



Departmental Overview, December 2018

# Commercial and Contracting

# Commercial and Contracting

This overview summarises the UK government's commercial management activity across departments. It includes what government does, how much it spends, recent and planned changes, and what to look out for in assessing government's commercial management in the future.

## Overview

 Introduction	 About government's commercial relationships	 Commercial spending across government
 The procurement process	 Accountability and transparency	 Current and future initiatives

**PART ONE**

### Getting it right at the start



**PART TWO**

### Managing contracts



**PART THREE**

### Managing markets



**PART FOUR**

### What to look out for



**PART FIVE**

### Our audit methodology



If you would like to know more about the National Audit Office's (NAO's) work on commercial management activity in government, please contact:

**Joshua Reddaway**

Director

 [joshua.reddaway@nao.org.uk](mailto:joshua.reddaway@nao.org.uk)

 020 7798 7938

If you are interested in the NAO's work and support for Parliament more widely, please contact:

 [parliament@nao.org.uk](mailto:parliament@nao.org.uk)

 020 7798 7665



The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Sir Amyas Morse KCB, is an Officer of the House of Commons and leads the NAO. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund, nationally and locally, have used their resources efficiently, effectively, and with economy. The C&AG does this through a range of outputs including value-for-money reports on matters of public interest; investigations to establish the underlying facts in circumstances where concerns have been raised by others or observed through our wider work; landscape reviews to aid transparency; and good-practice guides. Our work ensures that those responsible for the use of public money are held to account and helps government to improve public services, leading to audited savings of £741 million in 2017.

Design & Production by NAO External Relations  
DP Ref: 006535-001

© National Audit Office 2018

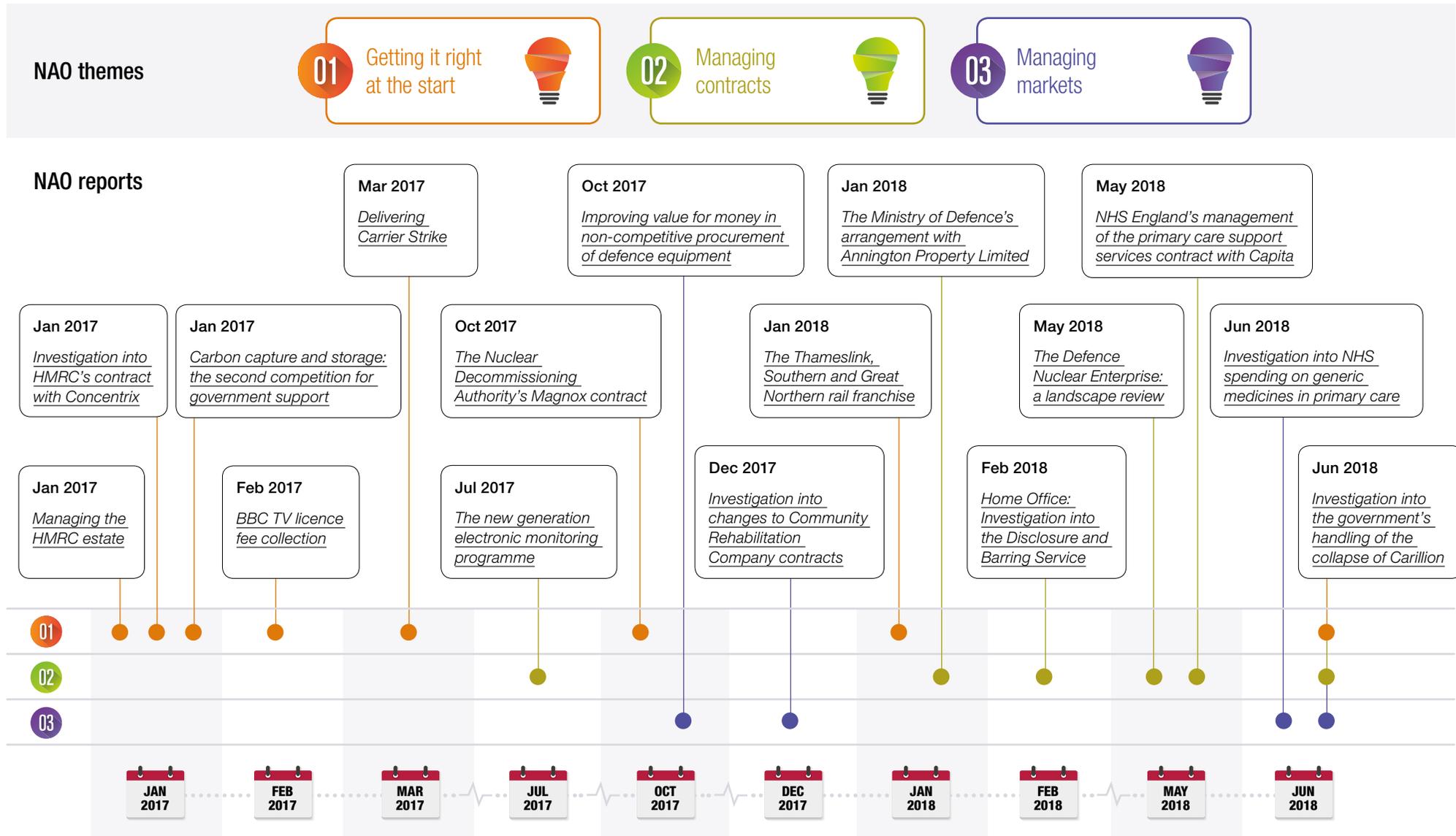


# Introduction



This overview summarises the UK government's commercial management activity across departments. It includes what government does, how much it spends, recent and planned changes, and what to look out for in assessing government's commercial management in the future.

Across all NAO reports since January 2017, 16 feature issues relating to commercial contracting. The diagram below shows the timeline of recent NAO reports that contain commentary on commercial contracting matters, some of which appear as case studies in this overview.



# About government's commercial relationships

## The range of government's commercial relationships

The UK public sector spent about £255 billion with external providers in 2016-17, including an estimated £118 billion on goods and services purchased by central government departments and the NHS that we directly audit. These relationships cover a broad range of goods and services including:

 <p><b>Assets and infrastructure</b></p> <p>For example, the Ministry of Defence's new aircraft carriers.</p>	 <p><b>Services to the public</b></p> <p>For example, the Department for Work &amp; Pensions' six main contracts for health and disability assessments.</p>	 <p><b>Support services for government</b></p> <p>For example, facilities management across government.</p>	 <p><b>Supply of goods</b></p> <p>For example, pharmaceuticals and consumables across the NHS.</p>
--	--	--	---

