



National Audit Office

Memorandum

for Parliament

Government contracting

The role of major contractors in the delivery of public services

Our vision is to help the nation spend wisely.

Our public audit perspective helps Parliament hold government to account and improve public services.

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National Audit Office

Government contracting

The role of major contractors in the delivery of public services

Report by the Comptroller and Auditor General

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to be printed on 11 November 2013

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National Audit Act 1983 for presentation to the House of
Commons in accordance with Section 9 of the Act

Amyas Morse
Comptroller and Auditor General
National Audit Office

8 November 2013

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.

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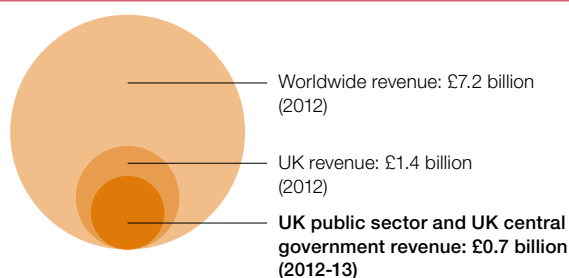
The logo for Atos, featuring the word "Atos" in a blue, sans-serif font. The letter 'o' is stylized with a white dot.The logo for Capita, featuring the word "CAPITA" in a blue, sans-serif font.The logo for G4S, featuring the letters "G4S" in a bold, black, sans-serif font. The number "4" is stylized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

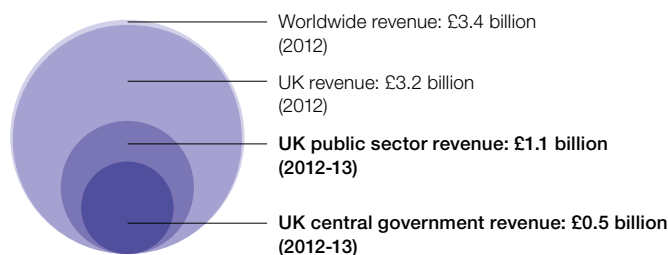
Atos

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.



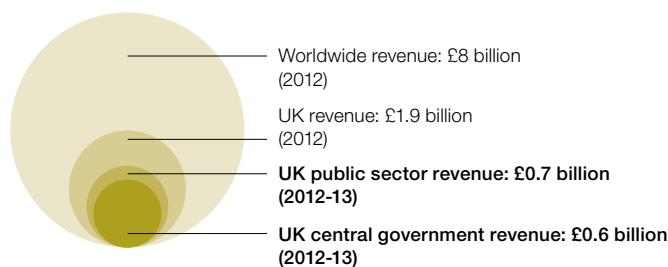
Capita

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



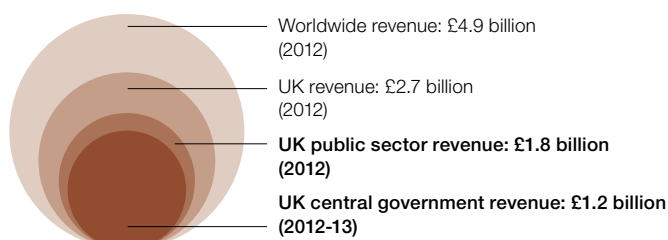
G4S

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.

