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Chair, Public Administrative and Constitutional Affairs Committee
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Tuesday 29th May

Dear Bernard,

During the hearing on Carillion on 9 May I promised to return to the committee with a fuller answer for three questions. These were:

- ***Q767:*** More detail on financial tests and how they were applied to Carillion
- ***Q782:*** The number of times it has been necessary to renegotiate and reprice outsourcing contracts in-flight
- ***Q791:*** The rationale for changing the gainshare model within the standard PF2 contract

Detail on each of these three is given below

Q767: Financial tests

The nature of financial capability tests are at the discretion of the contracting authority. Contracting authorities are advised that the test should be proportionate to the size of the contract and the perceived risk. For smaller contracts, the financial capacity test will likely be limited to a turnover test and a test of ratios to determine solvency. Data will be acquired from previously published accounts submitted by the supplier. For larger procurements, contracting authorities will draw up more complex tests that require better data and more sophisticated analysis.

Financial tests were applied to Carillion in the July 2017 HS2 procurement, for example. In this case the tests were applied by an external accounting firm, which made allowances for the impact of the profits warning on the recently published 2016 results. The tests were: Turnover, Net Assets, Liquidity, Gearing and Interest cover. In addition HS2 reviewed Carillion's Dun & Bradstreet Failure Score. Carillion passed all of these tests. The financial position of the firm deteriorated after July 2017 with two further profits warnings in 2017.

Q782: Renegotiation and repricing of outsourcing contracts 'in flight'

During the hearing there was a discussion of the reconfiguration of the "Transforming Rehab" contracts in 2017. These contracts were let on the basis of forecast demand for rehabilitation that did not materialise; as a consequence the contracts became financially unsustainable for providers. In order to maintain continuity of this essential public service it was necessary to adjust the pricing mechanism to give providers more budgetary certainty, although it should be noted that the total planned to be spent on the contracts was kept within the original envelope.

Renegotiations of this kind are rare. Procurement regulations bound the level of changes that can be made to a contract before it effectively becomes a "new" requirement, and a recompetition is necessary. In many circumstances, if such changes are needed, authorities will cancel a contract or competition and seek new bids against fresh terms (an example is the proposed competition to manage the Immigration Removal Centre at Brook House, Gatwick).

Since the beginning of 2016, we are aware of 12 examples over £10m (including Transforming Rehabilitation) that have been presented to the Cabinet Office for approval. These include the need to move a DEFRA data centre following a lease expiry, the reconfiguration and insourcing of part of DWP's IT application development, and the replacement of outdated technology on part of the MoD's satellite network.

Q791: The decision by HMT to reduce the amount Government takes back on refinancing PF2 deals

In 2016, Eurostat published new guidelines which set different requirements for the off balance sheet treatment of public private partnerships. PF2 models are designed as off balance sheet tools for the public sector and thus HMT made changes to the model to ensure that new projects can also be kept off balance sheet.

One of the key changes to the PF2 model to keep it as an off-balance sheet option is to reduce the gain-share percentage applied on a refinancing. As originally drafted, the PF2 contracts include a gain-share mechanism, so that the public sector will share at least 50% of any gains made from refinancing debt. Deals agreed since 2009 had a 70% share for gains above £3 million; however, under the new Eurostat rules, this increases the chance that the project debt will be recorded as government debt. HM Treasury subsequently changed the standard contract terms for PF2 projects to limit the amount that can be received under the gain-share mechanism to 33%.

To mitigate the negative impact that this change could have on Value for Money, HM Treasury will remove provisions that allow poorly performing contracts to use refinancing to achieve the rate of return they expected at financial close. Although reducing refinancing gain share may seem to slightly worsen Value for Money, it is partially offset by the removal of the “rescue refinancing” which was a benefit to the private sector.

I trust that these details provide the committee with the information it needs to complete its inquiries.

RT HON DAVID LIDINGTON CBE MP