



National Audit Office

Memorandum

for Parliament

Government contracting

The role of major contractors in the delivery of public services



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Report by the Comptroller and Auditor General

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Amyas Morse
Comptroller and Auditor General
National Audit Office

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This report can be found on the National Audit Office website at www.nao.org.uk/2013-private-contractors

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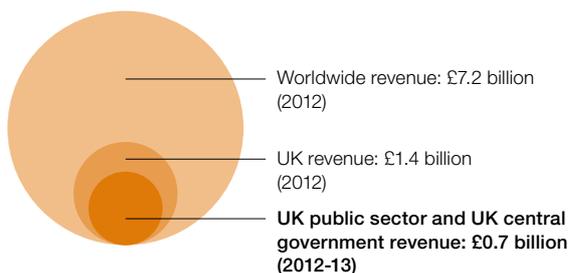
The logo for Atos, featuring the word "Atos" in a blue, sans-serif font. The letter 'o' is stylized with a white dot.The logo for Capita, featuring the word "CAPITA" in a blue, sans-serif font.The logo for G4S, featuring the letters "G4S" in a bold, black, sans-serif font. The number "4" is stylized with red and black geometric shapes.The logo for serco, featuring the word "serco" in a grey, sans-serif font. The letter 'o' is stylized with a red underline.

Key facts

The four contractors' revenue from the UK public sector

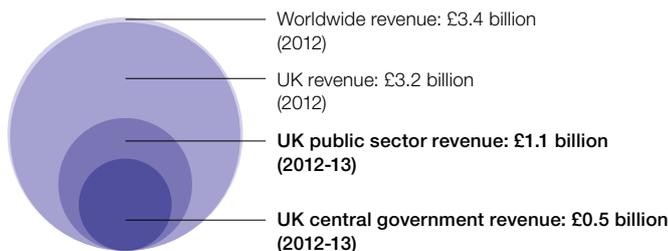
Atos

Atos is headquartered in France and provides ICT and business process outsourcing. The UK market is its second largest market after Germany and has origins going back to the 1960s.



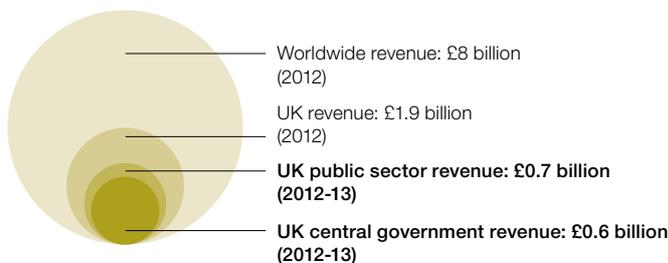
Capita

Capita is a FTSE 100 company with origins in local government outsourcing. Some 96 per cent of its revenue comes from the UK.



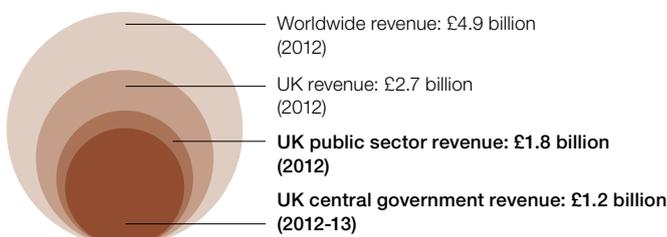
G4S

G4S is a FTSE 100 company providing security for buildings, people and cash in 125 countries.



Serco

Serco is a FTSE 350 company providing a range of public services. Its origins are in UK defence contracts, but it now has almost half its revenue from overseas governments.