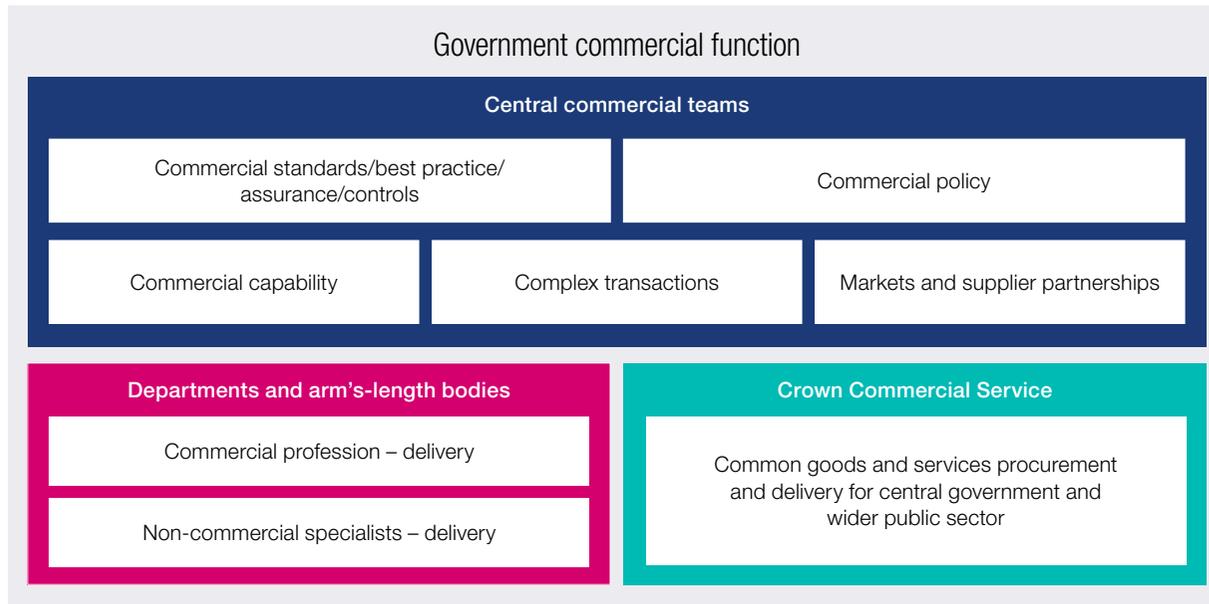
## The organisations involved:

**Departments and arm's-length bodies (ALBs)**, which are responsible for securing value for money from the goods and services they buy through commercial relationships.

**The Crown Commercial Service (CCS)** buys and manages a range of common goods and services on behalf of departments. Common goods and services include utilities, office supplies and temporary staff, and are typically bought from pre-approved suppliers who have won places on CCS framework contracts. The public sector spent **£13 billion** through CCS arrangements in 2017-18. CCS is an executive agency of the Cabinet Office.

**The Cabinet Office** hosts the **Government Chief Commercial Officer**, who is responsible for developing the commercial capability of the civil service. He coordinates the **Government Commercial Function**, a network of around 4,000 commercial staff across central government. The Government Commercial Function includes a number of commercial functions that had previously been managed in a fragmented way by departments. Central functions include:

- relationship management with and insight into the 29 strategic suppliers government has identified to be centrally managed by government's Crown Representatives and partner managers;<sup>1</sup>
- a team of commercial experts to support departments with complex commercial arrangements and disputes;
- commercial continuous improvement through setting standards and guidance and running masterclasses; and
- central employment of commercial staff in senior grades through the new **Government Commercial Organisation**, which deploys these staff across departments as needed.



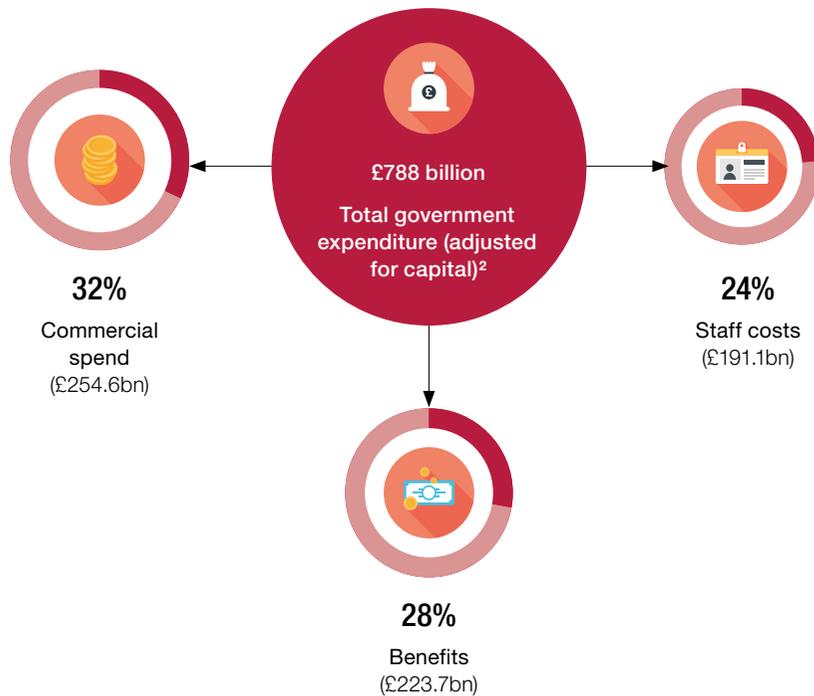
Source: Cabinet Office

<sup>1</sup> Crown Representatives are generally former senior board-level executives who work for the Cabinet Office on a part-time basis.

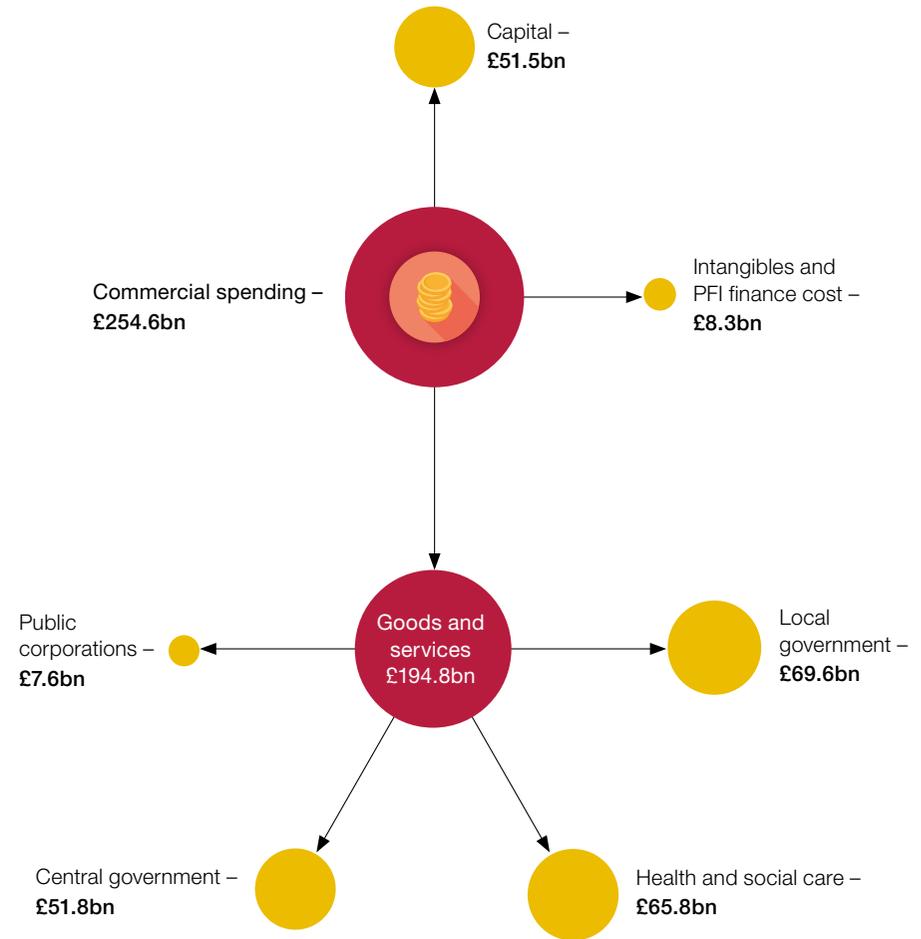
## Spending on contracts makes up one third of public spending