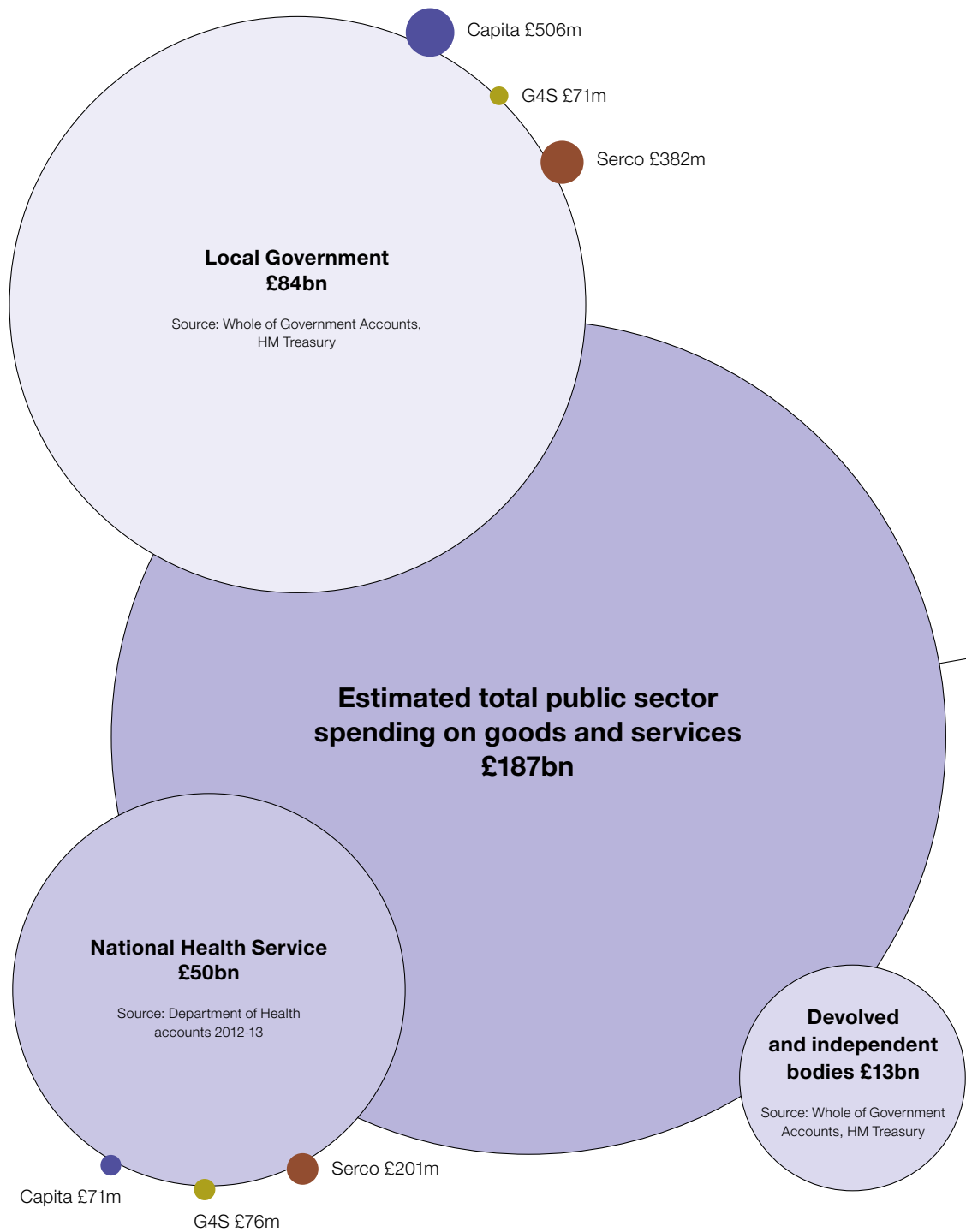


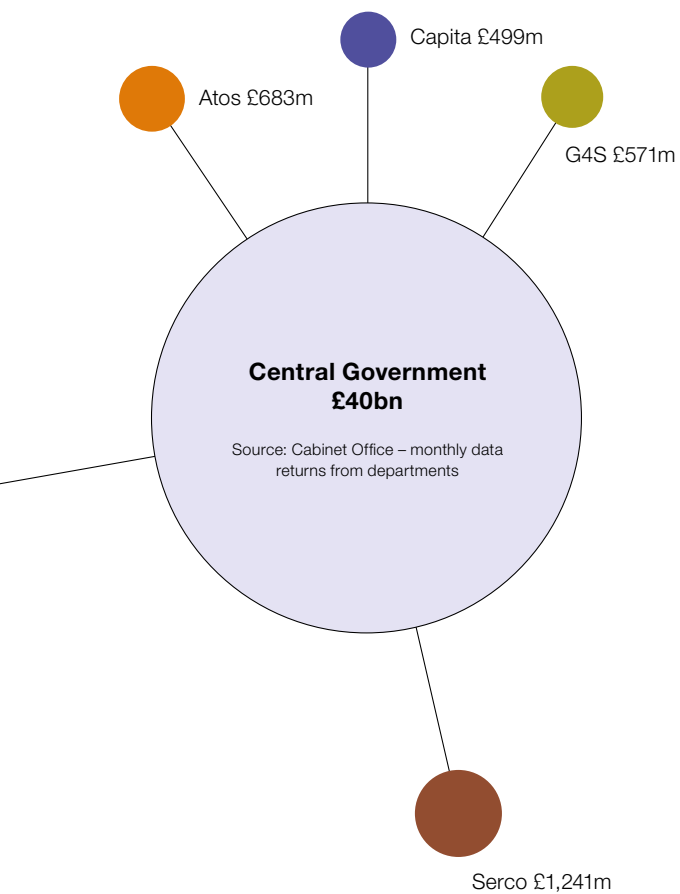
Note

- 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

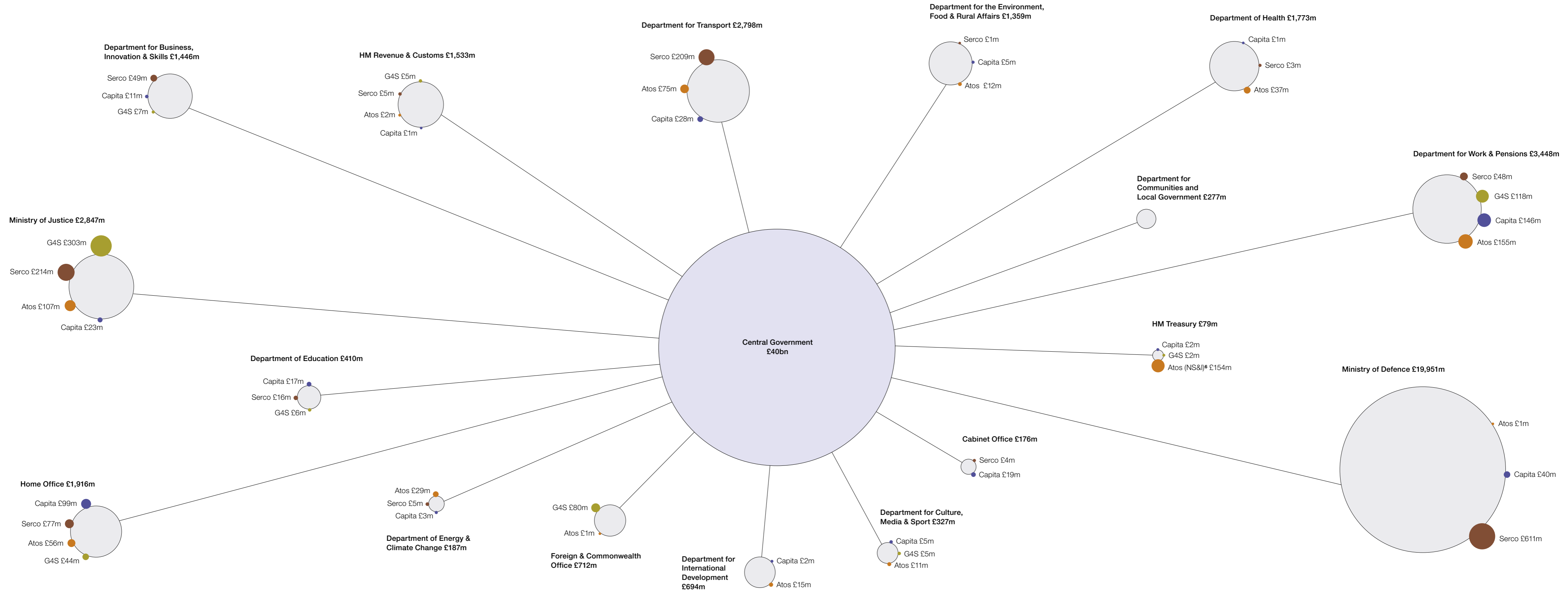




Notes

- 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.
-

Part One

Is there sufficient competition in contracted-out public services?

1.1 This part of the report focuses on competition in contracted-out public services. It explains:

- the general trend in contracting out and the main reasons why the government uses private contractors (pages 18 to 19);
- sources of each of the four contractors' public sector revenues (pages 20 to 21);
- the risks to competitiveness throughout a contract's life (pages 22 to 23); and
- the risks to market competitiveness through dominance of large suppliers (pages 24 to 30).

The increasing trend of contracting out public services

1.2 The government has increasingly contracted-out public services to private contractors since the 1980s. For example, the government increasingly contracts out 'back-office' functions such as facilities management, ICT support services, transactional services (such as processing car tax disc payments); and process and case management (such as pensions administration); as well as more 'frontline' activity such as helping the unemployed back to work, running prisons, and managing community health services.

1.3 This trend of increasing contracting out of public services follows trends in the UK private sector where businesses increasingly 'outsource' non-core business such as administration and customer management. It also follows repeated governments' desires to use contracting out as a catalyst to reform public services.

1.4 There is no agreed definition of contracted-out services or measure of how much the government is spending on them. A 2008 Department for Business, Innovation & Skills report estimated that the public services market is at least £79 billion.¹ We believe a sensible estimate of the contracting market is around half of the £187 billion that the government spends on all goods and services. Figures 1 and 2 on pages 6 to 9 show the distribution of this spending across government and the sectors in which Atos, Capita, G4S and Serco are providing their services. Detail on the sources of each of the four contractors' public sector revenues are also shown in **Figure 5** on pages 20 and 21.

