC 718, p. 24
90 Report by the Comptroller and Auditor General, PFI and PF2, Session 2017–19, HC 718, p. 46
91 Hansard 27 June 2018 Vol. 643 Col. 904
92 Q785
93 Q528
94 Q576 (Paul Davies)
95 HM Treasury Consolidated Budget Guidance February 2018 p. 117- the same point is made in HM Treasury A new approach to public-private partnerships (December 2012) p. 21, HM Treasury Managing Public Money March 2018 Paragraph A.7.4.3
96 Q786

Committee criticised this argument in 2010, arguing that incentives to use PFI which were not related to value for money should be removed.[97] This has been a particular issue in the UK; in other countries like Australia, "very few" PFI deals are off balance sheet.[98]

41. Concerns have been raised about the value for money of PFI for the public sector. Early PFI projects often reported huge profits for investors who made money when they refinanced the project after the asset had been built. Once the asset is built and the project has moved to the maintenance phase, risk diminishes so that banks were willing to offer a lower interest rate for the project debt.[99] Following recommendations from PAC, changes were made to ensure that these gains were shared with the public sector.[100]

42. In 2011, the Treasury Select Committee reported that "the use of PFI has the effect of increasing the cost of finance for public investments" as the cost of private sector borrowing through an SPV is always higher than the cost of the Government borrowing on its own account.[101] The Committee found that the main benefit claimed for PFI was the "the transfer of construction risk" but argued that a thirty year contract was "not necessary" to transfer responsibility for a construction project that might only last a couple of years. Sir Amyas Morse agreed that part of the issue with PFI was that the decision to bundle maintenance and building contracts together was a "bit naïve".[102] Margaret Stephens told us that these long contracts reduced flexibility and that "one of the problems with PFI has been inflexibility".[103] The NAO in their recent report said that there is still a "lack of data" on the benefits of PFI and PF2.[104] PAC have called for the Treasury to publish data about the benefits of PFI by April 2019 and set out how they will evaluate the value for money of current PF2 projects in the absence of this data.[105]

43. Both the UK Government and the Scottish Government have developed proposals to reform PFI.

- The UK Government developed PF2 which has some different features from PFI, including more transparency about equity returns on projects and the public sector retaining risks such as utilities costs and change in law.[106] The Minister said that the Government thinks "the PF2 approach provides better value for the taxpayer".[107] Earlier this year, the NAO reported that "the fundamentals of the financing structure and contract remain the same" as PFI.[108]

- The Scottish Government have also developed an alternative to PFI called the "Non-Profit Distributing" (NPD) model. It was announced in 2008. It said that this offers "significant improvements to previous PFI deals" including "greater transparency by having a public interest director serving on the board of the company delivering the project", "transfer of risk … without the excessive

97 Treasury Committee, Private Finance Initiative, Seventeenth Report of Session 2010–12, pp. 13–14
98 PWC Public Sector Research Centre, The Value of PFI; hanging in the balance (sheet)? (2008), p. 2
99 Report by the Comptroller and Auditor General, The refinancing of the Fazakerley PFI Prison contract, Session 1999–2000 , HC 584
100 Report by the Comptroller and Auditor General, PFI Refinancing Update, Session 2001–2002,HC 1288, p. 2
101 Treasury Committee, Private Finance Initiative, Seventeenth Report of Session 2010–12, HC 1146, p. 55
102 Q528
103 Q562
104 Report by the Comptroller and Auditor General, PFI and PF2, Session 2017–19, HC 718, p. 5
105 Public Accounts Committee, Private Finance Initiative, Forty-Sixth Report of the Session 2017–19, HC 894, p. 5
106 Report by the Comptroller and Auditor General, PFI and PF2, Session 2017–19, HC 718, p. 38
107 Q784
108 Report by the Comptroller and Auditor General, PFI and PF2, Session 2017–19, HC 718, p. 5

private sector profits", removing index-linking from payments relating to the construction cost and not including "soft facilities management".[109] (Soft facilities management includes services like cleaning and security and excludes building fabric maintenance.[110]) The Scottish Government in their evidence to our inquiry say that they have delivered "more than £1 billion in savings" through more efficient infrastructure spending.[111]

44. The Government originally designed mechanisms to limit the gains made by private sector investors after the refinancing of PFI schemes (Paragraph 40). The Government has recently decided to change its treatment of these gains: instead of sharing them equally with the investor, under PF2 the Government has decided to only take 30% of the gains. The NAO said that this change was made "to ensure that future projects are recorded as off-balance sheet and excluded from headline debt statistics under the new rules, even though these changes may reduce V[alue] f[or] M[oney]."[112] PAC have said that the Treasury should "revisit" this approach and should write to them before any new PF2 projects are signed to demonstrate " how the changes introduced under PF2 are not influenced by balance sheet treatment."[113]

45. **PFI financing costs more than government financing because the state can borrow at a cheaper rate than the private sector. While we are confident that PFI costs more than conventional procurement, neither we nor the National Audit Office nor the Public Accounts Committee can find any evidence of the benefits the Government claims for it. It is unacceptable that almost 30 years after the first PFI projects were initiated, the Treasury cannot produce an evidence base to support its claims that PFI is worthwhile for any reason apart from the fact that it takes debt off balance sheet.**

46. ***The Treasury and the Government should not approve any further PFI projects until they can clearly justify, based on evidence, their claims about the benefits of the scheme. It will seem bizarre to many observers that the Government has chosen to pay more than it could for £60 billion worth of projects, without evidence of any benefits from the extra cost involved in using this financing method. Ministers should be able to choose to use state finance where it is clear that private finance would bring no benefits. The Treasury should scrutinise in particular the recently approved transport projects (the A303 Stonehenge tunnel and roads and the £1.5 billion approach roads to the Lower Thames Crossing) to ensure that there is good evidence that private finance represents the best value for money in these cases.***

47. ***The Government should investigate the experience of the Scottish Government with the Non-Profit Distributing model and report back in its response to this report its view of what the UK Government can learn from the Scottish experience.***

109 LCC0033 (Scottish Government)

110 More detail can be found in International Facilities Management Association What is facilities management (2018)

111 LCC0033

112 Report by the Comptroller and Auditor General, PFI and PF2, Session 2017–19, HC 718, p. 45

113 Public Accounts Committee, Private Finance Initiative, Forty-Sixth Report of the Session 2017–19, HC 894, p. 7

48. ***The Government has previously maintained that it selected private finance only when it judged it to be value for money to do so. However both the comments of the Civil Service Chief Executive, and more importantly, recent changes to the Treasury's guidance on refinancing make clear beyond a reasonable doubt that the Government's true reason for using the Private Finance Initiative or PF2 is that the debt does not have to be shown in the National Accounts or within the national debt.***

49. ***Balance sheet treatment is not an appropriate justification for the choice of method of finance or for the terms of government contracts, especially if it means the contracts cost the Government more. We welcome the decision to clawback excessive profits from refinancing; however, it is wholly unacceptable that the Government have reduced this in order to conceal the true nature of public sector liabilities. The Government should note in their response that our recommendation follows similar arguments from both the Treasury Select Committee and the Public Accounts Committee. Without compelling evidence and justification from the Treasury, the Government should re-introduce refinancing provisions allowing 50% gain share for the public sector.***

4 The Government's approach to contracting: managing risk

The Government's power as a purchaser

50. Irrespective of whether the Government decides to increase or reduce what it buys from the private sector, it will still purchase some services or goods from the private or voluntary sector

51. In some markets, as we heard, the Government buys services in the same way as any other entity would: the Minister told us, for example, that in markets like those for business processes (such as generic accounting or human relations functions), the Government does not dominate.[114] However, in other markets the Government as a buyer does dominate. Rupert Soames, Chief Executive of Serco, described the Government, in these markets, as a "monopoly buyer".[115] Sir Amyas Morse, the Comptroller and Auditor General, said that in some markets, such as prisons, Departments "are the sole customer".[116] The Government's position as a monopoly buyer (or "monopsonist") may be ameliorated in some areas by the increasingly international nature of the market for public services.[117] In the aftermath of the collapse of Carillion, the Government asserted that it was just another customer but as a monopsonist buyer this cannot be true.[118]

52. Where the Government has this monopsony position it is, as Margaret Stephens, a former KPMG partner, told us "very influential in terms of behaviour" in the market.[119] She is not alone: the NAO has said that in these markets the Government enjoys "significant market power".[120] Where the Government has monopsony power, its approach to contracting determines the behaviour of the market. Professor Sturgess said that the current literature on contracting lacks "sufficient awareness" of the Government's dual roles in these monopsonistic markets as both the monopoly buyer and the ultimate market steward.[121]

53. ***The Government's position in some public sector markets is monopsonistic. It has huge power as the only buyer in those markets to set prices, standards of quality and to determine the behaviour of participants. The Government should recognise in its response to our report its position as a monopolistic buyer in some markets and commit to publishing a strategy which would identify what it thinks the risks that arise from this are, how it can mitigate them and what it can do to improve these markets and render them more stable.***

114 Q764 (David Lidington MP)
115 Q632
116 Q517
117 Q517 (Sir Amyas Morse)
118 Official Report, 17 January, Vol. 634, Col. 872
119 Q579
120 National Audit Office A short guide to commercial relationships (December 2017) p. 24,
121 Q424

The Government's approach to contracting

Risk Transfer

54. Ultimate responsibility for any project rests, as David Simmonds from the Local Government Association argued, with the public sector as "they are the ones with the statutory duty to do whatever it is they are procuring for".[122] Michael King, the Local Government Ombudsman, also took this view, arguing that the public sector" can outsource the service but it cannot outsource its responsibilities".[123]

55. The Government's guidance in the Green Book says that risks should be "borne by the organisation that is best placed to manage and monitor" them.[124] Sir Amyas Morse, while discussing the case flow of a typical service for vulnerable people, explained what this meant:

> if I ask you to sign a contract to take costs down and I make you responsible for the case flow under that contract, and I say, "If you don't get any more cases, you still have to deliver the same service and I am not going to up the price per case that you can charge", and I hold you to the contract and I make sure it is on very restrictive terms, I am simply making it impossible for you to be successful in the business".[125]