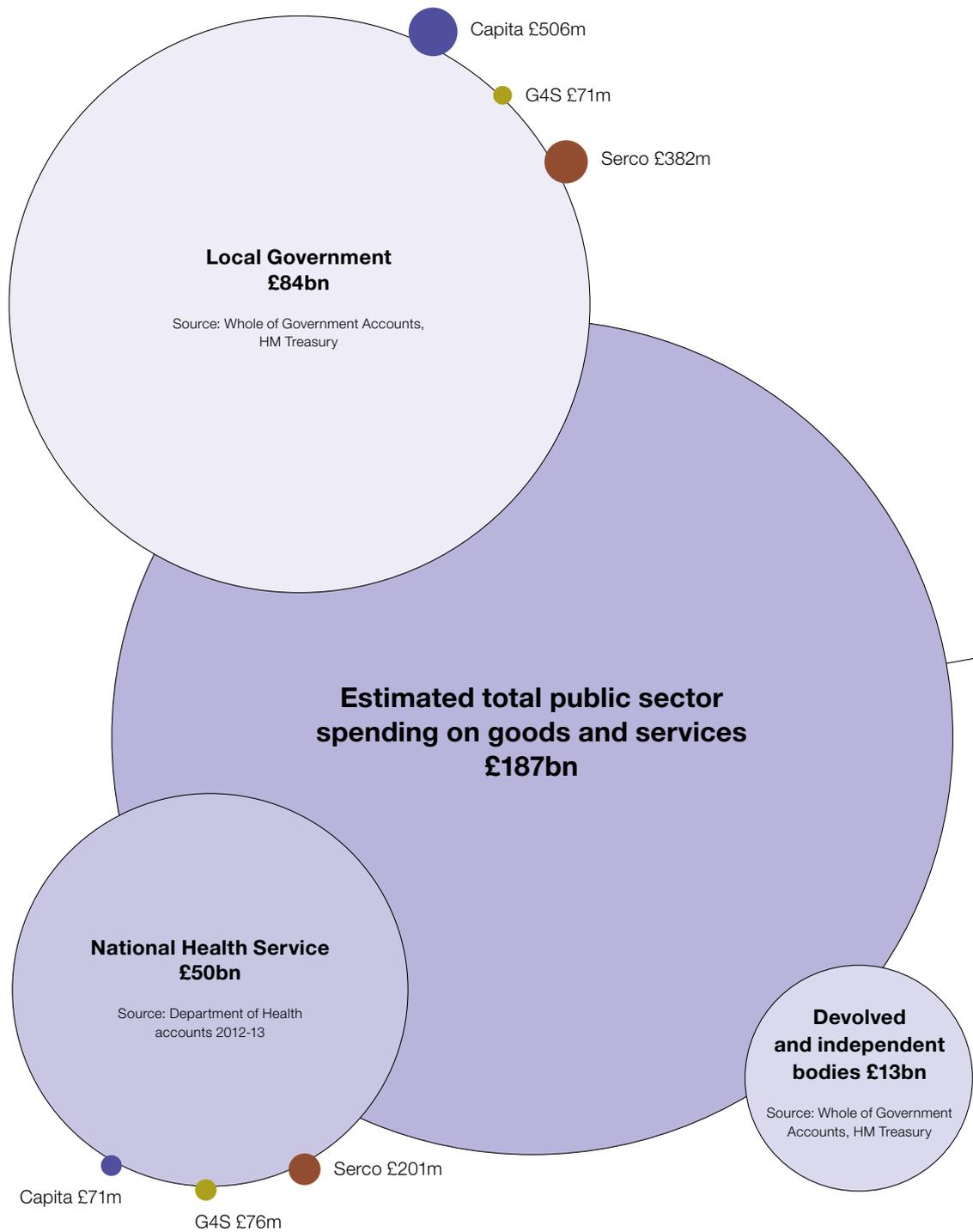


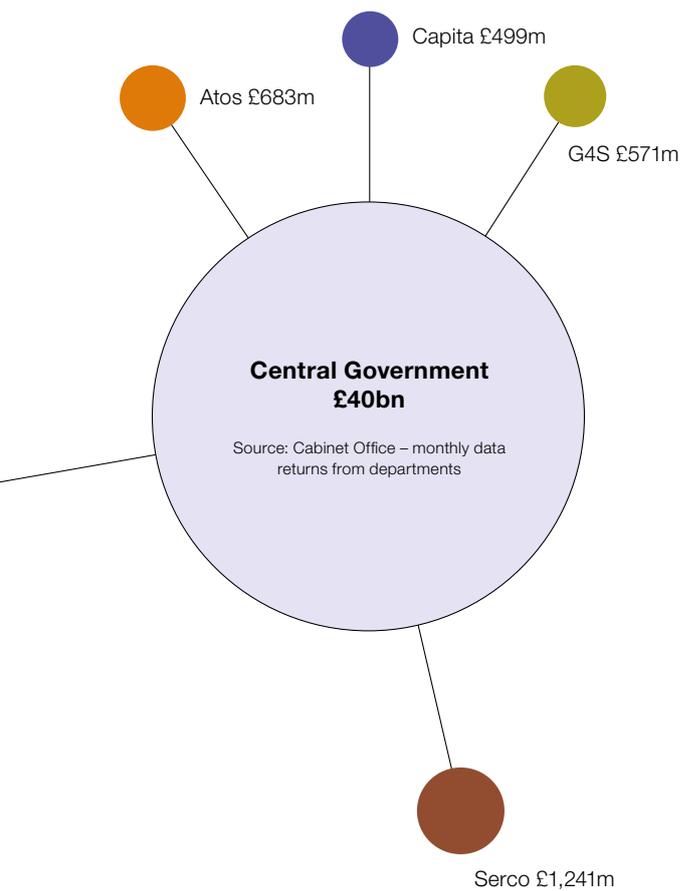
Note

- Worldwide and UK revenue figures as reported in contractors' 2012 accounts. UK public sector and UK central government revenue are amounts received in cash in 2012-13, as reported by the contractors to the Cabinet Office.
- UK public sector figures exclude devolved spending in Scotland, Wales and Northern Ireland.
- G4S's UK public sector and central government revenue figures exclude £142 million of revenue from contracts relating to the Olympics (before the settlement).

Figure 1

Estimated expenditure with third parties across the public sector, showing spend on Atos, Capita, G4S and Serco