1.5 Contracting out is more common in some areas of government than others. For instance, local government has been contracting out a lot of operations, such as waste collection, since the 1980s; prisons have been operated by a mixture of public and private providers since 1992; and while some police forces have been contracting out since 1999, most police custody and administration is done in house. In general, fewer central government services are contracted out than local government services.

1.6 As for any other major change in how services are run, commissioning public authorities need to put together a robust business case before they decide to contract out public services. These business cases generally make one or more of three generic strategic cases for contracting out services:

- Contractor specialism, economies of scale and access to skills.
- The ability to do things that are difficult to do in the public sector.
- The rigour that contracts bring to understanding public services and defining service requirements.

Figure 4 shows examples of services offering these benefits.

¹ DeAnne Julius CBE, *Public Services Industry Review*, Department for Business, Innovation & Skills, July 2008.

Figure 4

Why the government contracts out services

Reason**Focus, economy of scale and access to skills**

For example, contractors can:

- free up the client's management to focus on policy, strategy and stakeholders;
- use similar management, processes and operations across different sectors; and
- use specialists across a number of projects, providing both career paths for the specialists and flexibility for the customer.

Doing things that are difficult to do within the public sector

For example, using a private contractor can encourage:

- 'spend to save' investment;
- innovation and performance improvements by aligning commercial incentives to the required performance; and
- operational flexibility by reducing the management chain involved in making decisions.

Rigour of defining the requirement and performance regime through a contract

For example, writing a contract can:

- concentrate attention on the required resources to do the work; and
- establish a more rigorous monitoring regime over performance.

