

## **Submission to the Public Administration and Constitutional Affairs Committee by Serco plc**

### **Sourcing public services: lessons learned from the collapse of Carillion**

Background on Serco: we are a British company, quoted on the London Stock Exchange, which employs over 50,000 people across the UK, North America, Europe, the Middle East, Hong Kong and Australia. Our business is supplying services for Governments in the fields of Defence, Justice & Immigration, Transport, Citizens Services and Health. About half our business is in the UK, where we employ about 24,000 people; we have contracts with, amongst others, the MoD, DWP, Home Office and Ministry of Justice, as well as many Local Authorities.

#### ***Are there limits to what can be outsourced?***

1. We do not believe blanket rules or generalisations for sourcing decisions are helpful, other than to say that there should be a clear line between policy development and policy delivery. Politicians and Civil Servants working to their direction should be solely responsible for policy development. The best mechanism of policy delivery should in our view be chosen on a case-by-case basis through a robust, rational, documented and publicly accountable "make-or-buy" decision-making process to determine what delivery mechanism is likely to produce the best outcome for the taxpayer and service users. We believe that the National Audit Office could usefully opine on what this process should comprise.
2. We believe it should be standard practice to formally assess every element of policy delivery against different delivery options: state only, mixed state & private provision, private provision only, and for each of these options to be costed in a formal framework. If Ministers subsequently decide that for political or policy reasons they wish to instruct a route that the process has determined is sub-optimal, they can do so, but we think that taxpayers would expect there to be a documented and robust options-development process, along with an formal record of decision.
3. The involvement of non-state operators in the delivery of public services, be they private companies, mutuals or charities, can bring numerous benefits: they can bring new ideas, access to talented people, investment, clear accountability, lower costs, greater flexibility, choice and competition. Because of these potential benefits, it should be only in exceptional circumstances that Government takes a decision on how to deliver a policy without a formal, documented, sourcing process.
4. We see few hard limits on the ability of the private sector to deliver policy. Across the world, private companies have been entrusted by Government to perform the most sensitive tasks; private companies are entrusted with nations' most secret secrets. In defence, private companies manage the design and development of the most powerful weapons, and run the most secure communications networks. In critical infrastructure such as power and telecommunications, private companies provide the services and own the assets. Primary healthcare in the UK is outsourced to 67,500 private contractors called GP's. In Serco, many of our employees are Military Reservists, who at a moment's notice swap their civilian uniform for a military one.
5. Whilst we think the working assumption should be that the private sector can do anything in terms of policy delivery, certain areas should be the sole preserve of employees of the state. Those who sit in judgement on their fellow citizens; those who enforce the law and prosecute; those who we equip and train to go abroad and kill the Queen's enemies. But even in these areas, lines may be smudged rather than drawn. Private contractors give out parking tickets; manage prisons and prisoner transport; and make sure that when the army needs to fight, it does so on a full stomach with ammunition that does the job.

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***What lessons need to be learned from the collapse of Carillion about how Government and the public sector manages the risk from suppliers throughout the life-cycle of outsourcing a public service?***

***Does the Government effectively monitor and manage risk for its largest suppliers, and does it have effective failure regimes in place? And do current procurement rules and policies allow risks to be managed effectively?***

6. Firstly it must be recognised that the UK Government successfully buys some £200 billion of goods and services from private companies, mutuals and charities each year. There are over one million people employed by the private sector and charities delivering services which have been outsourced by the Government, and the vast majority of this work is delivered to a high standard. Huge benefits have been delivered by private companies and charities in providing public services which are both efficient and innovative.
7. Second, the issues that felled Carillion were due largely to its construction businesses (but not solely – it took £200m of provisions against losses in its services business). Out of approximately 12,000 insolvencies a year in the UK, some 2,500 are construction companies, far more than any other sector (Source: Insolvency Service / Companies House). This is because companies in the sector often run poorly-capitalised; when profit margins in a business are as low as 2-3%, the only way to make a return on capital is to have very little of it. One of the reasons many customers of construction companies are sanguine about their suppliers going bust is that when one builder goes bust with a half-finished building, another can step in after a few weeks and finish the work. The same is not generally true when delivering services on a daily basis, such as delivering food to schools or cleaning hospitals, where service cannot be disrupted for a day.
8. It should be noted that in the case of Carillion's collapse, there have at the time of writing this evidence been few reports of public services not being delivered, which we believe is attributable to the contingency planning the Cabinet Office and other Departments did in advance of the liquidation. Without such planning the consequences could have been truly dreadful.
9. Whilst Carillion is the first major supplier of public services to Government to go into liquidation for many years, it is not the first Government supplier to get into financial difficulty. A large number of companies have lost tens of millions, or in Serco's case, hundreds of millions, of pounds, on UK Government contracts in recent years, mainly because the market for the supply of government services has become much more competitive, and Government has become too good for its own good at transferring risks, often completely unmanageable, to its suppliers. When these risks have crystallised, private companies have largely done what they had promised to do, which is to swallow the losses, and thus protect the taxpayers from these risks. So far, most outsourcers have managed to survive, but the sector is now much weaker than it was in 2010. This weakness has been painfully exposed in the last year by the capital markets: in the last 12 months, some £8.4 billion, or 50%, has been wiped off the value of the largest public companies who have a significant involvement supplying services to the UK Government. During the same period, the FTSE-250 increased in value by 15%.