56. Nick Davies provided an example of successful apportionment of risk: in the Thames Tideway tunnel, the Government guaranteed that "for certain catastrophes for example, if drilling happens to flood the Underground" the Government would take the risk as the private sector could not effectively manage it.[126] This kind of catastrophic risk contrasts with risks that the private sector can manage, which Nigel Kletz, Chair of the National Advisory Group for Local Government Procurement, described as risks around "day-to-day operational delivery".[127]

57. However, despite this guidance, there is evidence that successive governments have sought to transfer risk inappropriately and that they continue to do so. Rupert Soames said that in his view "Government has started transferring unmanageable amounts of risk into the private sector".[128] Michael King told us that "all too often" local authorities try to outsource responsibility for a contract as well as operational risk.[129] Professor Sturgess wrote in his recent report that, in his own work with private contractors, risk transfer was the topic mentioned more often than any other as a matter of concern for them.[130] The NAO found that the Home Office had allocated risks to Raytheon, the IT contractor on the Eborders programme, which the company had "proved ill-placed to manage" (these included the risk that the company's designs for the programme did not meet the Department's detailed specifications).[131]

122 Q277 (David Simmonds)
123 Q277 (Michael King)
124 HM Treasury, The Green Book: Central Government guidance on appraisal and evaluation, March 2018, p. 30
125 Q520
126 Q453
127 Q278
128 Q627
129 Q277 (Michael King)
130 G. Sturgess, Just another paperclip: Rethinking the Market for Complex Public Services, Business Services Association, March 2017, p. 10
131 Comptroller and Auditor General Eborders and successor programmes (December 2015) p. 10, 34

58. Professor Sturgess wrote in 2017 that "the experience of recent years has been that procurement teams are aggressively seeking to maximise risk transfer".[132] The IfG agrees: reporting that the Government is "transferring more financial risk onto providers".[133] A recent report by the CBI finds that 37% of businesses who work with the Government felt that the "government's handling of risk had deteriorated since 2015, with almost half stating there had been no improvement during this period".[134]

59. The Government recently used innovative contractual models to do this. The NAO says that, when designing payment by results schemes, the Government needs "to understand potential providers' capacity to take on risk".[135] It is not clear that the Government have done this. For example, in the Work Programme, the Government "set initial performance expectations too high".[136] They based these expectations on the unemployment rate for the period between 2001 and 2008 even though economic conditions had since changed.[137] The Work and Pensions Select Committee described the Programme as "very ambitious" and said that they were "concerned" about the "financial viability of prime contractors" on it.[138] Similarly, in the Transforming Rehabilitation Programme, the Government's initial estimates of demand and cost proved inaccurate.[139] In 2014, over 80% of providers reported concerns about their exposure to financial risk on Payment by Results contracts.[140]

60. Sir Amyas Morse said that, where the Government uses these innovative contractual models, they should set up trials to test what risks can and cannot be transferred and how effectively such models work.[141]

61. We have found several instances where the Government has contracted with the private sector without knowing key data about the services it was asking companies to bid for. In these circumstances, the Government has asked the contractors to absorb any losses resulting from its own ignorance of the initial condition of the service. Recent examples of this include:

- In 2014, the NAO reported that, in the Compass contracts for asylum accommodation, "providers believe the information provided to them by the Department during the procurement was inadequate in some areas and has resulted in some of the difficulties now faced in running the service".[142] The NAO said that the contractors took on responsibility for the accommodation "without carrying out full inspections" and the Department had had to delay the transition to the new contracts and failed to apply its performance regime during this period.[143]

132 G. Sturgess, Just another paperclip: Rethinking the Market for Complex Public Services,Business Services Association, March 2017, pp. 10–11
133 D. Crowe, T. Gash and H. Kippin, Beyond Big Contracts, Institute for Government and Collaborate, January 2014, p. 6
134 CBI, Partnering for Prosperity: CBI/Browne Jacobson 2018 Public Procurement Survey, June 2018, p. 12
135 Comptroller and Auditor General Outcome-based payment schemes: government's use of payment by results (June 2017) p 7
136 National Audit Office The Work Programme (June 2014) p. 7
137 National Audit Office The introduction of the Work Programme (January 2012) p. 22
138 Work and Pensions Select Committee, Work Programme Providers and contracting arrangements, Fourth Report of Session 2010–12, HC 718 , p. 34
139 Ministry of Justice, Probation reform: open letter from the Secretary of State for Justice, July 2017
140 D. Crowe, T. Gash and H. Kippin, Beyond Big Contracts, Institute for Government and Collaborate, January 2014, p. 6
141 Q532
142 National Audit Office, Compass contracts for the provision of accommodation for asylum seekers, January 2014, p. 6
143 Ibid. p. 5

- The 2016–17 accounts for the National Offender Management Service revealed that "historically the costs of [prison] maintenance and services were not clearly understood … and consequently planning assumptions have not held true."[144] They admitted that consequently the contract they had let for prison maintenance was "underfunded".[145] The Minister, Rory Stewart, disclosed to the Justice Select Committee in June 2018 that the contractor's bid had been £15 million lower than the cost of doing the work.[146]
- In May 2018, the NAO reported on NHS England's contract with Capita for primary care support services. It found that NHS England "did not know enough about the services it inherited to set achievable service specifications and performance standards from the start of the contract" and that Capita "underestimated the scale and nature of the task".[147]

This is still happening. Serco recently disclosed analysis showing that, in twelve recent procurements, the Government asked participants to take on the risk that the Government had got its own data wrong.[148]

62. Transferring too much risk can be counterproductive. On the Work Programme, the Work and Pensions Select Committee found that "elements of the programme have inhibited genuine innovation in the services delivered to participants, often leading to a fairly generic set of interventions."[149] The IfG found that "providers concerned about their financial survival are generally unwilling to take on further risks by doing things differently".[150] A recent study of payment by results programmes notes that "because of the financial risk transfer to providers" these programmes have "been more likely to stifle innovation" than stimulate it.[151] This is not merely an issue with payment by results: the CBI's 2018 survey of 250 firms found that only 5% thought that current public sector procurement policies "incentivise innovation".[152]

63. **UK governments have often transferred risks to contractors that they cannot possibly manage. This is driven, in part, by the decision to use contractual models such as payment by results which involve risk transfer on a huge scale. The transfer of large amounts of risk is often counter-productive: leading to more conservative approaches to service delivery. This situation has been made worse by the fact that governments have often not understood fully the services or projects they have wanted the private sector to manage and without any understanding or data about the assets being handed over.**

144 National Offender Management Service, Annual Report and Accounts 2016–17, p. 69
145 Ibid.
146 Oral evidence taken before the Justice Committee on 26 June 2018 HC (2017–19) 483, Qq 41, 46 (Rory Stewart)
147 National Audit Office NHS England's management of the primary care support services contract with Capita (May 2018) pp. 7,9
148 Rupert Soames, Lecture to the Business Services Association (June 2018)
149 Work and Pensions Select Committee, Welfare-to-Work, Second Report of Session 2015–16, HC 363, p. 8
150 D. Crowe, T. Gash and H. Kippin, Beyond Big Contracts, Institute for Government and Collaborate, January 2014, p. 6
151 K. Albertson, C. Fox, C. O'Leary, G. Painter, K. Bailey and J. LaBarbera, Payment by results and social impact bonds: outcome based payment systems in the UK and US, February 2018
152 CBI, Partnering for Prosperity: CBI/Browne Jacobson 2018 Public Procurement Survey, June 2018, p. 14

64. ***The Government's guidance on risk transfer is sensible but too often that guidance appears to have been ignored in Departments. The Government must ensure that in the future this guidance is followed. In areas where the Government lacks information about the state of existing provision of services, it must evaluate which risks its partners are capable of taking on and which risks must remain with the Government. The Government ultimately cannot outsource the need to understand what it is outsourcing. We expect the Government to set out to us new procedures to ensure guidance about risk transfer is followed in the future. For example, contract announcements could be accompanied by a disclosure of which risks each party has agreed to manage.***

65. ***The complexity of risk management is exacerbated in some of the innovative contractual models that the Government has used recently. The Government should pause its roll-out of these models, such as payment by results, given the difficulties the Government has had in evaluating which activity leads to outcomes and working out costs. In areas where payment by results has been implemented, we believe that the Government should, if it decides to re-purchase the services, re-evaluate how it apportions risk between itself and providers. The Government should in its response to this report lay out how it would do this.***

Pricing of public sector contracts

66. The Government appears to focus unduly on cost in its contracting decisions, with a detrimental effect on service quality. The British Institute for Facilities Management complained about "a continual drive for the lowest price" on the part of the Government.[153] The National Council of Voluntary Sector Organisations said that government contracting was "primarily driven by price exclusively".[154] Sir Amyas Morse said that it was "certainly not unusual" to see Departments accepting the lowest priced bid when procuring for a service.[155] Paul Davies portrayed the Government as "pushing the lowest cost".[156] Professor Sturgess wrote that "competitive tendering [is] being actively used to drive down prices, with the fees paid for some mature contracts reduced by 25–30%".[157]

67. Government contractors are acutely aware of the focus on cost. Rupert Soames told us that "in the four and half years that I have been running Serco I know one occasion" in which Serco had won a contract despite not having the lowest bid.[158] Phil Bentley agreed that price was "pretty important" to winning bids.[159] The CBI, in a recent survey of 250 contractors, said that only 2% of them thought that service quality was the determining factor in the award of Government contracts, whereas 60% thought it was the lowest initial bid cost.[160] David Simmonds, from the Local Government Association argued, this is a "very much live issue" in social care.[161] Karl Wilding, from the NCVO, told us that

153 British Institute for Facilities Management LCC0020
154 NCVO LCC0026
155 Q525
156 Q581
157 G. Sturgess, Just another paperclip: Rethinking the Market for Complex Public Services, Business Services Association, March 2017, p. 18
158 Q647 (Rupert Soames)
159 Q649 (Phil Bentley)
160 CBI, Partnering for Prosperity: CBI/Browne Jacobson 2018 Public Procurement Survey, June 2018, p. 12
161 Q271

charities are effectively being asked by the Government to "subsidise contracts with their donated income"; on average, he said, large charities lose 11% on each contract they have with the government.[162] Consequently he told us these charities are "walking away".[163]

68. This has consequences. The Government's priority to save costs has frequently led to worse services: in the primary care support services contract, the NAO found that NHS England's assessment of contract risk "focused on the likelihood of it failing to achieve its financial savings target" and "did not adequately assess the risk of Capita failing to provide the service to a good standard".[164] Rupert Soames said that he was concerned that "technical evaluations may be fudged to allow technically poor but cheap bidders to continue in a competition, simply because the customer is desperate for the saving".[165]