Case study

National Savings & Investments (NS&I) contracted out the entire operations of the organisation (effectively running a savings bank) to allow its management team to focus on policy, strategy, and product pricing, development and marketing. Siemens Business Services (acquired by **Atos** in 2011) took on around 4,200 NS&I staff. The contractor reports that the staff required to manage services to customers has reduced to around 1,300 UK-based staff and 480 in India, and that NS&I saved £530 million since 1999, while avoiding significant redundancy costs. In 2012 **Atos** won a fresh competition to provide services until 2021, proposing further efficiency savings and a strategy encouraging customers to switch from post and over-the-counter services to telephone and online banking.

The Department for Work & Pensions is able to make use of the economies of scale provided by established private sector customer contact centres. **Capita's** Dearne Valley contact centre employs 4,500 staff providing call centre services for British Gas, BMW, O2 and the RSPCA. The Department has contracted out a range of its customer contact operations to the centre, including supporting appointment bookings for Jobseeker's Allowance claimants and more complex requirements such as information relating to pension age entitlements. The Department benefits from the operational flexibility a centre like Dearne Valley can provide as well as economies of scale on the costs of running call centres.

The Ministry of Defence contracted out the management of its back-office delivery business in order to make flexible use of skills and expertise not available in house.

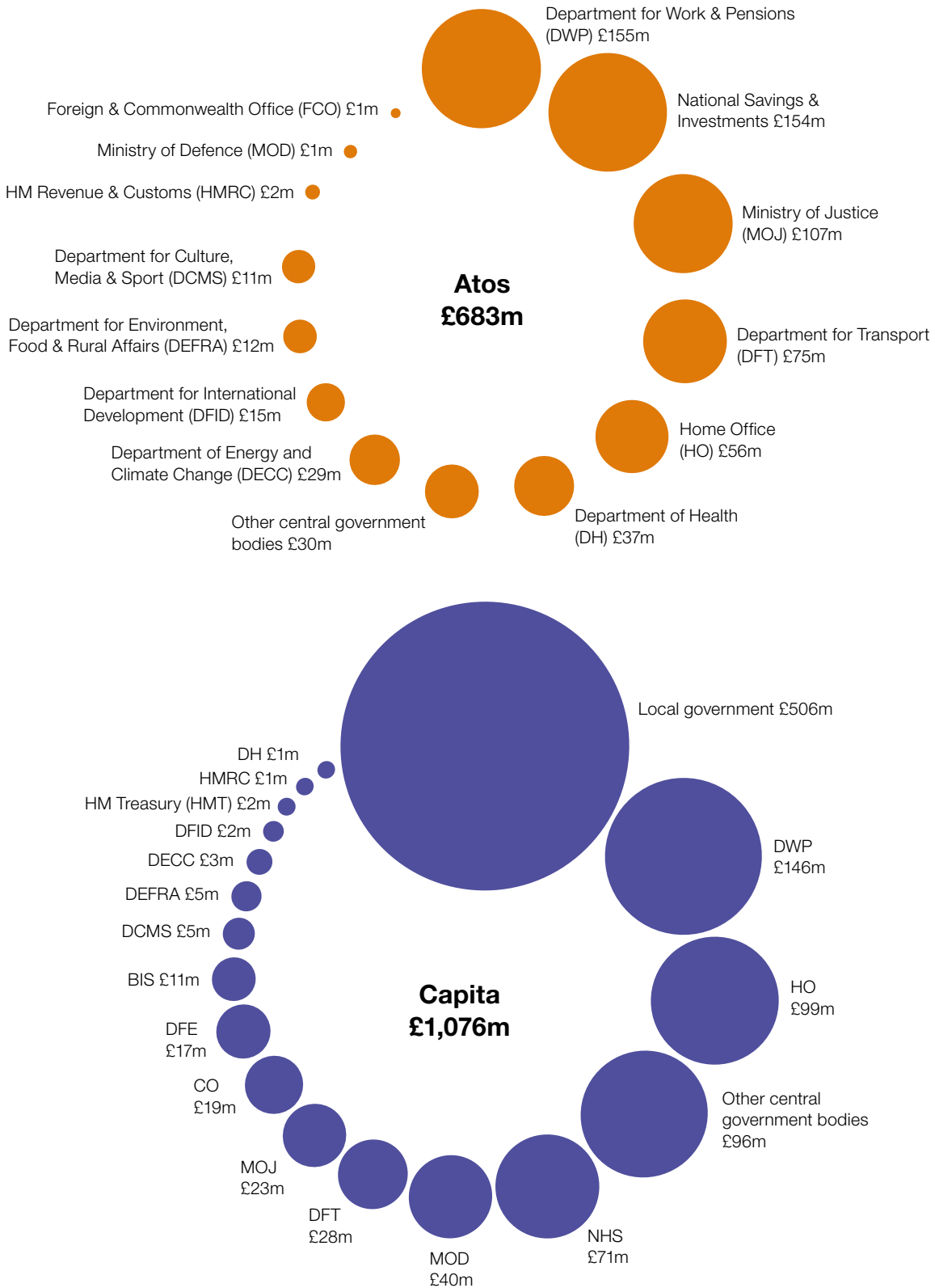
Defence Business Services (DBS) was established in 2011 to create a single shared service organisation delivering a variety of human resources, finance and other back-office services across the Ministry of Defence. After open competition the Ministry appointed **Serco** in March 2012 to accelerate the pace of transformation and drive efficiency savings in DBS. Under the deal **Serco** provides a senior management team and other technical support to manage DBS, allowing the Ministry to benefit from external expertise to transform the organisation. **Serco** plans to invest £12.3 million worth of staff and technology resources in DBS over the four-year contract. The Ministry will invest a further £6.3 million in enabling DBS transformation. **Serco's** fee is entirely based on receiving a share in the savings delivered to the DBS budget over the four-year period.