The two main data sources for government spend on commercial relationships are HM Treasury Whole of Government Accounts (WGA) and its Public Expenditure Statistical Analyses (PESA).<sup>1</sup>

Based on our analysis of the latest Whole of Government Accounts, we estimate that the public sector spent around £254.6 billion through commercial relationships in 2016-17. At 32% of total government expenditure, this is one of the largest spending categories in government.



## Breakdown of commercial spending in the Whole of Government Accounts



### Notes

- WGA and PESA data (see page 6) are not directly comparable because they are prepared on different bases. 2017-18 WGA data is not yet available. For 2016-17, WGA data suggests total commercial spending of £254.6 billion compared with PESA data which suggests a total of £255.4 billion.
- Total expenditure on public services as per WGA was £761 billion. We have adjusted this figure to include capital expenditure and the cost of Private Finance Initiative interest. Depreciation and amortisation have been excluded. Most, but not all, capital spending will be through commercial relationships.
- The remaining £118.6 billion of government expenditure is on grants and subsidies (£53.6 billion), interest costs on government borrowing (£31.8 billion), provision increases (£18.6 billion) and impairments and revaluations (£14.6 billion).

# Distribution of commercial spending across central government departments 2017-18

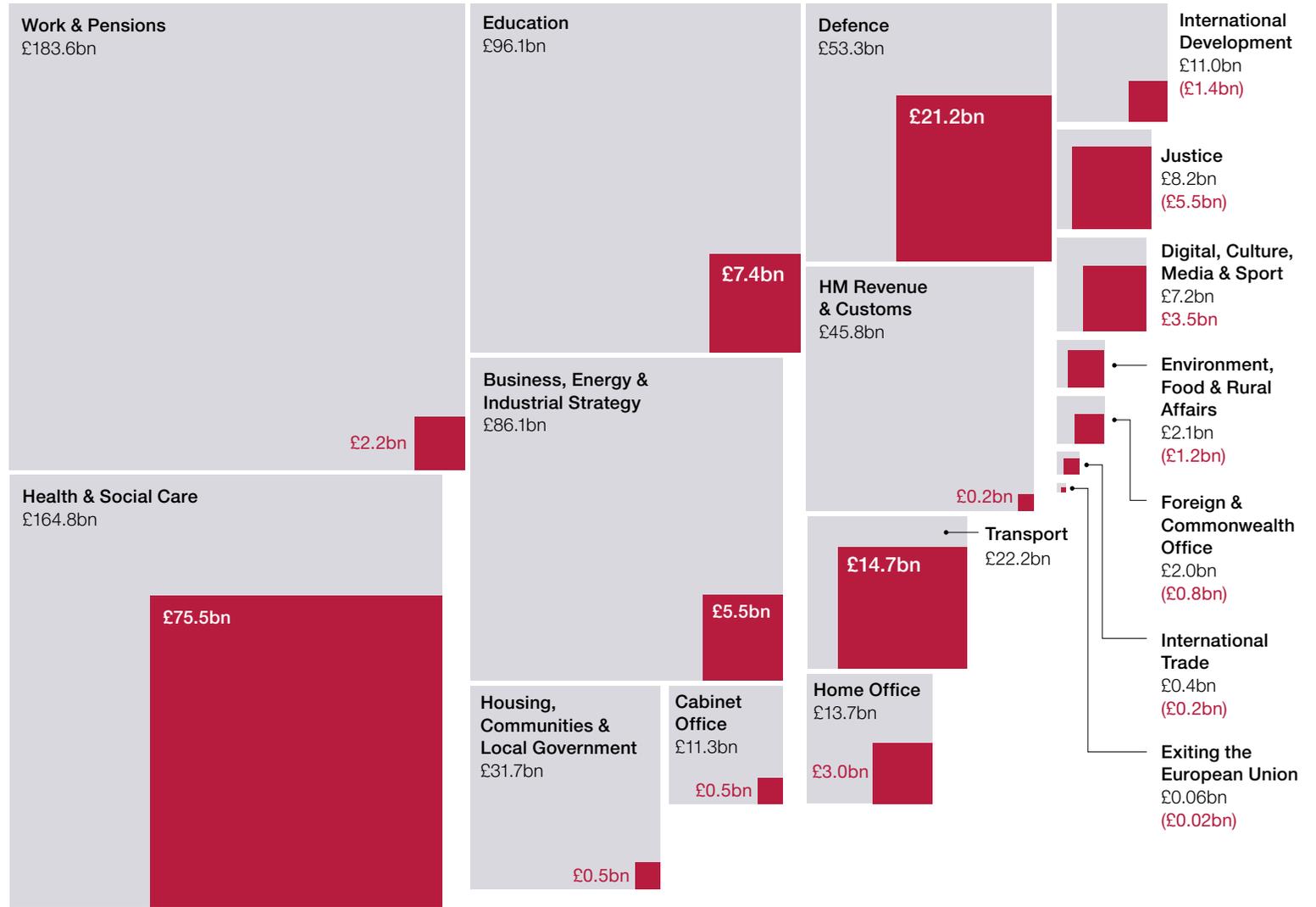
The Whole of Government Account data does not provide a breakdown of commercial spending by departments. This breakdown is available from Public Expenditure Statistical Analyses.

**Commercial expenditure**

**17 departments**

**£143.3bn total spend**

This analysis shows that commercial expenditure, including capital spend, across 17 major central government departments totalled **£143.3 billion**, 19% of the **£739.4 billion** spent in total by those departments. Spending by some of the key spending departments are set out on the [next page](#).