69. The Government conceded that it has been overly-focussed on cost in awarding contracts. We were told that this is because it has sometimes struggled to understand the outcomes it requires. John Manzoni told us that "we have not had the sophistication internally to do much other than go for price."[166] Gareth Rhys Williams, Government Chief Commercial Officer and Non-Executive Director, Crown Commercial Service, told the Committee that "if we are not acute enough or precise enough about how we evaluate quality, such that each vendor gets eight out of ten, for example, even if the quality scores are 80% of the marks … then price is the only factor" in the procurement. He told us that "we need to get better at assessing quality factors".[167] The Minister admitted that "for too long, Governments have been suspicious of the right of companies to make a fair return on their investment".[168]

70. The Government's approach of pursuing the lowest possible cost and the highest possible risk transfer has flowed from a very transactional approach to contracting. Paul Davies said that the Government have been "very transactional in a lot of their relationships".[169] According to Mr Davies, the Government have ignored "things like robustness, commitment and long-term sustainability" in always focussing on the cheapest possible price for a particular deal.[170] John Manzoni agreed; saying the Government were trying to widen the factors that procurement teams were considering in evaluating bids.[171]

71. ***The Government's preoccupation with price has been noticed by the market and is a matter of grave concern. The Government's failure to assess the quality of services as well as their cost is lamentable. There needs to be a complete reappraisal of how the Government assesses quality of the work it commissions. This will both incentivise providers of services to focus more on quality and ensure there is less chance of providers aggressively undercutting bids deliberately with the intention of potentially renegotiating the contract later on. This is particularly important in cases of complex services for vulnerable people, where the risks and the consequences of service failure are most acute. It is no surprise that the quality and reliability of privately supplied services is so variable if the Government nearly always judges bids on price alone.***

162 Q699
163 Q699
164 Report by the Comptroller and Auditor General NHS England's management of the primary care support services contract with Capita, Session 2017–19, HC 632, p. 10
165 Rupert Soames, Lecture to the Business Services Association, June 2018
166 Q757
167 Q763
168 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
169 Q581
170 Q584
171 Q783

Renegotiating contracts

72. The Government's focus on cost and aggressive risk transfer during negotiations has led to difficulties during the operational phase of contracts. The Government has responded to this in some cases by forgoing performance penalties that were available to it. For example, in the Compass contracts for asylum seekers' accommodation, the Home Office did not apply performance penalties to contractors during its transition phase, because, as they told PAC, they were engaged in "commercial discussions" with their contractors about the failure to provide them with adequate information.[172]

73. The Government has also renegotiated the terms of some contracts. In July 2017, David Lidington MP, who was then Secretary of State for Justice and Lord Chancellor wrote an open letter confirming that "we have adjusted the CRCs' contracts to reflect more accurately the cost of providing critical frontline services".[173] The Justice Select Committee in their report in June 2018 criticised what they described as the "constant renegotiation" of the Transforming Rehabilitation contracts and said that the changes the Ministry made raised "serious questions" about the Ministry's capacity to let contracts.[174]

74. Transforming Rehabilitation is not the only example of a programme in which the Government has had to renegotiate contracts. The Government has written to the Committee saying that, since 2016, there have been 12 contracts worth more than £10 million each which have been altered in this way.[175] Peter Smith, a former Government procurement director, has written about the potential legal dangers that this may expose the Government to, as UK and EU regulations on contracting are "pretty prescriptive when it comes to changing major contracts post-award".[176] Presumably, such renegotiations involve additional costs to the public sector for legal and other work.

75. **The Government's decision to revise the terms of some contracts underlines the failure of contracting within government. We agree with the Justice Select Committee that these renegotiations point to underlying issues with the capacity of the Government to successfully let contracts. Renegotiation often reflects poor risk allocation and poor information about the original service that was contracted out. The Government is also potentially exposed to legal risk through doing this. We have not received evidence about the costs of bringing in these changes but presume they are substantial. While it may be unavoidable that the Government has to re-negotiate some contracts to ensure services continue to function, the fact that it has had to renegotiate over £120 million of contracts in the last two and a half years is an indictment of its initial negotiating approach.**

172 Report by the Comptroller and Auditor General COMPASS contracts for the provision of accommodation for asylum seekers, Session 2013–14, HC 880 p. 23. Public Accounts Committee, COMPASS: provision of asylum accommodation, Forty-fifth Report of Session 2013–14, HC 1000, p. 11

173 Ministry of Justice, Probation reform: open letter from the Secretary of State for Justice, July 2017

174 Justice Select Committee, Transforming Rehabilitation, Ninth Report of Session 2017–19, HC 482, p. 3

175 Rt Hon David Lidington MP Chancellor of the Duchy of Lancaster and Minister for the Cabinet Office to Bernard Jenkin 29 May 2018

176 Peter Smith, Are Top UK Civil Servants Breaking The (Procurement) Law? Yes, According to PACAC Committee Evidence, Spend Matters, May 2018

76. ***In each case where the Government has had to renegotiate a contract because its initial assumptions about cost, risk transfer or contractual structure have proved incorrect, we believe the Government should undertake a lessons learned exercise to identify what went wrong. The lessons identified in this exercise should be shared with the Comptroller and Auditor General and his officials to decide whether there are any issues to report to Parliament.***

5 The effect of Government monopsony on the private sector

The health of private sector contractors

77. The failure of Carillion did not exclusively arise from its public sector business. However, while we do not have information to suggest that any of the other major outsourcing firms are currently at risk of failure, many of them have had to make announcements of restructuring to the stock exchange:

- In 2014, Serco "issued a number of profit warnings, culminating in making provisions for losses and write-downs of £1.3bn, equivalent to 20 years of accumulated profits". Serco says that "had banks not agreed to give us time to raise extra capital," they "would have gone bust."[177]
- In 2016 and 2017, Mitie published several profit warnings and downgrades to their balance sheet.[178]
- Announcing Interserve's 2017 results, Glyn Barker, its Chairman, said that the company was affected by "unprecedented levels of disruption and faced a number of significant challenges" in 2017 and described its financial performance as "extremely poor".[179]
- On 31 January 2018, Capita announced a £700 million rights issue and a series of other measures designed to "to strengthen the balance sheet".[180]

78. These difficulties flow, in part, from the way that the Government has contracted out. Karl Wilding spoke about similar issues in the charitable sector and said that "the risks to the charities and therefore to the system here come from, again, the style of procurement".[181] Nick Davies argued that in some cases companies pursued a strategy of "land and expand", where the company wins a "contract that might not be particularly profitable" and then negotiates changes.[182]

79. Private sector companies can also respond to low margins via expansion. According to Sir Amyas Morse, contractors get into a "hamster wheel effect" "where you are always taking on new contracts".[183] He argued that these contractors, faced with declining margins, report profits as they recognise the "initial profit" when they successfully tender for a contract and then just keep reporting new profits after new contract wins.[184] Sir Amyas said that companies on this hamster wheel "don't see … whether the underlying profitability of these contracts really justifies … [their] business."[185] These companies, as Professor Haslam has said, relied upon extra contracts not only to drive reported profits

177 Serco LCC0022
178 Mitie Trading Update (September 2016), Mitie Trading Update (January 2017), Mitie Trading Update (May 2017)
179 Glyn Barker Chairman's statement (April 2018)
180 Capita, Update on Capita's transformation, capital structure, funding and trading outlook, January 2018
181 Q704
182 Q465 (Nick Davies)
183 Q7 Liaison Committee 7 February 2018
184 Q7 Liaison Committee 7 February 2018
185 Q7 Liaison Committee 7 February 2018

but also acquisitions which "supercharged growth in revenues".[186] In Carillion's case, the House of Commons Library said that Carillion had followed this model and had been "£845 million too optimistic about its contracts".[187]

80. These companies were driven by their need to generate returns for shareholders and business growth. The House of Commons Library said in its report on the collapse of Carillion that the firm had "paid out £333 million more in dividends than it generated in cash from its operations in the five and a half year period from January 2012 to June 2017."[188] Both Professor Haslam, Dr. Tsitsianis and Professor Leaver argue in their submissions that some of these companies have used "financial engineering" to create returns for shareholders.[189]

81. Professor Haslam and Dr Tsitsianis also argued that this led to these companies taking on more onerous contracts and holding more goodwill on their balance sheets than most companies.[190] Carillion's treatment of goodwill (the difference between the purchase price of a company and the value of its net assets) has been criticised. The joint report by the BEIS and Work and Pensions Committees said that Carillion had "propped up its balance sheet" using goodwill.[191]

82. The Government agreed that recently "all the household names" in the sector had struggled and had "in the last year or two changed their management, changed their strategies" in response.[192]

83. Some of our witnesses argued that these poor results were due to poor management or to the sectors that contractors were involved in. Phil Bentley of Mitie told us that Carillion's problems were due to their construction contracts.[193] Mr Bentley also argued that "it is up to us" as contractors to work out whether a specific contract was affordable or not.[194] Paul Davies asked us why the Government "would do it any better than the private sector when you already have credit analysts and lenders and so on" analysing whether companies like Carillion will collapse.[195] The Government argued that the Boards concerned were responsible for their companies: the Minister said that "we are not directors of those companies; we are important customers of those companies."[196]

186 Professor Haslam and Dr Nick Tsitsianis LCC0029
187 House of Commons Library Briefing Paper Number 8206, The Collapse of Carillion, March 2018, p. 18
188 Ibid. p. 19
189 Professor Haslam and Dr Nick Tsitsianis LCC0029, (Professor Leaver) LCC0043
190 Goodwill is an accounting estimate on the value acquired by a firm when purchasing another firm over and above the value of the assets acquired. Professor Haslam and Dr Nick Tsitsianis LCC0029
191 Business, Energy and Industrial Strategy and Work and Pensions Committees Second Joint report of Session 2017–19, Tenth Report of the Business, Energy and Industrial Strategy Committee of Session 2017–19 and Twelfth Report of the Work and Pensions Committee of Session 2017–19, Carillion, HC 679, p. 13. J. Ford 'Carillion's troubles were shrouded in a fog of goodwill' Financial Times, 18 June 2018
192 Q757
193 Q633
194 Q640
195 Q606
196 Q807