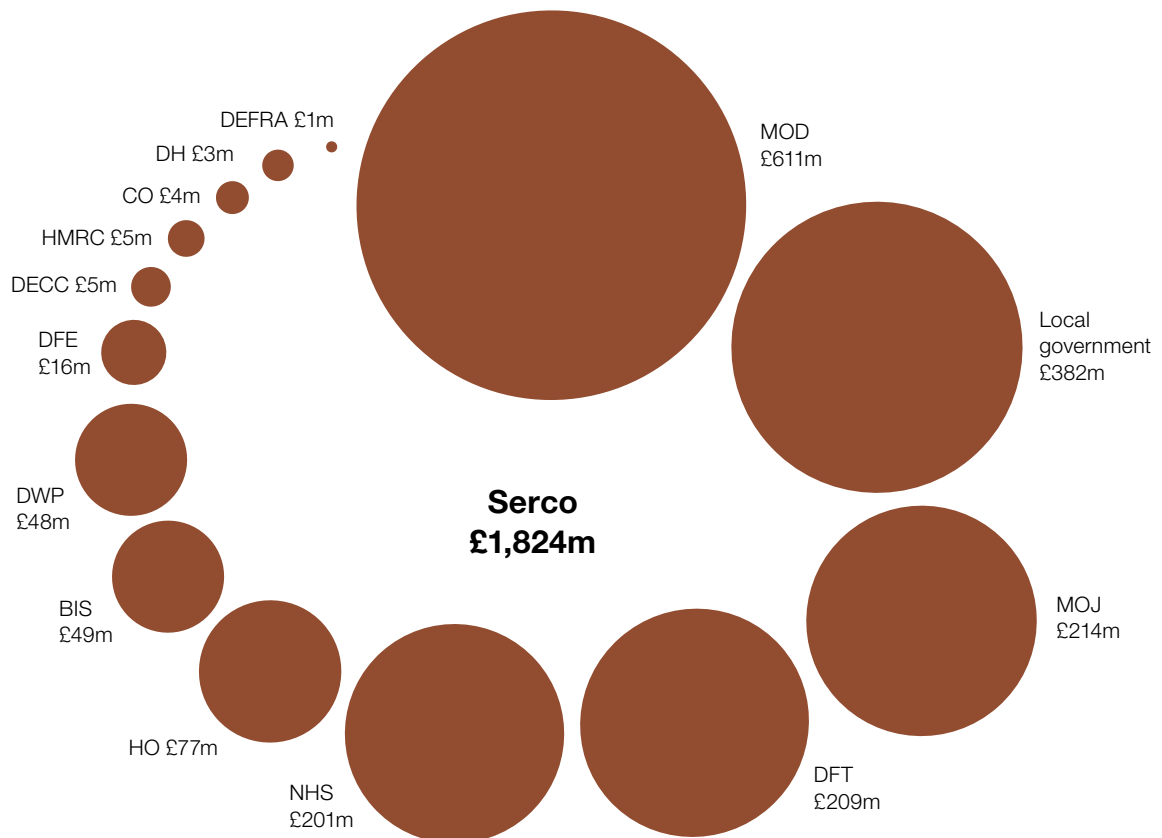
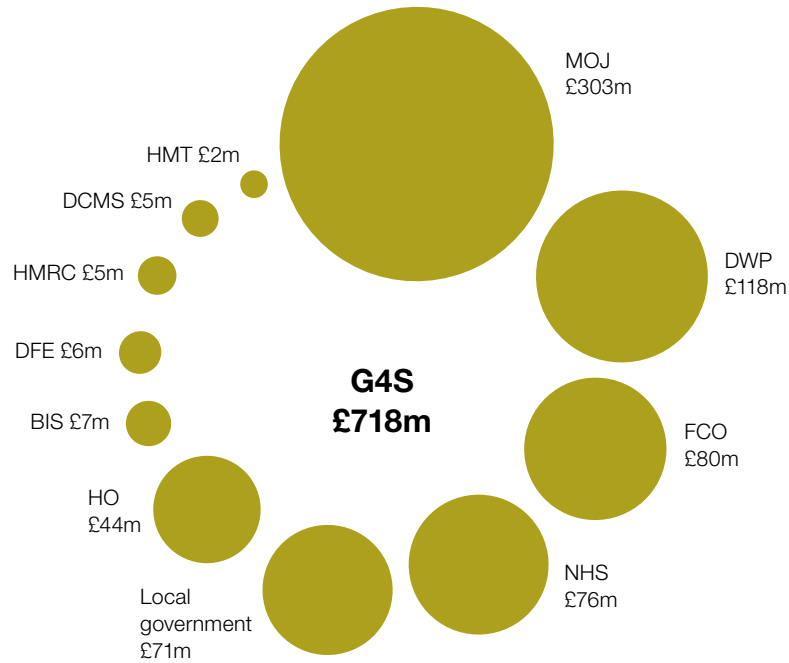
Negotiating contracts for the private sector to provide prison services helped to challenge established understanding of the level of staffing resources needed to run a prison. The first contracts were let in 1992 and private companies (including **G4S** and **Serco**) now run around 10 per cent of all prisons in England and Wales. The Ministry of Justice and its independent inspectorate monitor performance consistently across public and private sectors. The competitive processes that create private prisons has helped the whole prison system to be more specific about the relationship between resources and desired outputs and outcomes. This has been helpful in successive rounds of efficiency savings.