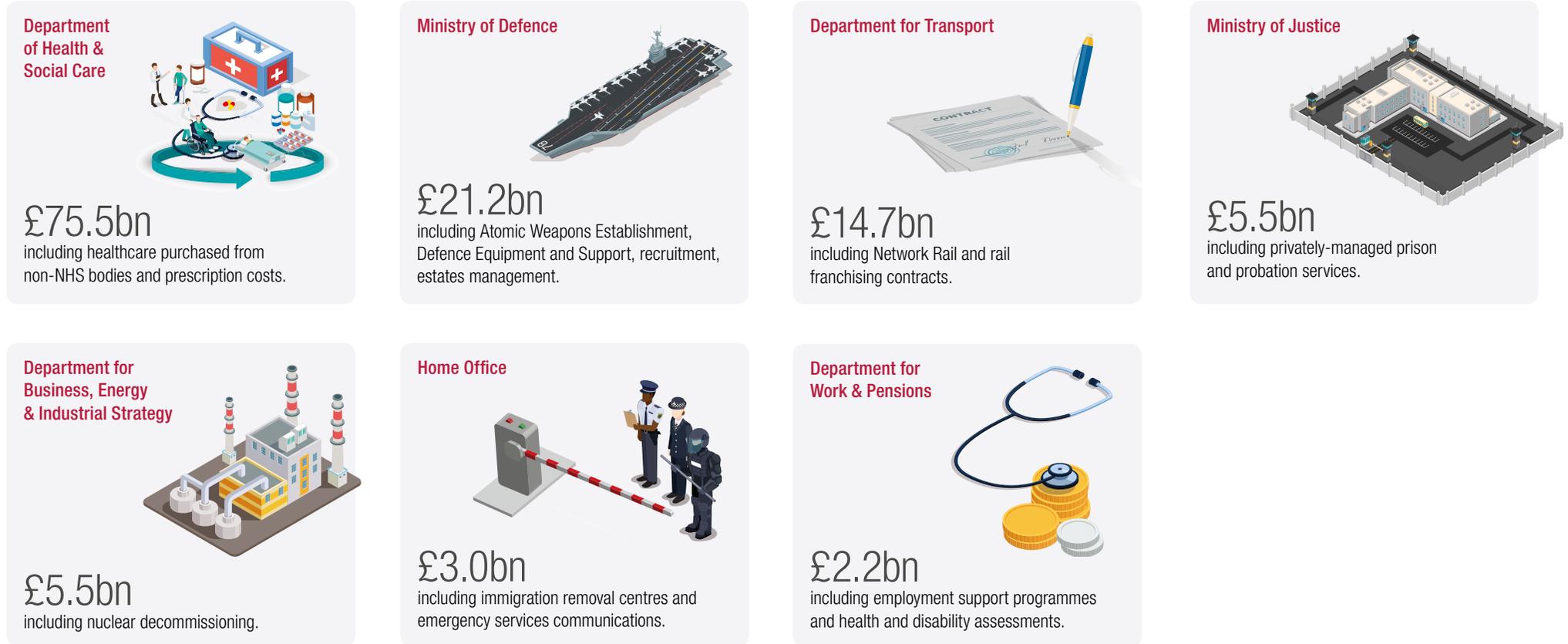
- Total expenditure for each departmental group
- Commercial expenditure for each departmental group

**Notes**

- 1 Total spending data are sourced from Table 1.13 of *HM Treasury's Public Expenditure Statistical Analyses*, published July 2018, which sets out 'total managed expenditure' for each departmental group.
- 2 Commercial spending data are sourced from Tables 2.2 and 2.3 of *HM Treasury's Public Expenditure Statistical Analyses*, published July 2018, which sets out 'gross current procurement in budgets' and 'gross capital procurement in budgets' for each departmental group.

# Distribution of commercial spending across central government departments 2017-18

Spending by some departments is set out below:



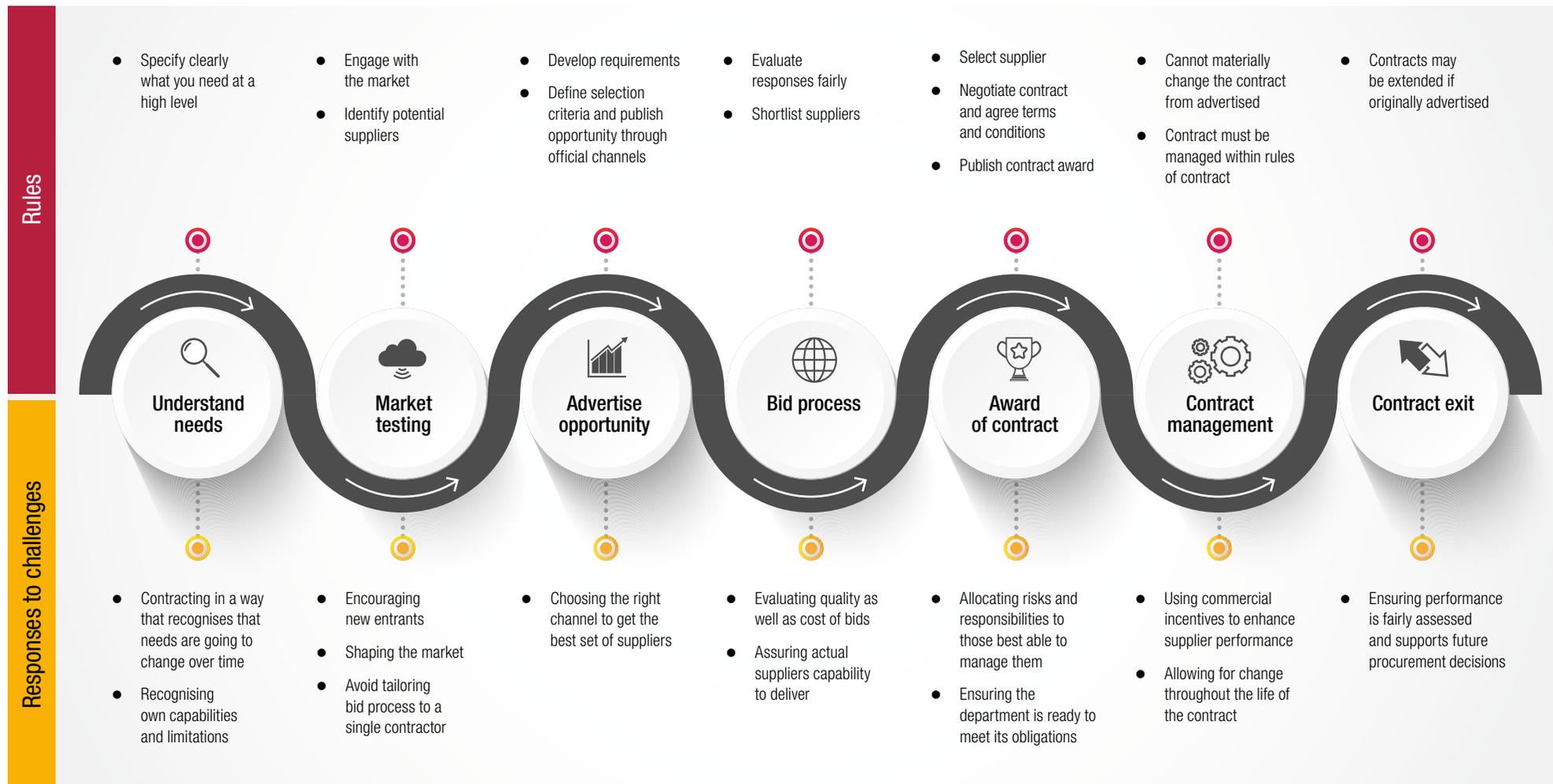
## OVERVIEW

# The procurement process

Most public sector contracts are procured within the Public Procurement Regulations, which are designed to avoid unfair procurement, corruption and fraud. They are derived from the European Union (EU) regulatory regime, and are therefore subject to the EU Treaty principles of non-discrimination, free movement of goods, freedom to provide services and freedom of establishment. Non-EU Organisation for Economic Co-operation and Development nations are covered by similar procurement regulations under the World Trade Organisation Agreement on Government Procurement (1994).