84. Despite this, witnesses suggested that the Government could have done more to protect itself through better due diligence on the balance sheets of its contractors, especially in the contest of the new contracts awarded to Carillion. Professor Haslam suggested that the Government needed to conduct much more sophisticated due diligence of the providers that it was engaged with.[197] Sir Amyas Morse agreed that the Government should do more stress testing on its suppliers.[198] Sir Amyas Morse said that when contracting and, especially, transferring risk, "the credibility of the counterparty really matters."[199] Professor Leaver suggested in particular that the Government should assess the amount of goodwill held by suppliers on their balance sheet compared to their net asset position.[200]

85. The Cabinet Office told us in correspondence that their current due diligence for contractors differed depending on the size of the contract. On smaller contracts the tests would be "limited to a turnover test and a test of ratios to determine solvency".[201] On larger contracts, the contracting authorities will "draw up more complex tests that require better data and more sophisticated analysis". On the HS2 contract, the Cabinet Office told us that HS2 Ltd applied" quite detailed tests on the financial capability of Carillion" which included tests of their "turnover, net assets, liquidity, gearing and interest cover" and they "reviewed Carillion's Dun & Bradstreet Failure Score".[202]

86. **Some of the Government's contractors developed unsustainable business models over recent years, underbidding for contracts, recklessly acquiring other businesses and maintaining high bonuses and dividends. For example, Carillion's balance sheet, before its failure, was propped up with high risk construction contracts and high valuations of goodwill, arising from overpayments for acquisitions. The directors and shareholders of the companies involved are responsible for this. Share prices, buy, hold or sell recommendations and public statements are a poor guide to the long term security of companies. Shareholders can accept higher risks for an equity rate of return and can exit at short notice. Government is in for the long term and cannot take such risks with public money or with the security of public services. The Government as the major customer of these firms is responsible for the services they supply and consequently needs to ensure that its contractors are able to deliver those services sustainably. As Ministers are accountable for the resilience of services, they cannot be blind to the risks that the companies delivering those services hold.**

87. ***The Government should improve its due diligence processes to understand the resilience of the cashflow and financial position of its partners. In 2017, the Government still awarded contracts to Carillion despite the weakness of the company's balance sheet on the basis of "quite detailed tests on the financial capability of Carillion". The Government should urgently review its due diligence procedures on the contracts awarded to Carillion. The Government should commit to announcing its findings from this review in its response to this report.***

197 Q473
198 Q551
199 Q551
200 LCC0043 (Professor Leaver)
201 Rt Hon David Lidington MP Chancellor of the Duchy of Lancaster and Minister for the Cabinet Office to Bernard Jenkin 29 May 2018
202 Rt Hon David Lidington MP Chancellor of the Duchy of Lancaster and Minister for the Cabinet Office to Bernard Jenkin 29 May 2018

Competition and contestability

88. In conjunction with this trend towards more aggressive strategies which led to companies facing difficulties, there has been more and more concentration in some public service markets. The Minister told us that in some markets, for what he described as "the provision of complex public services" there was significant concentration, as the top five suppliers have nearly "60% of the market by value".[203] However, he also argued that there were markets for facilities management, construction and business processes (such as accounts or pensions administration) where the market is less concentrated.[204] Phil Bentley, CEO of Mitie, agreed with the Minister: he said that the government's facilities management contracts had the "least concentration" he had ever seen in a market.[205]

89. Other witnesses to our inquiry agreed with the Minister that some markets for government contracts were too concentrated. Paul Davies said that "concentration is an issue" in the market.[206] Reform, a think tank, said that the "supply side is concentrated and becoming increasingly concentrated".[207] Sir Amyas Morse, the Comptroller and Auditor General, argued that "there has been an unhappy tendency for market concentration to happen and I do not think that the Government have done very much to prevent it".[208] Matt Dykes from the TUC said "we have seen market concentration reducing choice and contestability".[209] While Rupert Soames of Serco disagreed that there was concentration in the entire government services market, he acknowledged that "if you get particular specialisms like prisons … you can get narrow individual markets".[210]

90. The Minister agreed with these concerns about the concentration of some public sector markets. However, he cautioned that "getting in new big contenders for that particular market in complex public services is not straightforward because you need companies that have the administrative financial capacity to provide services of that character".[211]

91. However, this point was challenged in our evidence. Professor Sturgess argued that it was not competition but contestability ("the credible threat of competition") which "seems to make the difference".[212] He argued that "as long as the barriers to entry are low and there is a credible threat of competition, the monopolists will act in a competitive manner."[213] As Chris Ham stated "the stimulus to improve performance… exists when providers know that purchasers have alternative options" even if they do not immediately exercise them.[214] The Australian Productivity Commission argued that in situations where you have long or medium term contracts the real impetus to reform comes from what they described as "periodic contestation".[215] Domberger and Jensen (University of Sydney) argue that contestability should ensure that even natural monopolies "need not result in

203 Q750
204 Q750
205 Q627
206 Q577
207 LCC0006
208 Q503
209 Q684 (Matt Dykes)
210 Q626
211 Q751
212 Q394
213 Q417
214 Chris Ham, Contestability: a middle path for healthcare, British Medical Journal, Vol. 312 (January 1996)
215 Australian Productivity Commission, Introducing Competition and Informed User Choice into Human services: reforms to human services, No. 85, October 2017, p. 24

losses of economic efficiency".[216] Therefore Professor Sturgess argued the Government should be less concerned about the number of participants in each market, than about the barriers of entry to new entrants.

92. Barriers to entry however do appear to exist in public sector markets. Small and medium sized enterprises (SMEs) have difficulties in gaining in government contracts. The Government "reckon that about a quarter of all Government expenditure with third parties goes to SMEs either directly or indirectly", this includes spending which goes through large companies who buy from SMEs.[217] Reform told us that "government does not have the expertise to procure and manage contracts with SMEs" and describe onerous bidding processes involving hundreds of meetings and documents.[218] Competitions exist in which bidding processes take over 18 months and require the equivalent of 12 A4 boxes of information.[219] 89 per cent of firms working with the public sector, according to the Federation of Small Businesses, received late payments of bills.[220] The Federation also argues that small businesses struggle to get accepted onto Government framework contracts.[221] The British Institute for Facilities Management linked concerns about price and risk transfer had both "deterred businesses, both large and small, from bidding".[222]

93. The Government are committed to "lively, innovative and dynamic markets".[223] The Minister argues that the Government will "maximise the number of alternative suppliers" through "requiring" Departments to follow a "playbook of guidelines, rules and principles that will encourage new entrants to the market."[224] In particular, the Minister committed the Government to remove barriers to entry for small businesses.[225]

94. **There is widespread agreement that contestability (the credible threat of competition) is important in order to support an efficient market for public sector services. Contestability motivates firms to improve services and cut costs and motivates the public sector itself in the same way. The combination of limited competition and high barriers to entry generates worse outcomes however for the Government.**

95. ***The Government needs to ensure that the market for Government contracts remains contestable from within the public sector, from existing companies and new entrants. We welcome the Minister's commitments in this area and we await to see in the Government's response details on its new measures to increase small and medium sized enterprises' participation in the market.***

216 S. Domberger and P. Jensen, Contracting out by the public sector: theory evidence and prospects, Oxford Review of Economic Policy, Vol. 13, Issue 4, December 1997, p. 69
217 Q753
218 Reform LCC0006
219 Public Accounts Committee, Contracting out public services to the private sector Forty seventh report of the Session, Forty-seventh Report of Session 2013–14, HC 777, p. 9
220 Federation of Small Businesses, Nine out of ten public sector suppliers hit by late payments, April 2018
221 A framework agreement is an arrangement made with providers that sets out terms and conditions for specific purchases, which can be made through the term of the agreement Federation of Small Businesses, UNSTACKING THE DECK: BALANCING THE PUBLIC PROCUREMENT ODDS p. 5
222 LCC0020
223 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform (June 2018)
224 Ibid
225 Ibid

96. ***The Government should test the thesis that less competition (as opposed to contestability) also undermines outcomes for the public sector. This reflects a widely held consensus but it would be useful for the Government to commit in its response to commission further research. The Government should outline in its response to our report the detail behind the Minister's commitment to a new playbook of guidelines, rules and principles.***

Instability in Large Contractors and the case of Carillion

97. The capital structure of many of the large companies involved in public sector services means that it was increasingly likely a company would fail. The increased concentration in the market meant that when a company did fail, it was more likely that it would have a major impact. Companies in this case may become too big to fail. There have been recent cases in the public sector where this has been a reality: in 2016, Learndirect received an adverse Ofsted report; whereas the Department for Education would normally have cancelled the company's contract, in this case it did not. PAC speculated after these events as to whether this suggested that Learndirect Ltd was "too big, and too important to government to be allowed to fail".[226]

98. The NAO in 2015 published guidance to Departments about the failure of providers of public services. They suggested that Departments should develop contingency plans for failure.[227] Our predecessor Committee made similar points after the collapse of the charity, Kid's Company, when we argued that contingency plans should be prepared to protect vulnerable users in the event of a failure.[228]

99. The Government has argued that Carillion's collapse was not entirely due to their UK government contracts. The Minister told us that Carillion's difficulties "arose out of some construction contracts" and involved "overseas clients".[229] Overall Carillion's margin on public sector work was 1.4 per cent in 2017.[230] The Minister is correct that Carillion's business spanned the private and public sector: according to its accounts, the UK public sector accounted for 33 per cent of its global income and 46 per cent of its UK income in 2016.[231] However, as we noted above, Carillion's business model made it very vulnerable to a few contracts becoming unprofitable and undermining the entire business (Paragraphs 79 to 81).