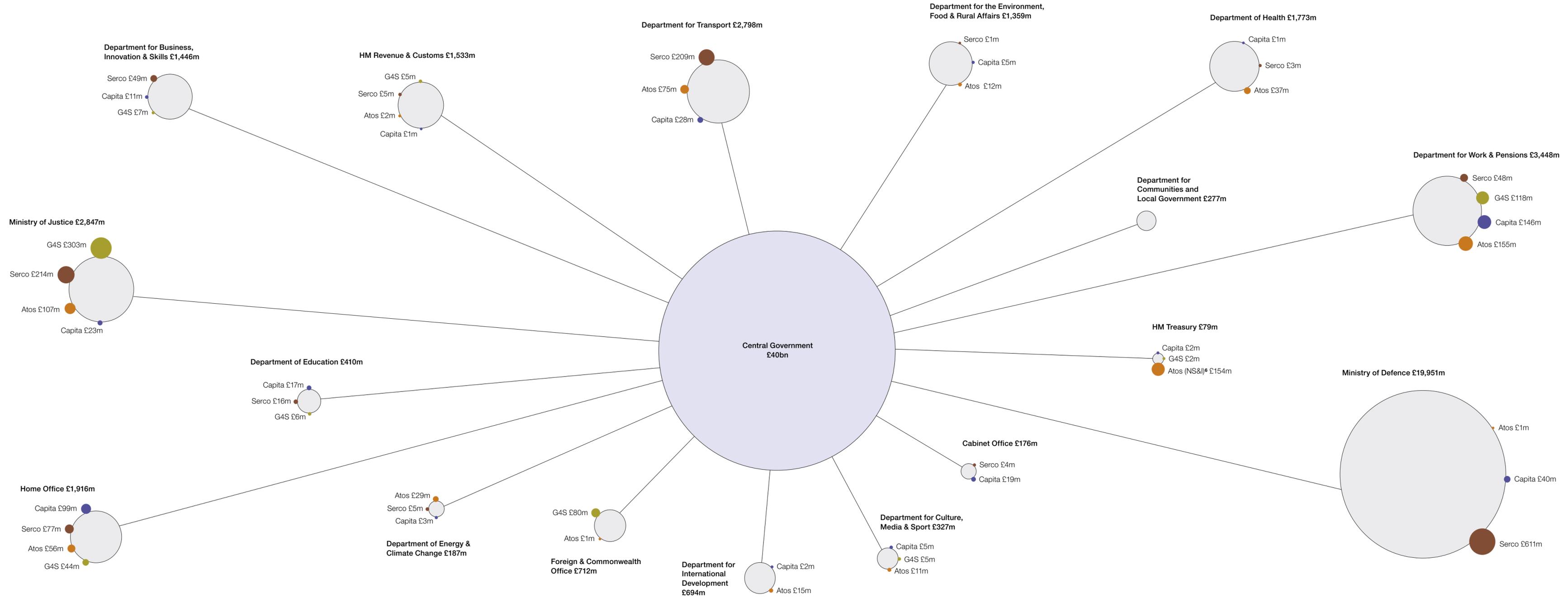




Notes

- 1 **Cabinet Office – monthly data returns from departments:** The Cabinet Office estimates that departmental returns cover approximately 90 per cent of central government expenditure. Data taken from department returns to the Cabinet Office include direct expenditure only. For full details see Appendix Two.
- 2 **Whole of Government Accounts:** figures are for financial year 2011-12. The remainder of expenditure shown is for 2012-13.
- 3 **NHS:** This is a combination of NHS trusts, foundation trusts, Strategic Health Authorities and Primary Care Trusts.
- 4 The total figure of £187 billion is the sum of different sources and should be seen as an estimate only.
- 5 Revenue for G4S excludes the Olympics (£142 million revenue in 2012-13 before the settlement).
- 6 Spend by devolved and independent bodies with the 4 contractors is not available.

Figure 2
 Estimated central government expenditure with third parties showing Atos, Capita, G4S and Serco



Sources and notes to Figure 2

Sources

Source for department totals: Cabinet Office – monthly data returns from departments: The Cabinet Office estimates that departmental returns cover approximately 90% of central government expenditure. Data taken from department returns to the Cabinet Office include direct expenditure only. For full details see Appendix Two.

Source for strategic supplier expenditure: Cabinet Office quarterly data returns from strategic suppliers 2012-13.

Notes

- 1 Supplier revenue figures have not been validated by departments and may differ from departmental published information.
- 2 Supplier expenditure data includes direct revenue and revenue earned through subcontracting. There may therefore be some double-counting across different suppliers.
- 3 There may be some misallocation of supplier revenue where arm's-length bodies have been incorrectly assigned to a departmental family.
- 4 Suppliers are not expected to report on low value contracts. In some cases, suppliers have included information on smaller value contracts in aggregate form. Where this has been allocated to a department, this has been included.
- 5 Some expenditure from within the wider health system could be included in the Department of Health expenditure figures.
- 6 Atos revenue of £154m against HM Treasury is a contract with NS&I. NS&I is a non-ministerial department of HM Treasury and this figure is not included in HM Treasury's total expenditure