In addition to the fundamental treaty principles, some general principles have emerged from case law through the European Court of Justice. The most important of these general principles of law are equality of treatment; transparency; mutual recognition; and proportionality. Very small contracts, certain national security contracts and some NHS contracts are exempt from these EU regulations.

The procurement rules can restrict commercial practice compared with the private sector. Commercially mature organisations are able to overcome many of these challenges through effective commercial and contract management.



Rules

Responses to challenges

## OVERVIEW

# Accountability and transparency in government's commercial relationships

Good contracting should help hold government and suppliers to account but we find that the way contracts are set up sometimes inhibits transparency and accountability

	Good practice	What we find
01	 <p>The contract should set clear spending commitments and objectives</p>	<p>Despite a clear legal and policy expectation that all contracts are made publicly available, we find that many are either not published or are significantly redacted.</p>
02	 <p>Public accountability requires the contract to be embedded within mechanisms such as user feedback, independent inspections and public transparency</p>	<p>The contract often only provides a mechanism for the client to hold the supplier to account.</p>
03	 <p>The contract should set out clear roles and responsibilities that establish whom to hold to account</p>	<p>Blurred roles and responsibilities are a cause of contracts going wrong. For instance, government may find it difficult to hold contractors to account for poor delivery if it has not met its own contractual obligations or if it is not clear who has responsibility for risk.</p>
04	 <p>The contract should set out robust performance and cost data to establish the right incentives</p>	<p>Many of our reports focus on the problems of setting appropriate performance benchmarks and accurate open book accounting.</p>

Source: Adapted from accountability essentials set out in National Audit Office, *Accountability to Parliament for taxpayers' money*, February 2016

## The demand for accountability and transparency is increasing

### Government retains responsibility for the services it contracts



The Accounting Officer for each department is responsible for ensuring that contracted-out services contain appropriate accountability arrangements to meet the standards expected of public services. While the contract is the principal way of setting requirements, these often need to be supplemented with other mechanisms for transparency, accountability and dealing with user feedback. These arrangements should be set out in the Accounting Officer System Statements published by each department.

### Public scrutiny of the contractors is increasing



Failings in key contracts, such as the 2012 G4S Olympic contract and the overbilling on electronic monitoring by G4S and Serco, have contributed to increased public scrutiny of strategic suppliers over the past six years.<sup>1</sup> Carillion's collapse in January 2018 has only added to that scrutiny. G4S, Capita and PwC, among others, have all appeared in front of Parliamentary select committees since January 2018 to be held to account for the public services they provide.

### Government has promised citizens more information on how contracts are performing



In June 2018, government announced its intention to increase transparency across key commercial contracts by requiring a number of key performance indicators to be published so that taxpayers can monitor outcomes and track how their money is being spent.

<sup>1</sup> Strategic suppliers are those government suppliers with contracts across a number of departments whose revenue from government exceeds £100 million per annum and/or that are deemed significant suppliers to government in their sector.

# Current and future initiatives – government commercial and contracting

## The present – current initiatives

In 2014, following the overbilling on the Ministry of Justice’s electronic monitoring contracts, the National Audit Office reported that government had systematically underinvested in managing contracts, and that the problems were deep rooted and cultural.

Since then, the Cabinet Office has been responsible for a programme of commercial capability improvement across government. That programme is ongoing with progress being made across a number of areas, and strengthening commercial capability is one of the top three management priorities for developing the Civil Service.

Developments include:

01

### Government Commercial Organisation (GCO)

Created in early 2017, the GCO aims to attract and retain the senior commercial talent across government. It offers a different remuneration package from the rest of the civil service to try and recruit top commercial talent.



02

### Commercial Blueprints

Since 2016-17, the Cabinet Office has overseen a programme of Commercial Blueprints across departments. These unpublished documents set out new workforce models, new organisation structures and transformation plans for departments to acquire the commercial skills they need.



03

### Training and development

The Government Commercial Function provides online training and accreditation and publishes professional standards for commercial specialists at foundation, practitioner and expert levels. It also ensures that senior commercial professionals attend the Commercial Assessment and Development Centre.



04

### Commercial operating and contract management standards

Commercial operating standards were released in 2016 to help departments to ensure effective commercial delivery and to drive continuous improvement. In February 2018, the Government Commercial Function released contract management professional standards that set out the capabilities expected of government professionals who are involved in the management of contracts.



# Current and future initiatives – government commercial and contracting

## The future – policy and aspirations

The Cabinet Office has identified the following areas to improve commercial outcomes and mitigate the risks of outsourcing. There is a significant degree of overlap here with issues we identify in this overview:

01

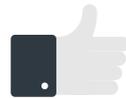


### Strengthen initial approval processes

(see [Getting it right at the start](#))

By strengthening business case reviews, establishing risk frameworks and improving assessment of the quality of bids

02



### Improve contracting capability

(see [Managing contracts](#))

By sharing best practice, providing guidance and continuing to develop commercial skills across government

03



### Strengthen central monitoring of markets and suppliers

(see [Managing markets](#))

By supporting financial and business health checks on suppliers

04

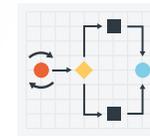


### Improve resilience to failure

(see [Managing markets](#))

By developing processes for responding to commercial failure and ensuring continuity in public services

In addition, in a speech in June 2018, the Cabinet Office Minister David Lidington set out specific measures that the government intends to introduce:



- **Living wills** produced by strategic suppliers to help ensure that contingency plans are put in place quickly in the event of future liquidations



- **Playbook** of guidelines, rules and principles that will aim to encourage new entrants to the market and build mixed markets of suppliers



- **Publication of key performance indicators** on key contracts to enable taxpayers to monitor outcomes



- **Social value** – the 2012 Social Value Act to be extended to make central government explicitly set and evaluate social value criteria on all major procurements

Our recent work has highlighted that many problems arise before procurement begins. Good contracting requires:



### It is important to focus on getting contracts right from the start



Many of the problems we have reported on recently arise from decisions made before procurement even began. This is particularly true when the requirement is complex or any transformation is involved. Not fully understanding what is being contracted and the risks involved can lead to the choice of the wrong supplier or contract. In some cases, this has led to early termination of major contracts.

### Both client and contractor need to do sufficient due diligence



We see many problems arise during a contract that should have been known at the start. Contractors often complain that they do not get enough time to do their own due diligence and have to rely on statements from the procuring authority. Conversely, contractors are often accused of bidding for contracts with insufficient regard to whether they can deliver them in full. Proper due diligence on both sides is needed to ensure that what is required and what might go wrong are clearly understood.

### Risk should be allocated to those best able to manage it



At their simplest, contracts set out who is responsible for managing tasks and risks. Contractors have recently been vocal in their complaints about onerous terms and conditions. Our work has shown that government sometimes uses the wrong sort of contract and sometimes contracts out parts of a service it should have retained. We also still hear of government trying to transfer all the risk to the private sector provider in the belief that this will protect government if things go wrong. In reality, transferring too much risk – that is, risks that cannot be managed by suppliers – increases costs and does nothing to manage the risk of the contract going wrong. Transferring too much risk can lead to a renegotiation or a bailout. It may also make the procuring authority forget to manage the risks that they are best placed to manage.