<b>FTSE-250 2017</b>	<b>18,078</b>	<b>20,726</b>	<b>+15%</b>
<b>UK Government suppliers of outsourced services</b>	<b>2017 share price high</b>	<b>Share price 9th Jan 18</b>	<b>Movement %</b>
Carillion	238p	0p	-100%
Interserve	352p	86p	-76%
Capita	706p	159p	-77%
Mitie	297p	165p	-44%
Serco	150p	86p	-43%
Babcock	970p	680p	-30%
G4S	341p	285p	-16%
Average			-55%

### Government Scrutiny of Suppliers

10. Serco has good insight into the effectiveness of Government scrutiny of companies in distress, as we ourselves have been subject to it. After I joined the company 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; had banks not agreed to give us time to raise extra capital, we would have gone bust. Instead, they gave us space to raise some £1bn from a combination of selling off parts of our business and getting extra money from our shareholders, which enabled us to reduce our debt and stand by all the contractual commitments we had made to the UK and other Governments.
11. For most of 2014 and 2015 we were under intense Government scrutiny of our finances, and, although it was at the time not a comfortable experience for management, in retrospect we think Government did a very good job of keeping themselves informed of what was going on. As well as a financial crisis, we also had to deal with a crisis in customer confidence as a result of accusations of improper behaviour on a tagging contract. As a result of this we were also subject to a Government-mandated and supervised "Corporate Renewal" programme which was wide-ranging and thorough, and comprised 90 discrete actions we had to take and report on to Government. To give credit where credit is due, the sophistication and intensity of UK Government scrutiny that we saw in 2014 and 2015 far exceeded that of any of our other customers, and indeed of any customer I have seen in over 30 years in business.
12. However, unless they are willing to step in with financial assistance, Government cannot save companies. Their responsibility if a key supplier becomes distressed is simple and singular: they need to keep themselves informed so they can make appropriate contingency plans should the supplier fail. However, Government also need to be aware that other interested parties, investors, suppliers, lenders, other customers, will know that Government will be better informed than they are. Hundreds of millions of pounds of bank debt and equity and tens of thousands of jobs and hundreds of subcontractors businesses will be preserved or lost if a company survives (as Serco did) or fails (as Carillion did). People can make or lose millions if they make the right call in advance, and Government by its perceived actions or inactions can determine the course of events. I have no doubt that in Serco's darkest hour, a careless word from a senior Civil Servant, a throwaway line from a Minister,