226 Public Accounts Committee, The monitoring, inspection and funding of Learndirect Ltd, Twenty-Second Report of Session 2017–19, HC 646, p. 3

227 Report by the Comptroller and Auditor General, Principles Paper: Managing provider failure, Session 2015–16, HC 89, p. 15

228 Public Administration and Constitutional Affairs Committee, The collapse of Kids Company: lessons for charity trustees, professional firms, the Charity Commission, and Whitehall, Fourth Report of Session 2015–16, HC 433, p. 43

229 Q764

230 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–9, HC 1002, p. 7

231 Ibid. p 16

100. The Government was initially surprised by the profits warning made by Carillion in July 2017.[232] PAC published papers which suggest that the Government "was not aware of Carillion's financial distress" until its July profits warning.[233] This is despite the fact that some investors were cautious about Carillion from 2015. Euan Stirling, Global Head of Stewardship and ESG Investing, Aberdeen Standard Investments, told the BEIS and DWP joint committee that Carillion's "debt levels that were growing every year and every half-year as the company failed to convert its profitability into cash flow".[234] Other investors however found Carillion's profit warning in July 2017 "surprising".[235]

101. From July 2017, the Cabinet Office began preparing contingency plans for the Government. This process was complete for central government in January 2018, though the Cabinet Office was "still seeking information on schools and local authorities" at the point that Carillion went into liquidation.[236] These difficulties were apparent to the company. Keith Cochrane, the former Chief Executive of Carillion, said that the Cabinet Office "expressed their frustration to us on occasion" about their communication with other parts of the Government and found "it quite challenging" to pull together a single public sector contingency plan.[237]

102. In January 2018, the Government took the decision not to supply Carillion with emergency liquidity. Sir Philip Green, the Chair of Carillion at the time, said that he was "deeply disappointed" and "surprised" by the Government's decision as, in his view, "this was a business capable of making cashback profits in the medium term."[238] Carillion asked for a total of £223 million support for a period from January to April 2018, including £160 million of direct support from the Government and the deferral of £63 million of Carillion's tax liabilities.[239]

103. The Government decided not to provide this support. The Cabinet Office were pessimistic about Carillion's plans for the future and believed the company might ask for further funding in the future.[240] They performed an options analysis exercise which "concluded that a trading liquidation was the preferred option" as it "met the Government's objectives" to maintain services, minimise disruption, maintain job security, minimise cost and avoid setting a precedent.[241] The Government argued that it was "right not to reward failure" and that Carillion's "directors, shareholders and lenders… should bear the brunt of the losses".[242]

232 Ibid. p. 7
233 Public Accounts Committee, Forty-first Report of Session 2017–19, Government risk assessments relating to Carillion, HC 1045
234 DWP BEIS Joint Inquiry Q998
235 DWP BEIS Joint Inquiry Q1026
236 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–9, HC 1002, p. 31
237 Q112
238 Q116
239 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–9, HC 1002, p. 37
240 Ibid. p. 44
241 A trading liquidation involved insolvency proceedings starting but with the Insolvency Service funded to continue public services. Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–9, HC 1002, pp. 41–3
242 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018

104. At this point, the Government's contingency plans came into operation. The Minister argued that the Cabinet Office at this point faced "one of the biggest challenges that it has probably ever confronted".[243] The collapse of Carillion, according to him, represented "a huge risk to some of our core public services".[244]

105. The Minister said that "the contingency planning for the most part did work effectively" and "there was no interruption in the provision of key Government services".[245] The Local Government Association told us in their experience that services had continued on the ground.[246] Sir Amyas Morse pointed out that in many cases the partnership structures the Government had designed "worked rather well".[247] The NAO believe that the net costs of the liquidation of Carillion to the Cabinet Office will be £148 million (the cost to the public sector as a whole will be "slightly higher").[248]

106. As some failure of suppliers is inevitable, we have heard suggestions about how the Government's approach to failure might be improved after Carillion. Sir Amyas Morse said that the Government should "have more open discussions with bidding contractors about scenario planning and what would happen in certain scenarios".[249] Rupert Soames, CEO of Serco, and Matt Dykes from the Trade Union Congress both supported "living wills" (meaning a document setting out clearly what would happen in the event of a company failing).[250]

107. Contractors can and have withdrawn in the past from contracts in situations where they themselves did not go bankrupt. For example, on the Department for Work and Pensions troubled providers threatened to pull out in December 2012.[251]

108. John Manzoni told us that the Government also could see the point of ensuring that suppliers had contingency plans to ensure services would continue.[252] The Minister told us that the Government was pursuing its own review of its work with Carillion during its collapse to identify lessons for the future.[253] In a speech in June 2018 the Minister said that the Government would "require all key suppliers to develop what are known as 'living wills'".[254]

109. **The Government made the right decision to let Carillion fail. The Government lacked confidence in the plans put forward by the company's management. The cost of funding the company would have been higher than the costs of the liquidation. It is notable that the shareholders and financers of Carillion have lost money through the failure of the company. We agree with the Minister that this is appropriate as it sends a signal that ultimate responsibility for Carillion rested with its management, shareholders and financers.**

243 Ibid
244 Ibid
245 Q767
246 Q322
247 Q548
248 Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–9, HC 1002, p. 48
249 Q550
250 Q675 (Rupert Soames), Q726 (Matt Dykes)
251 Report by the Comptroller and Auditor General, Programmes to help families facing multiple challenges, Session 2013–14, HC 878, p. 8
252 Q809
253 Q751
254 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018

110. **The failure of Carillion could have resulted in the collapse of public services. It did not. The Cabinet Office and the Government ensured through contingency plans worked on between July and January that they could cope with the liquidation. The Government deserves credit for ensuring that, in January 2018, services mostly continued. The Government were right to prioritise the interests of the public who use those public services.**

111. ***The Minister for the Cabinet Office has announced a review of how the Cabinet Office responded to the Carillion crisis. That review should take note of the weaknesses in the Government's approach. These include the Government's surprise that Carillion issued a profits warning in July 2017, when some investors had been warning about the state of the company for years.***

112. ***The Cabinet Office should ensure that it holds appropriate information about the contracts held by each of its strategic suppliers and aggregate the risk exposure from across the whole of Government to large contractors like Capita and Serco. We understand that the Public Accounts Committee will be reporting on this issue shortly and we await their recommendations with interest. The Cabinet Office should also ensure that it learns lessons from this crisis about how to quickly collaborate with local government to deal with the issues raised by a collapse such as Carillion.***

113. ***We welcome the Minister's commitment to bring forward proposals for living wills with each key strategic supplier. The Government should lay out in their response to this report what these living wills will contain. The Government should clarify whether these wills would only apply when a contractor goes bankrupt, or whether they would also apply when a contractor withdraws effectively from a contract. The Government should set out measures to ensure that the public knows that these living wills are agreed: so that users of services can have confidence in their resilience despite what may or may not happen to particular companies.***

6 The Capability of the UK civil service

Commercial capability

114. Numerous reviews of the Contractual Function within the UK Civil Service have identified weaknesses around capability. In 2014, an internal Cabinet Office review of the management of 73 contracts found that, for 40 of them, the contract management team was not appropriately staffed.[255] This lack of capability has led in the past to disasters such as the failure of the Ministry of Justice to appropriately scrutinise the contractors involved in the electronic monitoring contracts. The Ministry later discovered that it was "being charged in ways not justified by the contracts and for people who were not in fact being monitored."[256] More recently, in October 2017, the NAO reported that as of August 2017, the Ministry of Defence had 386 unfilled commercial posts—24 per cent of the total number of commercial posts in the department.[257]

115. The Government decided to change. In recent years, there has been an increasing focus on recruiting individuals with commercial skills into the Civil Service. It is an area where increasing capacity has been a priority.[258] John Manzoni told us that the Government is having to reconsider both remuneration and career structures to ensure that they recruit and retain the right skills and capabilities.[259] In 2015, Bill Crothers, the former Civil Service Chief Commercial Officer, told the Public Administration Select Committee that this improvement in capability should lead to "fewer contractual failures".[260] Recently, the Minister recommitted to this objective: saying that all 30,000 civil servants involved in managing contracts across Whitehall would receive "high quality training".[261]

116. Wider attempts to reform the civil service included developing cross-departmental Functions, including a Commercial Function. We have addressed these Functions in more detail in our report on Civil Service effectiveness, published in June this year.[262] The IfG commented that they thought the reforms were "focussed on the right issues" though.[263] Gareth Rhys Williams told us that at the time of our hearing in May 2018 that central Government had 4,000 commercial posts, of which about 300 were empty: a proportion he described as "not bad".[264]

255 Report by the Comptroller and Auditor General, Transforming Contract Management, Session 2014–15, HC 269, p. 7
256 Official Report, 11 July 2013, Col. 574
257 Report by the Comptroller and Auditor General, Improving value for money in non-competitive procurement of defence equipment, Session 2017–19, HC 412, p. 4
258 See Civil Service Civil Service Workforce Plan 2016–20
259 Q792
260 Public Administration Select Committee, Developing Civil Service Skills: a unified approach, Fourth Report of Session 2014–15, HC 112, p. 10
261 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
262 Public Administration and Constitutional Affairs Committee, The Minister and the Official: The Fulcrum of Whitehall Effectiveness, Fifth Report of 2017–19, HC 497, paras 81–93
263 T. Gash, Government must not ease up on efforts to improve contract management (Institute for Government Blog)_ February 2017
264 Q794

117. This picture of improvement was supported by other witnesses to our inquiry. The CBI said that improvements in central Government commercial capability since 2010 were "widely felt" by businesses.[265] Rupert Soames of Serco described the Crown Commercial Service as "much better" than its predecessors.[266] Sir Amyas Morse told us that he thought that the Government's commercial capability "has got stronger", although he warned that he still believed they were at a permanent disadvantage because "the private sector can always pay for and amass more expertise in some areas than the public sector has".[267]

118. Witnesses from the Government told us that their rescue of the services run by Carillion would have been impossible without this increase in capacity. John Manzoni highlighted the contribution of the strategic suppliers programme, whereby the Government paid particular attention to its most important suppliers. Mr Manzoni said that that "had we had this situation a couple of years ago, I think the outcome would have been significantly different and probably significantly worse for the public sector than it is today."[268]

119. There are some discordant voices. The Global Sourcing Association reflected this caution, warning of the consequences of churn in central government procurement positions.[269] Rupert Soames and Phil Bentley agreed that, despite efforts to build capacity across government, commercial capability varied between departments with some weaker than others.[270] Commercial functions have suffered like the rest of the civil service from the effects of churn: the NAO noted in the Home Office in 2014 that there was "insufficient continuity of staff" over the lifetime of contracts.[271] The NAO recently reported that the Government's use of central buying through the Crown Commercial Service, by January 2017, yet to prove a success and that major strategic concerns remained about the service.[272]