Departments need to understand what they are trying to contract out and the risks attached

#### **The Thameslink, Southern and Great Northern rail franchise**

In 2013, the Department for Transport (DfT) put together a complex and ambitious rail franchise contract. The franchise is the largest in the country, operating on a congested part of the network whereby the underlying infrastructure is unreliable. DfT wanted to increase capacity and improve services. The franchise contract also included commitments offered by the winning bidder to increase 'driver-only operation' (DOO) beyond the Department's original specification. The rail unions opposed DOO, where services can run without a guard or conductor crewing the train as well as the driver.

In structuring and negotiating the contract, we found that DfT did not fully develop what the potential effects on passengers would be, particularly if the risks that DfT identified around industrial action crystallised. Service levels dropped to the lowest in the national rail network and, by December 2016, only 62% of trains were arriving within five minutes of schedule.



Departments need to understand who is best placed to take on those risks

#### **Concentrix**

HM Revenue & Customs' (HMRC's) contract with Concentrix aimed to provide additional capacity and analysis to review and correct personal tax credit payments using a payment-by-results model. In our investigation, we found that Concentrix had consistently failed to achieve its performance targets, and in 2016 both parties agreed to terminate the contract.

The contract was originally estimated to save £1 billion over its lifetime, but in the end HMRC estimated that it had delivered savings of £193 million at a cost of £32.5 million. HMRC concluded that the risks to customer service of a third-party arrangement outweighed the benefits.

HMRC said that it had learned lessons from this case, including whether third parties can understand the subtleties of delivering a public service, and whether a contract with financial incentives for reducing error and fraud is the right mechanism to ensure good customer service.



Departments must ensure the contract appropriately allocates risks and responsibilities

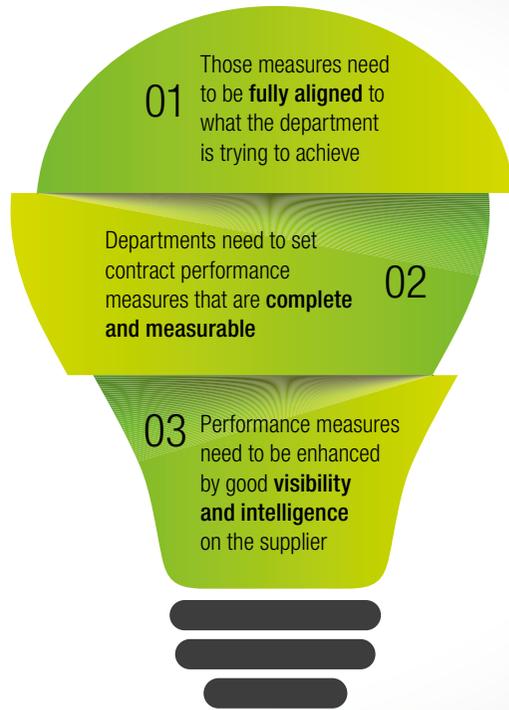
#### **The Magnox contract**

In 2014, the Nuclear Decommissioning Authority (NDA) awarded a 14-year contract to decommission 12 nuclear sites. The NDA said it recognised that the nature, scope and cost of work at the 12 sites could be different from what it expected when it started the competition. It therefore designed the contract to include a process that allowed the successful bidder to compare what it was told to expect on the sites and what it found on taking responsibility for them.

Between 2014 and 2017, the cost of the contract escalated from £3.8 billion to £6.0 billion. £1.2 billion of this, was due to the NDA's over-optimistic assumptions about the state of its sites before tendering the contract. In March 2017, the NDA decided to terminate the contract nine years early because of a significant mismatch between the work specified in the tendered contract and the work that needed to be done.

Our report concluded that the NDA's commercial strategy of using a target-cost contract, predicated on having a good understanding of the scope of work, appeared wholly inappropriate. We stated that the NDA needed to re-evaluate its commercial strategy and its capability to execute it, supported by expertise in government.

Our recent work has highlighted the need for better performance measures and use of intelligence in managing contracts:



## Commercial capability is improving but contract management remains weak



Following National Audit Office (NAO) reports on contracting failures in 2013 and 2014, government has recognised the need to improve contract management and has invested in building commercial capability and capacity across government departments. This has included developing stronger leadership within the commercial profession across government and providing more central support in terms of skills, expertise, standards and guidance. Despite improvements, contract management continues to be seen as one of the weakest areas of government's commercial capability, including by government's commercial directors (chart bottom left).

## Performance measures need to be established at the start and assess quality as well as cost to ensure that the contract delivers value for money



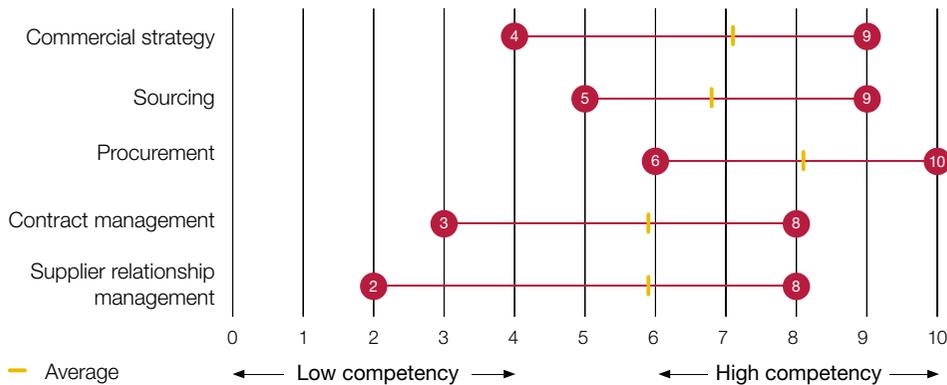
Managing contracts effectively requires departments to establish upfront what the key performance metrics should be. As well as being clear, measurable and achievable, metrics need to move beyond a simple focus on cost to cover the quality of the goods or services provided. Where the contract envisages a major change or transformation, we sometimes see performance metrics set in the expectation of the transformation being a success. This makes it difficult to hold contractors to account for delivering the change or the service during the change.

## Government departments need good intelligence on their suppliers to help them manage contracts effectively



Alongside setting appropriate key performance measures and metrics, departments need to ensure that they have sufficient visibility of their suppliers' performance, costs and financial health. Over the past few years, government has built on NAO recommendations around open book contracting to try new ways of gaining assurance on what is going on within contracts. This has helped it to understand, manage and mitigate many of the key risks to delivery of the contract. However, as some of the issues we reported around Carillion show, there is further to go in using this more widely.