- could have tipped the banks over the edge and resulted in a business now employing 50,000 people would have been destroyed.
13. Government faces a “damned if you do, damned if you don’t” conundrum. The easiest way to ensure that a supplier collapses is if Government expresses or shows by its actions that it thinks the company might not survive. And this would include not adjudicating the award of contracts in the normal course when a company might be in distress. If it tries to be supportive, or at least not blatantly unsupportive, and the company subsequently does collapse, Government is accused of naiveté and being asleep at the wheel.
  14. We think it is entirely proper that Government’s priority should be not to make the situation worse; not to carelessly put at risk thousands of jobs and hundreds of contracts delivering vital services. The failure of a major Government supplier (rare though it is) is a disruptive and expensive event; it is also miserable for the employees and sub-contractors and worrisome for the service users involved. So in our view, Government should be unembarrassed about not wanting to be publicly unsupportive of suppliers when they are in distress.
  15. The idea that a Government should not do business with a company that has issued a profits warning is in our view absurd. A profits warning is simply a statement that profits will not be within 5% or so of the level expected by the markets; a company where the analysts thought profits would triple would have to issue a profits warning if they were to merely double. Government has proved that it has sophisticated processes for monitoring companies in distress, but it cannot control or predict the behaviour of lenders, and cannot stop companies going bust, merely prepare for it, and be sure to do nothing that makes it more likely that the worst will happen.
  16. In terms of “business as usual” supervision of suppliers, we think the system works well. As a strategic supplier, Cabinet Office meets with Serco on a regular basis and tells us how it thinks we are doing. Our Crown Representative is a knowledgeable and experienced person who understands both Government and our business well, knows our management team, and we respect and listen to him. The Cabinet Office has people who understand our numbers and can interpret our results, and has access to market and investor commentary. In my experience the sophistication of Government’s “business as usual” supervision of key suppliers matches or exceeds practices in the commercial market. Where they differ is that in the commercial world, a long-term contract is the start of a relationship, where both parties adjust and adapt contracts to changing circumstances, whereas in Government contracting, once a contract is signed, it is almost impossible to change. This militates strongly against effective contract management.

#### Risk transfer in procurement

17. What does not work so well is risk transfer in procurement. As the Government’s commercial capability and legal expertise has become stronger, so it has become more successful at transferring risk to suppliers. It is a fallacy that Government is incompetent at competing and awarding contracts. In our experience doing business around the world, the British Government is the most aggressive on contractual terms, and the most inflexible in holding suppliers to those terms. It is also, for those whose business is supplying Government, a monopoly buyer, and it does not hesitate to use its position as the only buyer in the market to insist on conditions which in other markets suppliers would simply refuse to accept.
18. In recent years Government has used this monopoly-buyer position to achieve the transfer of risks to private companies that are essentially “state risks” which the suppliers have no way of mitigating or managing. Risks on contracts with a life of ten years in which any “Change of Law” is the suppliers’ risk (and how does that work with Brexit, or the Government’s ability to vary the Minimum Wage?); risk on volumes, which the suppliers have no way of controlling (e.g. Community Rehabilitation Companies); risk on the numbers of roads to be dug up to provide cycle lanes (Prisoner Escorting);

risk Government payments are deemed to be illegal state aid; contracts in which the penalty for not repairing a £200 heater in a flat within a few days is more than the cost of buying the flat itself; risk where one arm of Government (the customer) makes a private company contractually liable, and subject to financial penalty, if another arm of Government does not perform its statutory obligations; risk that the information supplied by the Government as part of the tendering process is materially incorrect. When Government complains that when a contract fails, the risk they thought they had transferred to the supplier comes back, it is most often because that risk was of a type that should never have been transferred to the supplier in the first place.

19. As a monopoly purchaser, and as the Government of the land, Government is in an extremely powerful position, and it is not a given that it will always behave judiciously or fairly in its procurements. It both makes the purchasing rules, and applies them, and suppliers have precious little redress or ability to influence them. Government can and does require suppliers to accept conditions (for instance, unlimited liability) which no commercial company would be able to impose as a customer, or be prepared to accept as a supplier, in the open market. Some might say “but you have redress – you don’t have to sign the contract, you can just walk away”. This is true, and, increasingly we and others do just walk away. But the objective of Government procurement should not be to create a market in which the only bidders are the dumb or the desperate, or those who are prepared to treat risks on a Government contract like a ten-year accumulator bet on the horses. The proposition from Government to suppliers on some of its largest and most sensitive contracts seems to be: if the risk does not arise, you might make 5% profit; if it does arise, we have an unlimited liability clause and we can bankrupt you.
20. At a time when Government will need to be delivering a whole lot more Government as result of Brexit, it needs a robust and healthy supply chain, capable of attracting capital and talent. Investors are prepared to invest in contracts that do not make much money; what they are not prepared to invest in is contracts which at best do not make much money, and at worst may destroy their company. And by “investors” we mean not just financial institutions looking after people’s pensions; we mean small and medium sized businesses where the owners are the managers and may have mortgaged their house to finance their business; and we mean the workers in a mutual who have their savings invested in their company; and we mean the philanthropists who have given money to charities to support good works.
21. There is a fundamental tenet of commercial life that risk must be balanced by reward. We believe that this relationship is too often not in proper balance in Government procurement of complex public services, and that this will produce an increasingly enfeebled supply base.