120. Professor Sturgess said that while the Government may have "improved" at procurement, there were other skills involved in successfully engaging with the private sector.[273] He mentioned that he thought the Government lacked expertise both in "system design" and expertise in the "stewardship" of its supply chain.[274] The integration of commercial capability alongside other specialisms within departments has also been criticised: for example, in the new generation of electronic monitoring contracts, the NAO found that "unhelpful disunity between operational, technical, commercial and programme staff".[275] Nick Davies agreed: suggesting that some departments like the Department for Education had tried to start understanding their supply chain, but that "other departments should be doing that type of thing much more often".[276]

265 Q359
266 Q665
267 Q533
268 Civil Service Effectiveness Oral Session Q376
269 Qq362–3
270 Qq 663–4
271 Report by the Comptroller and Auditor General, Transforming contract management, Session 2014–15, p. 54. Public Administration and Constitutional Affairs Committee, The Minister and the Official: The Fulcrum of Whitehall Effectiveness, Fifth Report of 2017–19, HC 497, pp. 20–24
272 Report by the Comptroller and Auditor General, Crown Commercial Service, Session 2016–17, HC 786, pp. 9–13
273 Q431 (Professor Sturgess)
274 Q431 (Professor Sturgess)
275 Report by the Comptroller and Auditor General, The new generation electronic monitoring programme Session 2017–19, HC 242, p. 9
276 Q431 (Nick Davies)

121. Although the Government has improved its ability to contract and commercially manage contracts, this may have enhanced its ability to reduce payments to contractors and force the private sector to accept more risks. For example, the procurement of support services for primary care was "supported by commercial experts in the Cabinet Office and subject to reviews by the Major Projects Authority".[277] Despite this, as we noted above (Paragraph 60), the Government let a contract where it did not know enough about "achievable service specifications and performance standards".

122. As the Public Administration Committee recommended in 2015, commercial training needs to be supplemented with skills in risk management. They noted then that they had "heard warnings about a lack of focus on risk management" and referred to issues suppliers to the Government faced as a consequence.[278]

123. The Minister in his reform speech says that it is a "duty of both government and industry alike to restore, repair and rebuild that trust between us."[279] He said that he wanted to "put values at the heart of our public services".[280] Karl Wilding told us that when commissioning the charitable sector works well, there is an "alignment of values" between the charitable and public sector.[281] The Minister referred in his speech to the "Supplier Code of Conduct", which sets out "the standards and behaviours that are expected of our suppliers".[282] Serco also have called for a code of conduct: but they argue that this should "set out expected standards of behaviour from Government and its contractors".[283]

124. **The Cabinet Office has invested significantly in commercial capability over the last few years. Outside observers have said that, since that investment, the quality of the Government's commercial management has improved, albeit from a low base. We look forward to the recommendations of the Public Accounts Committee about the future development of the Crown Commercial Service and the Government's commercial capability. We welcome the Government's decision to invest in this area but we remain concerned.**

125. ***The Government must continue its efforts to improve its commercial capability. Currently, this capability is unevenly distributed among departments. The Government also needs to take care that it does not, through having better negotiating capability, merely drive harder bargains with the private sector based on unrealistic estimates of service quality and cost. The Government needs to move beyond such a transactional approach and develop its understanding of the market and its partners in delivering public services. The Government and its contracting partners should share and express the same values. The Government should set out in its response to this Report its future vision for commercial capability, including measures to encourage collaboration within the public sector and verified trust between the Government and its providers. This should include a new code of conduct which would apply to both Government and suppliers and set out expectations of behaviour and shared values.***

277 Report by the Comptroller and Auditor General, NHS England's management of the primary care support services contract with Capita, Session 2017–19, HC 632p. 16
278 Public Administration Select Committee Developing Civil Service Skills a unified approach Fourth Report of Session 2014–15, HC 112, p. 6
279 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
280 Ibid.
281 Q706
282 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
283 LCC0022 Serco

126. ***The Government needs to improve, as our predecessor Committee suggested, its understanding both of risk transfer and of costing Commercial skills cannot be seen in isolation from other skills. We believe that it is vital that staff with commercial skills work alongside staff with other skills such as costing, project management, IT and financial planning in letting contracts. They should also work alongside staff with deep subject knowledge and expertise. In its response, the Government should set out its plans to integrate together teams which have IT, project management, costing, financial planning and commercial skills and possess deep knowledge and expertise.***

Information, Transparency and Accountability

127. The Government's information about contracts and their performance has also been criticised in recent years. The IfG said recently that "there is no centrally collected data outlining the scope, cost and quality of contracted public services across government".[284] The Government itself has admitted that it has a problem with the data it holds about contracts. Liam Maxwell, the Government's National Technological Advisor, has said that "we need to find our way of analysing that [procurement spending] effectively, so we can see where we are spending our money and how we are spending our money. We haven't systematically done that."[285] The NAO estimated in 2015 that only 31 per cent of government contracts had open book clauses allowing the Government access to the provider's information about a service.[286] In some cases, the Government relied on contractor information about performance without any verification.[287]

128. These problems with data are not confined to the data held within the contract. As our predecessor Committee's report, *Accounting for Democracy: Making Sure Parliament, the People and Ministers Know How and Why Public Money is Spent*, made clear, the Government often lacks data about the services it provides, including cost and performance data.[288] This has an obvious impact on the Government's ability to buy in some of these services, as it does not often know how much they cost or what reasonable performance should look like.

129. Alongside more data, we heard calls for more transparency about contractual data. The IfG have said that "in truth, it's currently impossible to find out precisely how well contractors delivering government services perform".[289] They say that "while some contract data is published" there are still "gaps in transparency".[290] The Information Commissioner argued that the Government needs to modernise the Freedom of Information Act to restore "the public's right to know irrespective of whether the service is delivered by public,

284 G. Freeguard, L. Campbell, A. Cheung, A. Lilly and Charlotte Baker Whitehall Monitor 2018 The General Election, Brexit and beyond, Institute for Government (January 2018) p. 69

285 Derek du Preez, Liam Maxwell explains rationale behind DCMS taking data control away from GDS Diginomica, April 2018

286 Report by the Comptroller and Auditor General, Open-book accounting and supply-chain assurance Session 2015–16, HC 91-I, p. 7

287 Report by the Comptroller and Auditor General, Transforming Contract Management, Session 2014–15, HC 268, p. 42

288 Public Administration and Constitutional Affairs Committee Accounting for Democracy: making sure Parliament, the people and Ministers know how and why Government money is spent, Fourteenth Report of Session 2016–17, HC 95, pp. 46–7, 51–2

289 Tom Gash, Outsourcing problems at the Ministry of Justice, Institute for Government blog, August 2017

290 G. Freeguard, L. Campbell, A. Cheung, A. Lilly and Charlotte Baker, Whitehall Monitor 2018 The General Election, Brexit and beyond, Institute for Government, January 2018, p. 69

private or third sector organisations."[291] Representatives of the private sector that we heard from were willing to commit to publishing information about contracts. Serco has called for performance information for contracts to be published by the contracting authority.[292] The CBI said that there was little if any information that companies would be unwilling to disclose and that, in their experience, it was public sector authorities rather than private sector companies who obstructed publication.[293] In January 2018, the Business Services Association wrote to David Lidington and said that the industry was open to "a reworking and agreement of what is meant by commercially confidential".[294]

130. Gareth Rhys Williams agreed that this was an area that there is "more we can do".[295] Mr Rhys Williams told us that "in many cases … [publication of the key performance indicators on contracts] would be quite helpful", would "focus the mind of the contracting authority on what is the outcome they are most desirous of" and "would allow us to hold these vendors to account more publicly".[296] In his speech to Reform, the Minister said that the Government would require "a number of key performance indicators to be published".[297] However, the Government did raise concerns about the abilities of small contractors to comply with increased Freedom of Information or other transparency responsibilities.[298]

131. The Government needs to understand the experience of service users on the ground as well as contractual data about them. The NAO reported in 2014 that there were contracts in which "users of contracted services reported that their experience was less favourable than the departments' assessment of contractor performance".[299] The Local Government Ombudsman told us that it found issues in which "individual complaints may point to wider problems in the delivery of a service that has been outsourced".[300]

132. The Ombudsman reported confusion in local services about who complaints should go to and suggested reform that "seeks to enshrine in our legislation an overarching principle that users of all publicly funded local services should have the right to access an independent ombudsman service".[301]

133. **The Government can only let and manage contracts successfully if it has the right data. The Government admits that it needs to improve its internal data. We are concerned by the fact that the Government has not systematically analysed where and how it spends taxpayers' money on procurement. This includes data not only about current contracts but also about areas that the Government wishes to purchase in the future. We welcome the Government's commitment to improving its data about contracts.**

291 LCC0009 (Information Commissioner)
292 LCC0022 (Serco)
293 Q377
294 Open Letter from Business Services Association to David Lidington, 26 January 2018
295 Q798
296 Q802
297 David Lidington, Chancellor of the Duchy of Lancaster speech to Reform, June 2018
298 Q800
299 Report by the Comptroller and Auditor General, Transforming contract management, Session 2014–15, HC 268, p. 20
300 LCC0008 (Local Government Ombudsman)
301 LCC0008 (Local Government Ombudsman)

134. **We welcome the Government's intention to publish a number of key performance indicators. We also welcome the comments from the private sector in support of this. The Information Commissioner is right to say that transparency is a key principle of democratic government. She is right to insist that, as more diverse models of service delivery develop, the Government should ensure that transparency is not lost.**

135. ***The Government needs to improve its internal information so that it can design, let and manage contracts more successfully. The Committee has made this point before in other contexts. The examples in this report strengthen the case that the Government needs to develop a full understanding of the services it provides to the public. The Government should set out in its response how its strategy to improve management information will tie into its commercial strategy.***

136. ***We understand the Government's concerns about the implications of increased transparency for some smaller contractors, and such requirements should be proportionate. However, we think that the principle that Parliament and the public need to have key information about the delivery of public services is important. The Government should set out in its response to our report which key performance indicators it has decided to publish and its justification for the choice of those indicators. The Government should work with the Information Commissioner to ensure that revisions to the Freedom of Information Act address her concerns.***

137. ***We recommend that the Government should consult with the Local Government Ombudsman and the Parliamentary and Health Service Ombudsman about the problems identified by the Local Government Ombudsman in relation to complaints made about private sector contractors, over whom he has no jurisdiction. We agree with the overarching principle that all users of public services, regardless of who delivers the service, should have the right of access to an independent ombudsman. The Government has already published the Public Sector Ombudsman Bill in draft and this should be amended.***

Conclusions and recommendations

How appropriate is it for public services or projects to be run by the private sector?