- 7 Atos, Capita, G4S and Serco revenue from other central government bodies are shown in Figure 5.

Introduction and overview

1 Since the 1980s, the government has increasingly used contracting out to provide public services. We estimate that contracting out accounts for around half of the £187 billion that the public sector spends on goods and services each year. It includes both 'back-office' functions and more 'frontline' activities. Back-office activities include ICT support services and facilities management. Frontline activities include managing prisons, medical assessments of benefit claimants, and maintaining nuclear weapons.

Background

2 The current government, like the one before it, sees contracting out as a way to reform public services and improve value for money. Contracting out can significantly reduce costs and help to improve public services. However, there are several indications that better public scrutiny is needed across government contracting:

- There have been several high-profile allegations of poor performance, irregularities and misreporting over the past few months. These raise concerns about whether all contractors know what is going on in their business and are behaving appropriately; and how well the government manages contracts.
- The government believes that contractors generally have often not provided sufficient value, and can contribute more to the overall austerity programme. But the general level of transparency over contractors' costs and profits is limited. The government needs a better understanding of what is a fair return for good performance for it to maintain the appropriate balance between risk and reward.
- Third, underlying both these issues is the concern that government is, to a certain degree, dependent upon its major providers. There is a sense that some may be 'too big to fail' – and difficult to live with or without.

Memoranda on contracting out

3 We are publishing two memoranda to Parliament on government contracting (**Figure 3**). This memorandum focuses on the role of four individual contractors in the delivery of public services and is organised along three questions that we believe deserve greater public scrutiny:

- Is there sufficient competition in contracted-out public services (Part One)?
- Can we see whether contractors' profits reflect a fair return (Part Two)?
- How can we know whether contractors are delivering (Part Three)?