***Should contracts or tenders be structured differently? Are there other steps Government can take?***

22. The Cabinet Office has moved to address some of these “unfair contracting” issues; recently, it issued a guidance note to departments PPN 10/16 on Onerous Procurement Practices which in our view was sensible and balanced. Unfortunately, this guidance has as yet failed to gain traction in some Departments and is being adhered to only inconsistently.
23. We hope that the painful consequences of the collapse of Carillion and the widespread under-capitalisation of the sector may spur both Government and suppliers to work together to construct a new approach to the provision of public services. Few people believe that the provision of public services should be a closed shop whereby only employees of the state can be allowed to deliver public services. Most people would agree that public service provision should be a mixed economy of the state, not-for-profit organisations, and the private sector. But also that the provision of sensitive public services should not be completely exposed to the harshest rough-and-tumble, boom and bust

cycle, of a totally free market where the relative power of either a buyer or a seller may become disproportionate.

24. We will be proposing four principles which we suggest should to govern relations between Government and its suppliers, be they public bodies, not-for-profit organisations or private sector companies.

- We should **strengthen transparency in public contracting**. This means that for large contracts for public services, which are not commoditised, which do not impinge on National Security, and which do not include significant amounts of intellectual property, the presumption should be in favour of open-book accounting, in which the Cabinet Office and National Audit Office can see the suppliers' accounts of major contracts, whether they be performed by public or private operators. There should also be far greater transparency of operational performance: except in exceptional circumstances, suppliers, be they private or Government-owned, should be required to publish every six months their performance against key operational indicators, so they are held accountable for the delivery of their promises to the taxpayers who are paying for them and the users who they are serving. And we believe that there should be a formal, rigorous and transparent decision-making process by which Government decides what mechanism it should use, be it in-house or by a third party, to deliver a given project or policy. We call this the "Transparency Principle".
- **Both suppliers and the Government should have the right, on payment of an agreed break fee, to exit a contract** at pre-determined intervals. We call this the "Orderly Exit Principle". The purpose of this is to give both Government and supplier the ability to exit contracts which are not working out as intended. For instance, if the supplier is making greater-than-expected profits, or Government policy changes, or performance is unsatisfactory but still within the bounds of the contract, the Government should be able, on payment of a break fee, to re-compete or take back in-house the contract; and likewise if the supplier was making unexpected losses, or changes in regulation had made it impossible to deliver the contract as intended, the supplier can exit the contract on payment of a fee which would compensate the Government for the cost of re-tendering. This would, for both Government and supplier, significantly reduce the risk of being stuck together in unhappy marriages.
- **Suppliers of sensitive contracts should be obliged to lodge with Government a "living will"**, being a set of arrangements to facilitate the transfer of a contract back to Government or to another supplier if required. This would significantly reduce the operational risk to Government of supplier failure. This is the "Security of Supply Principle".
- **Government and suppliers should agree to abide by a mutually-agreed code of conduct**, which would set out expected standards of behaviour from Government and its contractors. This would involve the Government agreeing not to impose punitive or unfair terms and conditions or transfer unmanageable state risk; and suppliers would agree to maintain certain metrics of financial stability; pay their sub-contractors in a timely fashion; and adequately fund their pensions. We think it would be important to have a process of independent arbitration built into the code of conduct to ensure that there is some avenue of redress and calling to account those who do not abide by the code. We call this the "Fairness Principle".

25. It is vital for the well-being of any country that public services are delivered to high standards and offer value for money, and for the most part, in the UK, private and third-sector providers have done a good job of doing this. The UK has hundreds of new hospitals and schools, built and maintained to high standards; thousands of contracts have delivered innovation, improved services and lower costs, along with far higher degrees of visibility of operational performance than is commonly available from public-sector delivery. And as the UK advances towards Brexit, it is clear that there will be the need for a whole lot more Government as we "take back control". With this in mind, we believe that there is an urgent need to re-think the relationship between the UK Government and its suppliers. We believe an approach based on the Four Principles above would serve to restore trust and common sense in the market; remove the risk of excessive profits or losses; and encourage a more vibrant and competitive market for Government services, one in which Serco would be an enthusiastic participant.

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