1. Government outsourcing is now more important than ever. This is true not only of the UK but also of most other advanced economies. The Government purchases almost as much from external providers as it spends on its own staff. There are few public services where the Government does not rely, to some extent, on some sort of contractual relationship. (Paragraph 14)

2. At different times, private, charitable and public providers have both succeeded and failed to contribute to successful public services. All the witnesses to our inquiry accepted that the public sector should buy in some goods or services from the private sector, and should insist on providing others internally. The public sector should not contract out the final decision making about policy. The public sector always retains responsibility for the entitlement of individuals to benefits or services. Whether ordinary services should be outsourced though will depend upon the capacity of the public sector, private sector or voluntary sector to deliver them, the comparative cost, and ultimately, the value that each provider can produce. (Paragraph 23)

3. There was a consensus among the witnesses to our inquiry that the Government should be taking a reasoned, evidence based make-or-buy decision. The Government has set out criteria for this in its Green Book guidance. This decision is not binary between private provision and public provision but should include a number of alternative methods of provision, several of which might involve commissioning the service or providing the service in-house. We heard conflicting evidence about whether the Government consistently follows its own guidance in this respect. It is impossible to tell from the outside whether decisions have been made appropriately. (Paragraph 30)

4. *It is intolerable that the Government is spending £250 billion with little evidence that it is currently following its own procedures to secure value for money. The business case procedure set out in the Treasury's Green Book provides a suitable basis for making decisions about whether and how to let contracts. However, we are concerned by the evidence of the Comptroller and Auditor General that this is not always followed. The Cabinet Office and Treasury should ensure that all contractual decisions are based on a sound business case and in accordance with the guidance laid out in the Green Book.* (Paragraph 31)

5. *Public trust in outsourcing has been seriously damaged recently. This is due to a number of high profile failures–including most recently the failure of Carillion. The Government needs to rebuild trust in the process by which it makes decisions about outsourcing. The Government can only achieve this by being transparent about how and why it decides to purchase a good or service. Especially in cases where private sector involvement or the type of commissioning is novel, the Government should publish its rationale for the decision and notify the relevant select committee. This might take the form of a published business case, for example.* (Paragraph 32)

6. *The Government must produce evidence about the advantages and disadvantages of purchasing from the private or third sector in different public services. This should include an assessment of the cost and quality advantages and disadvantages of purchasing services. The Government should establish a centre of excellence for research into applied contracting (for example, through establishing a new "What Works Centre").* (Paragraph 36)

The Private Finance Initiative: time for honesty

7. PFI financing costs more than government financing because the state can borrow at a cheaper rate than the private sector. While we are confident that PFI costs more than conventional procurement, neither we nor the National Audit Office nor the Public Accounts Committee can find any evidence of the benefits the Government claims for it. It is unacceptable that almost 30 years after the first PFI projects were initiated, the Treasury cannot produce an evidence base to support its claims that PFI is worthwhile for any reason apart from the fact that it takes debt off balance sheet. (Paragraph 45)

8. *The Treasury and the Government should not approve any further PFI projects until they can clearly justify, based on evidence, their claims about the benefits of the scheme. It will seem bizarre to many observers that the Government has chosen to pay more than it could for £60 billion worth of projects, without evidence of any benefits from the extra cost involved in using this financing method. Ministers should be able to choose to use state finance where it is clear that private finance would bring no benefits. The Treasury should scrutinise in particular the recently approved transport projects (the A303 Stonehenge tunnel and roads and the £1.5 billion approach roads to the Lower Thames Crossing) to ensure that there is good evidence that private finance represents the best value for money in these cases.* (Paragraph 46)

9. *The Government should investigate the experience of the Scottish Government with the Non-Profit Distributing model and report back in its response to this report its view of what the UK Government can learn from the Scottish experience.* (Paragraph 47)

10. *The Government has previously maintained that it selected private finance only when it judged it to be value for money to do so. However both the comments of the Civil Service Chief Executive, and more importantly, recent changes to the Treasury's guidance on refinancing make clear beyond a reasonable doubt that the Government's true reason for using the Private Finance Initiative or PF2 is that the debt does not have to be shown in the National Accounts or within the national debt.* (Paragraph 48)

11. *Balance sheet treatment is not an appropriate justification for the choice of method of finance or for the terms of government contracts, especially if it means the contracts cost the Government more. We welcome the decision to clawback excessive profits from refinancing; however, it is wholly unacceptable that the Government have reduced this in order to conceal the true nature of public sector liabilities. The Government should note in their response that our recommendation follows similar arguments from both the Treasury Select Committee and the Public Accounts Committee. Without compelling evidence and justification from the Treasury, the Government should re-introduce refinancing provisions allowing 50% gain share for the public sector.* (Paragraph 49)

The Government's approach to contracting: managing risk

12. *The Government's position in some public sector markets is monopsonistic. It has huge power as the only buyer in those markets to set prices, standards of quality and to determine the behaviour of participants. The Government should recognise in its response to our report its position as a monopolistic buyer in some markets and commit to publishing a strategy which would identify what it thinks the risks that arise from this are, how it can mitigate them and what it can do to improve these markets and render them more stable.* (Paragraph 53)

13. UK governments have often transferred risks to contractors that they cannot possibly manage. This is driven, in part, by the decision to use contractual models such as payment by results which involve risk transfer on a huge scale. The transfer of large amounts of risk is often counter-productive: leading to more conservative approaches to service delivery. This situation has been made worse by the fact that governments have often not understood fully the services or projects they have wanted the private sector to manage and without any understanding or data about the assets being handed over. (Paragraph 63)

14. *The Government's guidance on risk transfer is sensible but too often that guidance appears to have been ignored in Departments. The Government must ensure that in the future this guidance is followed. In areas where the Government lacks information about the state of existing provision of services, it must evaluate which risks its partners are capable of taking on and which risks must remain with the Government. The Government ultimately cannot outsource the need to understand what it is outsourcing. We expect the Government to set out to us new procedures to ensure guidance about risk transfer is followed in the future. For example, contract announcements could be accompanied by a disclosure of which risks each party has agreed to manage.* (Paragraph 64)

15. *The complexity of risk management is exacerbated in some of the innovative contractual models that the Government has used recently. The Government should pause its roll-out of these models, such as payment by results, given the difficulties the Government has had in evaluating which activity leads to outcomes and working out costs. In areas where payment by results has been implemented, we believe that the Government should, if it decides to re-purchase the services, re-evaluate how it apportions risk between itself and providers. The Government should in its response to this report lay out how it would do this.* (Paragraph 65)

16. *The Government's preoccupation with price has been noticed by the market and is a matter of grave concern. The Government's failure to assess the quality of services as well as their cost is lamentable. There needs to be a complete reappraisal of how the Government assesses quality of the work it commissions. This will both incentivise providers of services to focus more on quality and ensure there is less chance of providers aggressively undercutting bids deliberately with the intention of potentially renegotiating the contract later on. This is particularly important in cases of complex services for vulnerable people, where the risks and the consequences of service failure are most acute. It is no surprise that the quality and reliability of privately supplied services is so variable if the Government nearly always judges bids on price alone.* (Paragraph 71)

17. The Government's decision to revise the terms of some contracts underlines the failure of contracting within government. We agree with the Justice Select Committee that these renegotiations point to underlying issues with the capacity of the Government to successfully let contracts. Renegotiation often reflects poor risk allocation and poor information about the original service that was contracted out. The Government is also potentially exposed to legal risk through doing this. We have not received evidence about the costs of bringing in these changes but presume they are substantial. While it may be unavoidable that the Government has to re-negotiate some contracts to ensure services continue to function, the fact that it has had to renegotiate over £120 million of contracts in the last two and a half years is an indictment of its initial negotiating approach. (Paragraph 75)

18. *In each case where the Government has had to renegotiate a contract because its initial assumptions about cost, risk transfer or contractual structure have proved incorrect, we believe the Government should undertake a lessons learned exercise to identify what went wrong. The lessons identified in this exercise should be shared with the Comptroller and Auditor General and his officials to decide whether there are any issues to report to Parliament.* (Paragraph 76)

The effect of Government monopsony on the private sector

19. Some of the Government's contractors developed unsustainable business models over recent years, underbidding for contracts, recklessly acquiring other businesses and maintaining high bonuses and dividends. For example, Carillion's balance sheet, before its failure, was propped up with high risk construction contracts and high valuations of goodwill, arising from overpayments for acquisitions. The directors and shareholders of the companies involved are responsible for this. Share prices, buy, hold or sell recommendations and public statements are a poor guide to the long term security of companies. Shareholders can accept higher risks for an equity rate of return and can exit at short notice. Government is in for the long term and cannot take such risks with public money or with the security of public services. The Government as the major customer of these firms is responsible for the services they supply and consequently needs to ensure that its contractors are able to deliver those services sustainably. As Ministers are accountable for the resilience of services, they cannot be blind to the risks that the companies delivering those services hold. (Paragraph 86)

20. *The Government should improve its due diligence processes to understand the resilience of the cashflow and financial position of its partners. In 2017, the Government still awarded contracts to Carillion despite the weakness of the company's balance sheet on the basis of "quite detailed tests on the financial capability of Carillion". The Government should urgently review its due diligence procedures on the contracts awarded to Carillion. The Government should commit to announcing its findings from this review in its response to this report.* (Paragraph 87)

21. There is widespread agreement that contestability (the credible threat of competition) is important in order to support an efficient market for public sector services. Contestability motivates firms to improve services and cut costs and motivates the public sector itself in the same way. The combination of limited competition and high barriers to entry generates worse outcomes however for the Government. (Paragraph 94)

22. *The Government needs to ensure that the market for Government contracts remains contestable from within the public sector, from existing companies and new entrants. We welcome the Minister's commitments in this area and we await to see in the Government's response details on its new measures to increase small and medium sized enterprises' participation in the market.* (Paragraph 95)

23. *The Government should test the thesis that less competition (as opposed to contestability) also undermines outcomes for the public sector. This reflects a widely held consensus but it would be useful for the Government to commit in its response to commission further research. The Government should outline in its response to our report the detail behind the Minister's commitment to a new playbook of guidelines, rules and principles.* (Paragraph 96)