Source: National Audit Office interviews with those responsible for putting together the business cases

Figure 5

Four contractors hold public service contracts with £4 billion revenue in 2012-13





Source: National Audit Office analysis of Cabinet Office data (central government) and contractors' data (local government and NHS)

Competition in public service contracts

1.7 Competitive tension between providers of contracted-out services helps to bring innovation, to keep quality high and prices low. However, because the services are generally provided over a number of years, maintaining competitive tension between providers can be challenging.

1.8 Most of the contracts for the four contractors were competitively tendered, either through 'mini-competitions' with pre-selected contractors on a framework, or through an open competition (**Figure 6**). None of the contractors has a competitor that completely matches the full range of its business. Each contractor thus competes with a different set of competitors for each tendering competition it enters.

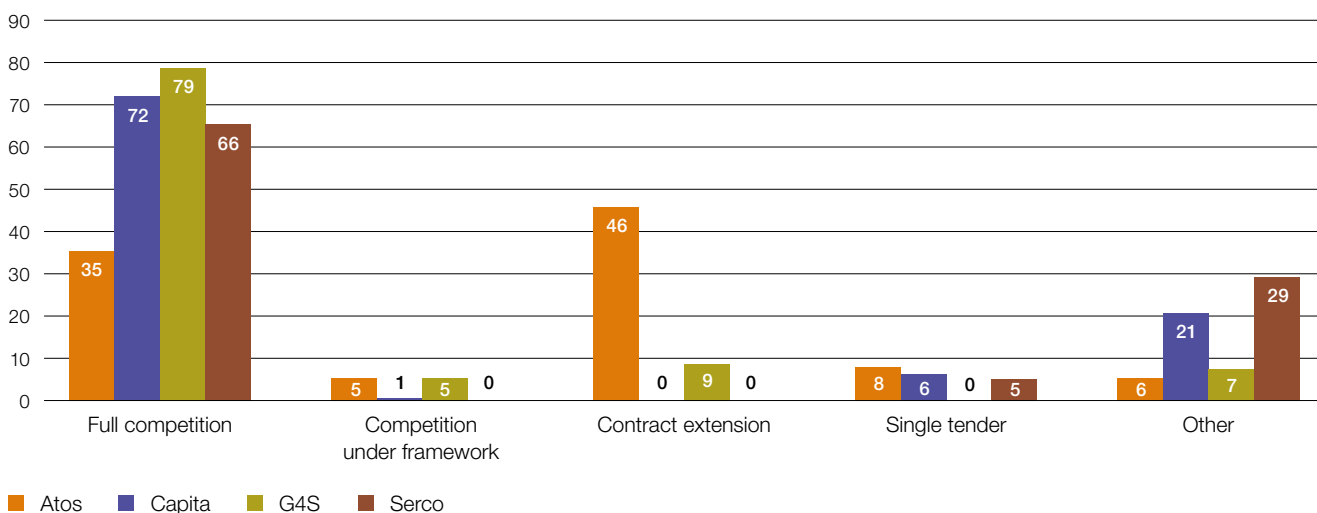
1.9 Making the most of competition for a specific service requires, among other things, a balance between repetitively tendering the service and working closely with the same contractor for a sustained period. For instance:

- Contractors aim to reduce their costs and become more efficient, so a longer contract is more profitable. Thus short, repetitively tendered contracts can increase price competition. However, longer contracts can increase the risk transferred, encourage investment and allow expensive bid costs to be recouped. The average contract length in the four contractors' portfolios ranges between five and twelve years (**Figure 7**). The average annual value of contracts up for renewal in each contractor's portfolio ranges between £54 million and £164 million.
- Changing a contract and adding requirements allows a contract to evolve, but can be less competitive than fully tendering the new requirement. Because of such changes, the total revenue through contract tends to grow, as reflected in the four contractors' portfolios (**Figure 8** on page 24). In our experience the contractors tend to make higher profit margins on these changes. Good practice aims to build in flexibility to the contract and relies on transparent costs and profits.
- Incumbents can be seen by procurement and policy officials as the easier and safer option. Across the 15 applicable services we looked at as case studies for this memorandum, seven had been re-tendered at least once, with four of the most recent competitions for each service being won by existing providers and three by new providers.