Commercial directors' evaluation of procurement skills in their departments



**Note**

1 We surveyed 17 ministerial departments. Two departments did not respond: HM Treasury and the Home Office.

Source: Comptroller and Auditor General, *Capability in the civil service*, Session 2016-17, HC 919, National Audit Office, March 2017



Departments need to set contract performance measures that are complete and measurable

#### **NHS England's management of the primary care support services contract with Capita**

In 2015, Capita was awarded a £330 million contract to deliver primary care support services for seven years. This contract saved NHS England £60 million in its first two years. Performance issues quickly emerged and, in September 2016, NHS England had to serve default notices on Capita. NHS England stated in December 2016 that Capita had failed to deliver key aspects of the service, thereby putting primary care services and patients at risk.

We found that, when NHS England took responsibility for primary care support services in 2013, it did not know enough about the services it inherited to set achievable service and performance standards, and it lacked adequate data on the volume and cost of the services. As a result, it made several assumptions to set service specifications and performance standards, and it included mechanisms within the contract to try and mitigate the risks around inadequate data. We also found that performance measures did not cover all the service areas Capita needed to deliver. In 2016, a review by NHS England found that 23 of 78 key activities Capita was contracted to carry out were not captured by performance measures.



Those measures need to be fully aligned to what the department is trying to achieve

#### **Home Office: The Disclosure and Barring Service convergence programme**

In 2012, the Home Office signed a five-year contract with Tata Consultancy Services to support the Disclosure Barring Service (DBS) and move to a transformed operating model by 2014. The first stage of this modernisation was not delivered until September 2017. By January 2018, further modernisation had not been delivered and it was unclear whether the expected transformation would be delivered by the time the contract expires in 2019.

We found that the contract did not directly link payment to completion of modernisation. Only 3% of the original contract value was payable on completion of milestones, and these only related to transition rather than modernisation. The contract included only an outline timetable for the modernisation, with detailed design work expected to happen during the contract's life.

DBS believes the service provides an effective safeguarding service, but there are no checks on effectiveness and the Home Office does not know if it has got value for money from the contract.



Performance measures need to be enhanced by good visibility and intelligence on the supplier

#### **Managing the HMRC Estate**

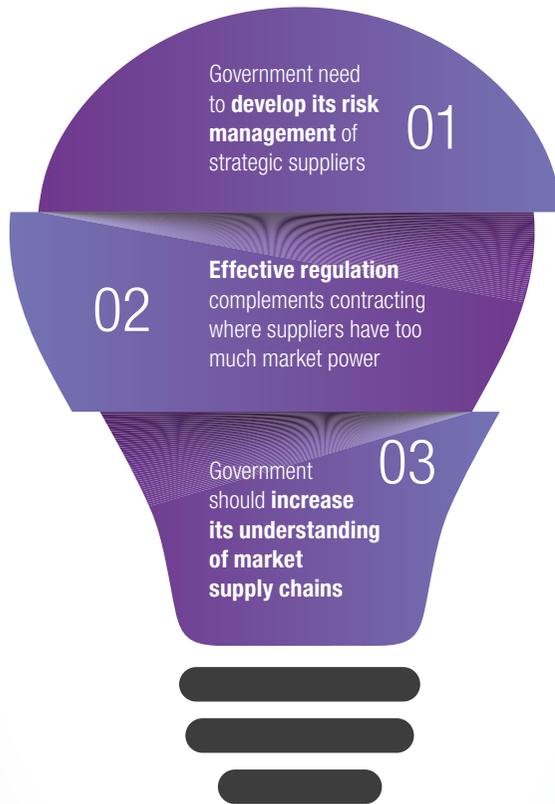
HM Revenue & Customs (HMRC) holds a 20-year Private Finance Initiative deal, signed in 2001, with Mapeley STEPS Contractor Ltd (Mapeley) for the management of two thirds of its estate. In 2009, we reported that HMRC was failing to manage significant risks in this contract effectively.

HMRC responded positively to recommendations from that report and established a specialist team to oversee the contract, as well as agreeing a memorandum of understanding with Mapeley to recognise HMRC's need for financial transparency from the supplier and Mapeley's need to know about HMRC's future plans.

Since then, there has been a good working relationship between the two sides, and greater access to the supplier's financial information has enabled HMRC to improve its understanding and management of risks to the delivery of services.

At the 2015 spending review, HMRC set out plans to move from a estate of 170 offices to 13 large regional centres. Improved management of the HMRC estate led to cumulative savings of £354 million between 2011 and 2016.

Our recent work has highlighted that the government has had mixed results in managing markets, and to ensure that risks are managed and value for money is delivered it needs to develop a more interventionist approach to the markets it has created. We have found that:



### Government has created a market for public sector work and needs to take a hands-on approach to shaping and managing it



The public sector spent £255 billion on commercial contracts in 2016-17, nearly one third of its total expenditure. It creates markets in which it is the sole buyer for goods and services, such as the management of prison services. These are not private markets where the government can choose to what extent it wishes to involve itself: they require the government to manage them effectively to protect value for money for the taxpayer.

### Government is starting to think about how it shapes markets for public contracts



Government has started to recognise that it could do more to shape the markets it uses. It already uses regulation to complement contracting when there is a risk of suppliers having too much market power. It is also developing a 'playbook' to provide government buyers with tactics to help shape markets they create.

### Government manages its relationships with key suppliers strategically



Public sector markets are dominated by a few large suppliers that are monitored through government's strategic supplier risk management policy. Under this policy, the Cabinet Office collects and monitors information on strategic suppliers and produces risk assessments based on suppliers' financial health and delivery performance. While this provides a framework for monitoring suppliers, failures around Carillion show that the Cabinet Office needs to do more to ensure that it is managing those risks at a portfolio level.

### Government wants to increase the participation of small and medium-sized enterprises (SMEs) in the market



Government is committed to increasing the proportion of its spend with SMEs to 33% by the end of the current Parliament. Government figures show that the proportion fell from **27.1%** in 2014-15 to **22.5%** in 2016-17. More than half of recorded spend is through work sub-contracted through major suppliers. It is therefore important that government understands the operations, incentives and consequences across the supply chains of strategic suppliers. The consequences of Carillion's collapse in January 2018 are still being felt throughout the extensive supply chain in the construction industry.



### Government needs to develop its risk management of strategic suppliers

#### **Investigation into the government's handling of the collapse of Carillion**

Carillion was a strategic supplier to government with around 420 public sector contracts. It was forced to issue three profit warnings in the second half of 2017 following an £845 million write-down on major contracts. It collapsed into liquidation in January 2018 after the government refused it financial support.

The Cabinet Office was monitoring Carillion in line with its strategic risk management policy. The risk assessments were based on performance evaluations of its public contracts and monitoring of publicly available financial information. This meant that the Cabinet Office was not aware of the large losses that were accumulating on Carillion's private construction contracts. It was also reliant on the validity of publicly available financial information. It had no assurance itself over the accuracy of this information.

The Cabinet Office only began detailed contingency planning for Carillion's potential collapse after the July profit warning. It was able to put together a detailed plan in a short period of time but encountered difficulties because there was no complete list of government contracts Carillion held.



### Effective regulation complements contracting when suppliers have too much market power

#### **Investigation into NHS spending on generic medicines in primary care**

The prices of certain generic medicines increased unexpectedly in 2017-18, adding unforeseen costs for clinical commissioning groups. The net spend on the affected medicines increased to £315 million, nearly seven times greater than the equivalent spend in 2016-17. The Department of Health & Social Care identified three main factors that may have caused the price increases but could not fully verify or quantify these. From July 2018, the Department has had new powers to introduce mandatory information-sharing arrangements for pharmaceutical companies and to control the price of generic medicines.