4 The accompanying memorandum, *Managing government suppliers*, covers the Cabinet Office's progress in improving how the government manages its relationship with 40 major contractors through its strategic suppliers programme. This programme is designed to strengthen control over departmental spending, share intelligence on suppliers across departments, and make savings.

Figure 3

The two National Audit Office memoranda

How the issues covered by each memorandum relate to the overall themes

Theme	The role of four contractors in the delivery of public services	Managing government suppliers
Managing the relationship with strategic suppliers	Is there sufficient competition in contracted-out public services?	What is government doing to manage its suppliers more effectively?
Getting value for money from contractors	Can we see whether contractors' profits reflect a fair return?	Is government securing value from its strategic suppliers?
Managing contractors' performance	How can we know whether contractors are delivering?	Does government have an overall view of supplier performance?

Source: National Audit Office

The four contractors – Atos, Capita, G4S and Serco

5 This memorandum aims to stimulate a public debate on how to improve government contracting. To illustrate the issues, it brings together information on four contractors – **Atos, Capita, G4S, and Serco**. Our choice of the four was based on our belief that a look at them would help to understand the cross-cutting issues. However, our choice does not mean that all the issues apply equally to these contractors or that there are no other contractors to whom they also apply.

6 In many ways these four were an obvious choice to explore contracting issues with. They are among the best known private providers of public services. They provide a wide range of public services across the public sector, costing over £4 billion in 2012-13. Of this some, £3 billion was for services contracted with central government departments (Figures 1 and 2 on pages 6 to 9). This is a small but significant part of the overall £187 billion that the public sector buys each year. The four contractors are also among the strategic suppliers identified by the Cabinet Office.

7 We are grateful for the help and cooperation provided by Atos, Capita, G4S and Serco in the preparation of this memorandum. Most of the information in this report is based on information the companies provided. Much of this would not otherwise be in the public domain. The contractors also helped us to understand their business and talked frankly about the risks, challenges and incentives they face.

8 However, we do not directly audit these companies and have not been able to verify all the information provided against underlying evidence. We have therefore presented the information in good faith, and attempted to compare different evidence sources wherever possible.

Achieving the intended benefits of contracting-out

9 Contracting out is used for a variety of reasons across government and the private sector, but generally because the contracting authority believes that it will help improve value for money, reduce costs and improve the quality of the service. There are generally three ways in which contracting out is intended to help improve public services:

- Getting a specialist in to deliver services can free up the client to focus on policy, strategy and stakeholders, and also deliver economies of scale. It can often provide access to skills that are difficult to retain in-house; contractors can provide clearer career paths for specialists and are not restrained by more rigid public sector pay structures.
- Involving a private sector partner can help to do things that are difficult to do within the way the public sector manages itself, such as facilitating 'spend to save' risk investment, using commercial incentives, and providing operational flexibility.
- Differentiating between the commissioner and the provider can help stimulate the reform of public services, particularly through the rigour of defining services through a contract, stimulating the search for new ways of providing the services and establishing a more rigorous performance regime.

10 Achieving these benefits relies on competitive markets, aligned incentives and sound accountability regimes. We set out these three main challenges below.

Is there sufficient competition in contracted-out public services (Part One)

11 The benefits of contracting out are underpinned by competition, which brings innovation, keeps quality up and prices low. There are two questions that need exploring:

- **Are public service contracts sufficiently competitive?** Maintaining competitive pressure through the different stages of the contract cycle can be hard. First, choosing a complex contracting model can risk diminishing competition – particularly if the government does not have the capability to manage it. Then, while there is great focus on competition at the tendering stage, this can quickly diminish when the contract begins. Expensive contract variations and not testing rigorously for ongoing value for money can reduce cost-effectiveness. Finally, when renewal is approaching, existing providers may have an in-built advantage because officials perceive them to be the safer and easier option.
- **Is the rise of a few major contractors in the public interest?** Larger suppliers can provide specific benefits: they can bring economies of scale and expertise; they can be less likely to suffer corporate failure and they can have the financial resilience to absorb upfront costs. They can also help to manage long supply chains of smaller providers. However, they can also come to dominate specific types of public services. Furthermore, the larger contractors often acquire smaller businesses that have won contracts, leading to a consolidation of the market. Such acquisition is, to an extent, a natural part of the business cycle, enabling entrepreneurs to exit their investment and allowing larger businesses to bring in new skills. However, it can lead to consolidated, less competitive markets and reduce innovation.