Figure 6

Much of the contractors' central government revenue is from contracts let competitively

Percentage of revenue from central government contracts in 2012-13



Note

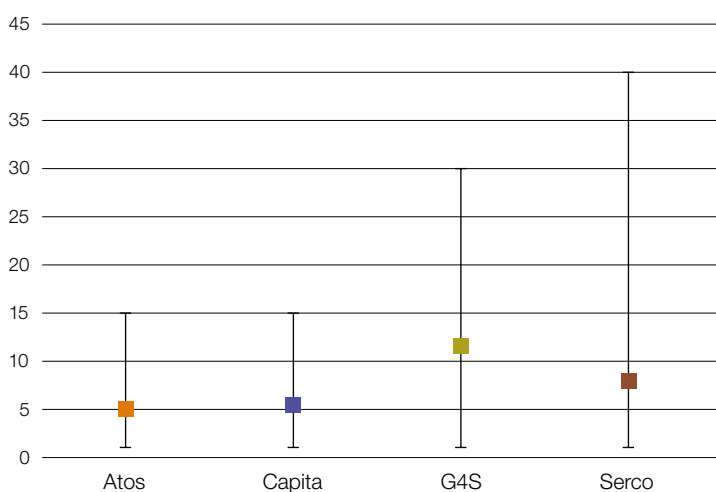
1 The Atos contract extension value is largely made up of two contracts. One has now been competitively re-tendered in the last year and the other is currently in the process of being competitively re-tendered.

Source: National Audit Office analysis of data from contractors and Cabinet Office

Figure 7

Average length of contracts varies from 5 to 12 years

Contract length for central government contracts (years)

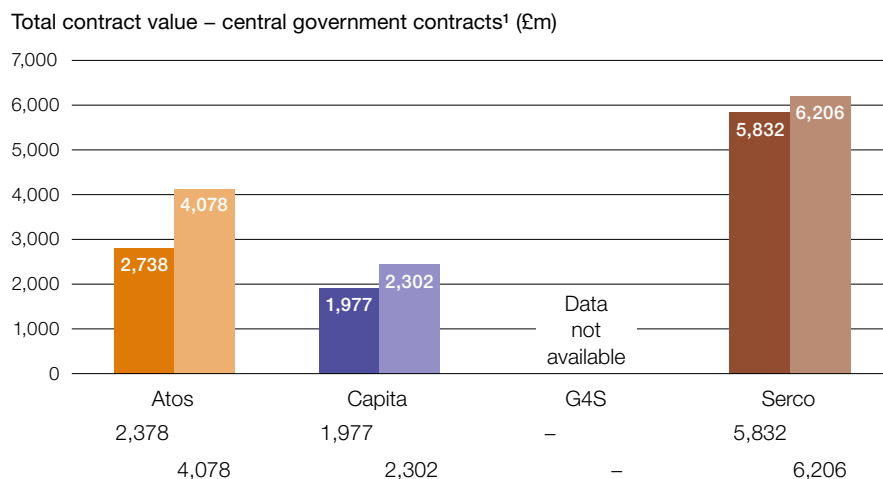


| | | | | |
|---------------------------|----|----|----|----|
| Longest contract (years) | 15 | 15 | 30 | 40 |
| Average length (years) | 5 | 6 | 12 | 8 |
| Shortest contract (years) | 1 | 1 | 1 | 1 |

Source: National Audit Office analysis of data from contractors and Cabinet Office

Figure 8

Contract values have increased



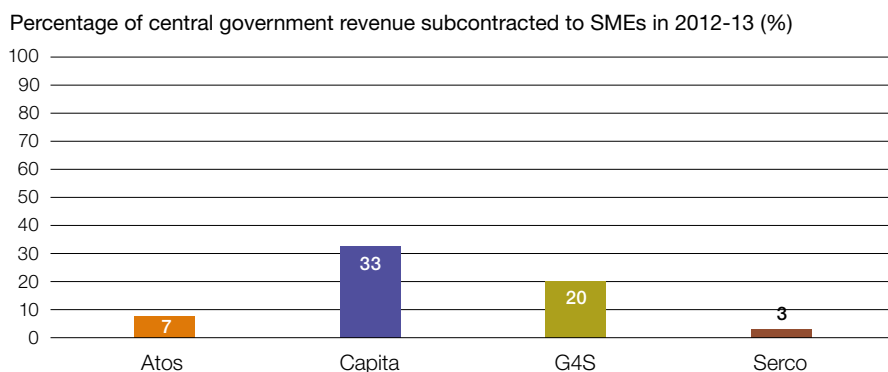
Notes

- Contract values only included where data is available for both the start and current total contract value. G4S do not hold records of total contract values when let. G4S provided us with data that estimated annual revenue on existing central government contracts rising from an estimated £386 million to £412 million.
- Contract values can grow because of contractual changes but also from increases in volumes.
- Atos's increase in contract values relates mainly to one contract which has since been competitively re-tendered.