#### **Improving value for money in non-competitive procurement of defence equipment**

The Ministry of Defence (MoD) lets some contracts non-competitively where, for example, security concerns necessitate the use of a trusted national supplier. Between 2013-14 and 2016-17, around 50% of MoD contracts have been let this way. The government introduced Single Source Contract Regulations in 2014 to try and ensure that the MoD gets value for money on these contracts.

The MoD estimates that, for relevant contracts let by July 2017, the regulations could reduce prices by £313 million over the lives of the contracts. This represents some 3.9% of total contract values. However, the MoD lacks good-quality data on its portfolio of non-competitive contracts, and regulations could be undermined by gaps in key commercial and cost assurance staff. The Department is due to update Parliament in December 2018 on progress it has made in these areas.



### Government should increase its understanding of market supply chains

#### **Government's spending with small and medium-sized enterprises (SMEs)**

In our 2016 report on SMEs, we noted a broad consensus among government departments that there were benefits to be achieved from working with SMEs, including greater innovation and flexibility compared with larger providers, and potential better value for money because of fewer corporate overheads and senior staff.

Despite these benefits, SMEs were more likely to be involved in the supply chains of prime contractors rather than contracting directly with government. Government has limited knowledge of how these supply chains work because the prime contractor appoints, sets contract terms and manages the supply chain directly. This inhibits the Cabinet Office's ability to track progress towards increasing competition and innovation in markets.

We recommended that government should identify areas where the majority of SMEs operate within a supply chain. In these areas, it should ensure that prime contractors' behaviour does not prevent subcontractors delivering benefits for the public sector, for example by introducing codes of conduct for prime contractors.

## What to look out for

	Issue	Future developments, risks and challenges
01	 <p>Transparency and accountability</p>	<p>There is an increased demand for greater accountability and transparency around how government manages its commercial relationships and contracts. However, despite a clear legal and policy expectation that all contracts are made publicly available, many are either not published or are significantly redacted. Government is also seeking to increase transparency across key commercial contracts by requiring departments to publish a number of key performance indicators (KPIs).</p>
02	 <p>Contract scope and risks</p>	<p>Outsourcing a problem is always a risk, especially if the full scale of the problem and the impact of the risk on a business and its customers is not known. Procurement teams in departments are now getting a better understanding of the processes and services they are outsourcing, and senior management are realising that some risks cannot be transferred to the outsourcer.</p>
03	 <p>Commercial capability across government</p>	<p>Progress has been made in improving commercial capability across government. Government has established detailed people and commercial standards, created the Government Commercial Organisation (GCO) and assessment centre for commercial staff, reviewed the pay and reward structure for staff in GCO and launched a civil service commercial fast-stream for new graduates. It recognises that more is needed, and strengthening commercial capability is one of the Civil Service's top three management priorities.</p>
04	 <p>Using good data</p>	<p>Departments are setting KPIs and performance criteria in contracts and then finding that they do not have the data and systems needed to measure their supplier's performance effectively. Departments will need to do more due diligence on their own data when putting contracts together to ensure that they have a clear baseline against which they can measure performance, and the technology, data and processes so they can hold suppliers to account for their performance as the contract is delivered.</p>
05	 <p>Supplier scrutiny and risk management</p>	<p>In August 2018, the Public Accounts Committee found that using RAG (Red/Amber/Green) risk ratings to assess strategic supplier risk was not working and recommended that the Cabinet Office develop an approach to examining the market to provide it with better intelligence on the motivations and intentions of companies bidding for central government work. Government is yet to respond to this recommendation.</p>
06	 <p>Understanding the market</p>	<p>Carillion's collapse outlined how important it is that government is prepared for the possibility of key strategic suppliers failing. The Cabinet Office put together a plan for dealing with Carillion but struggled to get sufficient engagement from some public sector bodies. The government has announced that it plans to require all key suppliers to develop 'living wills' that it hopes will enable contingency plans to be quickly put in place while ensuring that key public services are delivered in the event of another strategic supplier collapse, which remains a possibility given the current environment and the financial health of several strategic suppliers.</p>

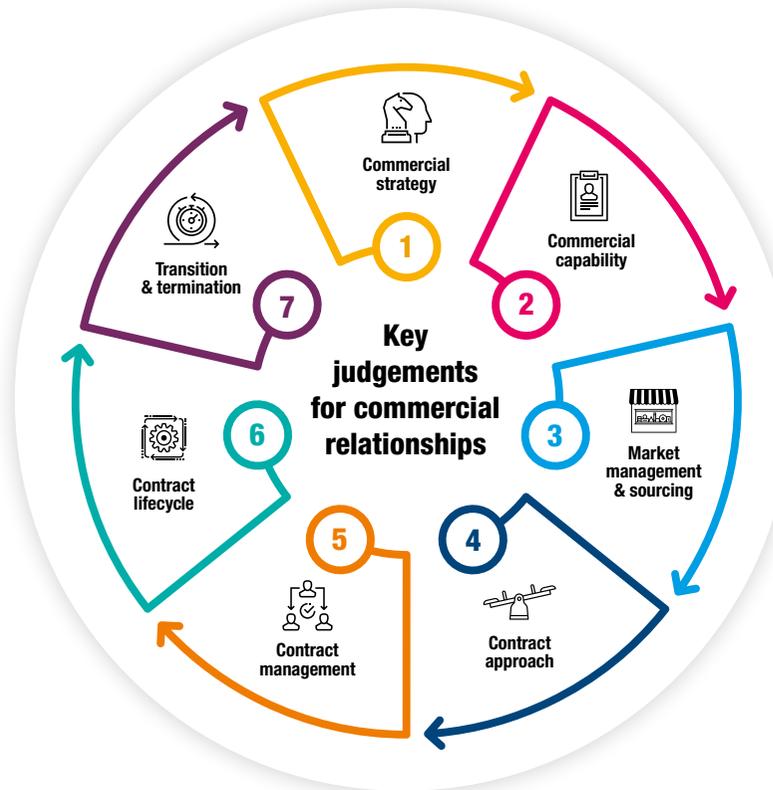
## Our audit methodology

### The National Audit Office (NAO) methodology for auditing commercial relationships

The NAO developed the contract lifecycle framework in 2016 based on previous reports and discussions with government and as a necessary extension to our 2008 good practice framework for contract management. We review government contracts against this framework to inform our value for money studies.

The lifecycle covers seven areas across commercial relationships from commercial strategy to contract termination.

Within the framework, we set out our insights on some of the areas where contracts go wrong, the warning signs that we look for and the examples of emerging good practice we have seen across government. We draw on many of our previous reports, our engagement with government as it has sought to improve its commercial capability, and our discussions with practitioners about the challenges they face. We also set out our framework for auditing commercial relationships that we intend to use increasingly to explore emerging good practice. The specific questions we ask will vary for each audit.



More information about the lifecycle can be found in our interactive Commercial and contract management insights and best practice document.