Areas for further exploration

- What benefits large contractors bring to public services.
 - Whether public service markets are truly competitive.
 - Whether public service markets contain the right mix of providers.
 - Whether the rapid growth of large contractors poses risks to public services.
 - Whether the large contractors can be replaced in public service markets.
-

Can we see whether contractors' profits reflect a fair return (Part Two)

12 What matters most to the taxpayer is whether contracted out services can provide improved quality at an improved overall cost. The level of contractors' profit is normally only a small component of that cost. However, understanding the contractors' profits is important; the balance of risk and reward shapes the contractors' incentives and can distort the contractors' behaviour if these are not aligned. The balance of risk and reward normally depends upon the structure of the contract and how well it is managed. Better information and understanding of the balance of risk and reward is necessary to improve both.

13 Transparency over the rewards contractors make is limited. In particular:

- Few companies publish sufficient information in their accounts to separately identify the revenues and profits from their public sector work.
- The government can generally only access profit information if they have agreed open-book accounting arrangements with the contractor, and then use them.
- It is difficult to see and understand the basis for the amount of tax contractors pay in the UK.
- Contractors reasonably fear losing a competitive advantage if they have to make more information available than their competitors. This is particularly the case where they provide the same service in the private market against competitors who do not provide public services.

14 Even where transparency exists, it is inevitably difficult to interpret profit information. It can be unclear what a reasonable margin looks like. In theory, the margin is meant to reflect risk, innovation and investment. But these are difficult to measure. Furthermore, profit is rarely presented consistently. It can be unclear how overheads are allocated. The profit margin changes, depending on the stage of the project. And different companies may target different rates depending on their business model.

Areas for further exploration

- Whether there is sufficient transparency over costs, profit and tax.
 - Whether the balance of risk and reward is providing the right incentives for contractors.
 - Whether profits represent a fair return.
-

How can we know whether contractors are delivering (Part Three)

15 Parliament, the government and the public have clear expectations of the standards expected of all public services. These include honesty, impartiality, openness, fairness, integrity, transparency, objectivity, and reliability, carried out in the spirit of the law, in the public interest, to high ethical standards and achieving value for money. The government relies heavily on the contract to ensure that standards are met in contracted-out services. This has not, however, traditionally allowed the government to assess or set requirements for how contractors maintain their corporate culture and environment.

16 To be a well-informed customer the government needs to satisfy itself that contractors' corporate governance structures work in taxpayers' interests, and that the companies are not paying 'lip service' at the centre with little group-wide control to back it up. Companies that are large and have sprawling structures, involving a vast number of subsidiaries, may have to make particularly strenuous effort to demonstrate this. There are two steps that government can take to encourage them to do this:

- **The government and public need transparency about performance.**
Transparency is needed to ensure that no one within the contractor can hide problems and that it is in the contractors' commercial interest to focus on their client's (the government's) needs. This requires more than just the key performance indicators reported to the client. For instance, it also requires public reporting and openness to public scrutiny; whistleblowing policies that encourage staff to report problems up the supply chain; and user feedback.
- **The government needs to ensure it is in contractors' financial interest to implement rigorous controls throughout their business.** Companies' own control environments will likely concentrate on maintaining shareholder value. Government needs to ensure that it is in the contractors' financial interests to focus their control environment more widely on meeting the standards expected of public service. This involves using contractual entitlements to information, audit and inspection to ensure standards are being met. And it is likely to involve financial penalties, banning from competitions and political fallout when problems are found.

Areas for further exploration

- Whether contractors are meeting the standards of performance the public expects.
 - What contractors consider themselves accountable for.
 - Whether transparency is sufficient to ensure contractors work in the taxpayers' interests.
 - Whether contractors' control environments focus on ensuring standards of public services are met.
-