24. The Government made the right decision to let Carillion fail. The Government lacked confidence in the plans put forward by the company's management. The cost of funding the company would have been higher than the costs of the liquidation. It is notable that the shareholders and financers of Carillion have lost money through the failure of the company. We agree with the Minister that this is appropriate as it sends a signal that ultimate responsibility for Carillion rested with its management, shareholders and financers. (Paragraph 109)

25. The failure of Carillion could have resulted in the collapse of public services. It did not. The Cabinet Office and the Government ensured through contingency plans worked on between July and January that they could cope with the liquidation. The Government deserves credit for ensuring that, in January 2018, services mostly continued. The Government were right to prioritise the interests of the public who use those public services. (Paragraph 110)

26. *The Minister for the Cabinet Office has announced a review of how the Cabinet Office responded to the Carillion crisis. That review should take note of the weaknesses in the Government's approach. These include the Government's surprise that Carillion issued a profits warning in July 2017, when some investors had been warning about the state of the company for years.* (Paragraph 111)

27. *The Cabinet Office should ensure that it holds appropriate information about the contracts held by each of its strategic suppliers and aggregate the risk exposure from across the whole of Government to large contractors like Capita and Serco. We understand that the Public Accounts Committee will be reporting on this issue shortly and we await their recommendations with interest. The Cabinet Office should also ensure that it learns lessons from this crisis about how to quickly collaborate with local government to deal with the issues raised by a collapse such as Carillion.* (Paragraph 112)

28. *We welcome the Minister's commitment to bring forward proposals for living wills with each key strategic supplier. The Government should lay out in their response to this report what these living wills will contain. The Government should clarify whether these wills would only apply when a contractor goes bankrupt, or whether they would also apply when a contractor withdraws effectively from a contract. The Government should set out measures to ensure that the public knows that these living wills are agreed: so that users of services can have confidence in their resilience despite what may or may not happen to particular companies.* (Paragraph 113)

The Capability of the UK civil service

29. The Cabinet Office has invested significantly in commercial capability over the last few years. Outside observers have said that, since that investment, the quality of the Government's commercial management has improved, albeit from a low base. We look forward to the recommendations of the Public Accounts Committee about the future development of the Crown Commercial Service and the Government's commercial capability. We welcome the Government's decision to invest in this area but we remain concerned. (Paragraph 124)

30. *The Government must continue its efforts to improve its commercial capability. Currently, this capability is unevenly distributed among departments. The Government also needs to take care that it does not, through having better negotiating capability, merely drive harder bargains with the private sector based on unrealistic estimates of service quality and cost. The Government needs to move beyond such a transactional approach and develop its understanding of the market and its partners in delivering public services. The Government and its contracting partners should share and express the same values. The Government should set out in its response to this Report its future vision for commercial capability, including measures to encourage collaboration within the public sector and verified trust between the Government and its providers. This should include a new code of conduct which would apply to both Government and suppliers and set out expectations of behaviour and shared values.* (Paragraph 125)

31. *The Government needs to improve, as our predecessor Committee suggested, its understanding both of risk transfer and of costing Commercial skills cannot be seen in isolation from other skills. We believe that it is vital that staff with commercial skills work alongside staff with other skills such as costing, project management, IT and financial planning in letting contracts. They should also work alongside staff with deep subject knowledge and expertise. In its response, the Government should set out its plans to integrate together teams which have IT, project management, costing, financial planning and commercial skills and possess deep knowledge and expertise.* (Paragraph 126)

32. The Government can only let and manage contracts successfully if it has the right data. The Government admits that it needs to improve its internal data. We are concerned by the fact that the Government has not systematically analysed where and how it spends taxpayers' money on procurement. This includes data not only about current contracts but also about areas that the Government wishes to purchase in the future. We welcome the Government's commitment to improving its data about contracts. (Paragraph 133)

33. We welcome the Government's intention to publish a number of key performance indicators. We also welcome the comments from the private sector in support of this. The Information Commissioner is right to say that transparency is a key principle of democratic government. She is right to insist that, as more diverse models of service delivery develop, the Government should ensure that transparency is not lost. (Paragraph 134)

34. *The Government needs to improve its internal information so that it can design, let and manage contracts more successfully. The Committee has made this point before in other contexts. The examples in this report strengthen the case that the Government needs to develop a full understanding of the services it provides to the public. The Government should set out in its response how its strategy to improve management information will tie into its commercial strategy.* (Paragraph 135)

35. *We understand the Government's concerns about the implications of increased transparency for some smaller contractors, and such requirements should be proportionate. However, we think that the principle that Parliament and the public need to have key information about the delivery of public services is important. The Government should set out in its response to our report which key performance indicators it has decided to publish and its justification for the choice of those indicators. The Government should work with the Information Commissioner to ensure that revisions to the Freedom of Information Act address her concerns.* (Paragraph 136)

36. *We recommend that the Government should consult with the Local Government Ombudsman and the Parliamentary and Health Service Ombudsman about the problems identified by the Local Government Ombudsman in relation to complaints made about private sector contractors, over whom he has no jurisdiction. We agree with the overarching principle that all users of public services, regardless of who delivers the service, should have the right of access to an independent ombudsman. The Government has already published the Public Sector Ombudsman Bill in draft and this should be amended.* (Paragraph 137)

Formal minutes

Tuesday 3 July 2018

Sir Bernard Jenkin, in the Chair

Ronnie Cowan	Kelvin Hopkins
Mr Marcus Fysh	Mr David Jones
Dame Cheryl Gillan	David Morris

Draft Report (*After Carillion: Public sector outsourcing and contracting*), proposed by the Chair, brought up, and read.

Motion made, and Question proposed, That the Chair's draft Report be read a second time, paragraph by paragraph—(*The Chair*).

The Committee Divided

Ayes, 4	Noes, 1
Ronnie Cowan	Kelvin Hopkins
Mr Marcus Fysh	
Dame Cheryl Gillan	
Mr David Jones	

Question accordingly agreed to.

Ordered, That the Chair's draft Report be read a second time, paragraph by paragraph

Paragraphs 1 to 137 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Seventh Report of the Committee to the House.

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

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134).

[Adjourned till 10 July 2018 at 9.45am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Tuesday 27 February 2018	*Question number*
Keith Cochrane, Chief Executive, Carillion, (Non-executive Director July 2015–July 2017), **Philip Green**, Chair, Carillion, **Richard Howson**, former Chief Executive, Carillion, 2012–July 2017, **Emma Mercer**, Finance Director, Carillion, from April 2017	Q1–237
Tuesday 13 March 2018	
Michael King, Local Government Ombudsman, **Nigel Kletz**, Chair, National Advisory Group for Local Government Procurement, and **David Simmonds**, Conservative leader, Local Government Association	Q238–326
Kerry Hallard, President, Global Sourcing Association; and **George McFarlane**, Confederation of British Industry	Q327–392
Tuesday 27 March 2018	
Professor Gary Sturgess, **Nick Davies**, Institute for Government, and **Professor Colin Haslam**, Queen Mary University of London	Q393–494
Tuesday 24 April 2018	
Sir Amyas Morse KCB, Comptroller and Auditor General, National Audit Office	Q495–559
Margaret Stephens, former Partner on Private Finance Initiative at KPMG, and **Paul Davies**	Q560–610
Tuesday 8 May 2018	
Rupert Soames, Chief Executive, Serco, and **Phil Bentley**, Chief Executive, Mitie	Q611–682
David Walker, The Guardian, **Matt Dykes**, Senior Policy Office for Public Services, TUC, and **Karl Wilding**, Director of Public Policy and Volunteering, NCVO	Q683–727
Wednesday 9 May 2018	
Right Hon David Lidington MP, Minister for the Cabinet Office and Chancellor of the Duchy of Lancaster, **John Manzoni**, Permanent Secretary for the Cabinet Office and Chief Executive of the Civil Service, and **Gareth Rhys Williams**, Government Chief Commercial Officer	Q728–809

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

LCC numbers are generated by the evidence processing system and so may not be complete.

1 Bristow and Sutor (LCC0044)

2 The British Institute of Facilities Management (LCC0020)

3 Cabinet Office (LCC0036)

4 Davies, Paul (LCC0031)

5 Demirag, Professor Istemi (LCC0034)

6 Hammond, Fiona (LCC0027)

7 Haslam, Professor Colin (LCC0029)

8 Information Commissioner's Office (LCC0009)

9 Institute for Government (LCC0040)

10 Leaver, Professor Adam (LCC0043)

11 Lloyds Bank Foundation for England & Wales (LCC0001)

12 Local Government and Social Care Ombudsman (LCC0008)

13 Mace (LCC0014)

14 Mitie plc (LCC0039)

15 National Council for Voluntary Organisations (NCVO) (LCC0026)

16 Reform (LCC0006)

17 Reissner, Dr Stephanie (LCC0041)

18 Scottish Government (LCC0033)

19 Scottish refugee council (LCC0016)

20 Serco plc (LCC0022)

21 Smith, Mr Peter (LCC0007)

22 Social Enterprise UK (LCC0042)

23 Sports and Recreation Trusts Association (LCC0032)

24 Stephens, Margaret (LCC0030)

25 Sturgess, Professor Gary (LCC0023)

26 TUC (LCC0018)

27 Tizard, John (LCC0005)

28 UKCloud Ltd (LCC0024)

29 UNISON (LCC0013)

30 Unite the Union (LCC0011)

31 Walker, David (LCC0002)

32 We own it (LCC0038)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	Devolution and Exiting the EU and Clause 11 of the European Union (Withdrawal) Bill: Issues for Consideration	HC 484
Second Report	Parliamentary Boundary Reviews: What Next?	HC 559 (HC 1072)
Third Report	PHSO Annual Scrutiny 2016–17	HC 492
Fourth Report	Ensuring Proper Process for Key Government Decisions: Lessons Still to be Learned from the Chilcot Report	HC 854
Fifth Report	The Minister and the Official: The Fulcrum of Whitehall Effectiveness	HC 497
Sixth Report	Accounting for Democracy Revisited: The Government Response and Proposed Review	HC 1197
First Special Report	Will the NHS never learn? Follow-up to PHSO report 'Learning from Mistakes' on the NHS in England: Government Response to the Committee's Seventh Report of Session 2016–17	HC 441
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