Source: National Audit Office analysis of contractor data

Figure 9

The contractors subcontract some of their revenue to SMEs



| | | | | |
|-------------------------------------------------------------------------------|--------------------|------------|--------------------|--------------|
| Estimated revenue subcontracted to SMEs (including the voluntary sector) (£m) | 51 | 164 | 114 | 34 |
| Estimated revenue subcontracted to other organisations (£m) | Data not available | 16 | Data not available | 200 |
| Estimated revenue not subcontracted (£m) | Data not available | 319 | Data not available | 1,007 |
| Total central government revenue (£m) | 683 | 499 | 571 | 1,241 |

Notes

- Revenue figures are estimated using percentage estimates of amounts subcontracted in the first three months of 2013-14, that contractors give the Cabinet Office.
- Data has not been audited and has some limitations. For example, G4S reported a negative amount of revenue from the Home Office.
- Atos is reviewing the way it collates this information for the Cabinet Office.

Source: National Audit Office analysis of contractor data

Competition in public service markets

1.10 Ensuring long-term competition and innovation in contracted-out public services requires a mixture of new and established providers. New providers bring new ideas and ensure that existing suppliers are challenged to continuously improve. Without new providers, the public service market will likely consolidate.

1.11 Atos, Capita, G4S and Serco, for instance, have grown significantly over the last decade (**Figure 10** overleaf). Much of their growth has come from buying other businesses, particularly small and medium-sized enterprises (SMEs) (**Figure 11a** on page 28). This can be seen by looking at their balance sheets. The premium paid for acquisitions is recognised as an asset, called goodwill, on the contractors' balance sheets. As at 31 December 2012 goodwill accounted for between 26 and 40 per cent of the four contractors' assets.

1.12 There are over 200,000 providers to government. However, there are some public services that are only provided by a few large providers. For instance, there are three providers of private prisons (Serco, G4S, Sodexo), two providers of child custody (Serco and G4S), and two providers for medical assessments (Atos and now Capita).

1.13 To avoid market consolidation, the government is trying to encourage new entrants by opening up procurement so that small companies are able to compete effectively for government business. In 2010, the government announced its aspiration that 25 per cent of its spend on goods and services goes to (SMEs). This 25 per cent aspiration includes spending through large contractors that is passed to SME subcontractors. Using Cabinet Office information we estimate the four contractors are passing on between 3 and 33 per cent of their central government revenues to SME subcontractors (Figure 9).

1.14 The government is encouraging two principal models for mixing large and small companies in supply chains (**Figure 11c** on page 29):

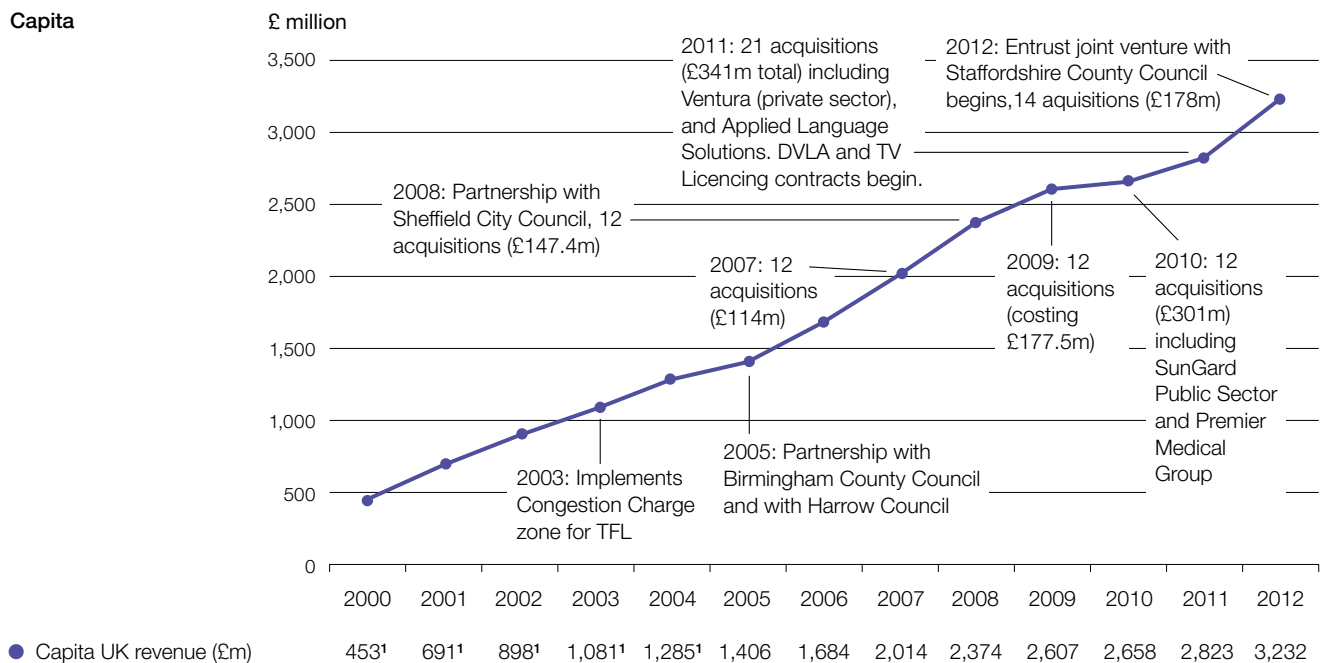
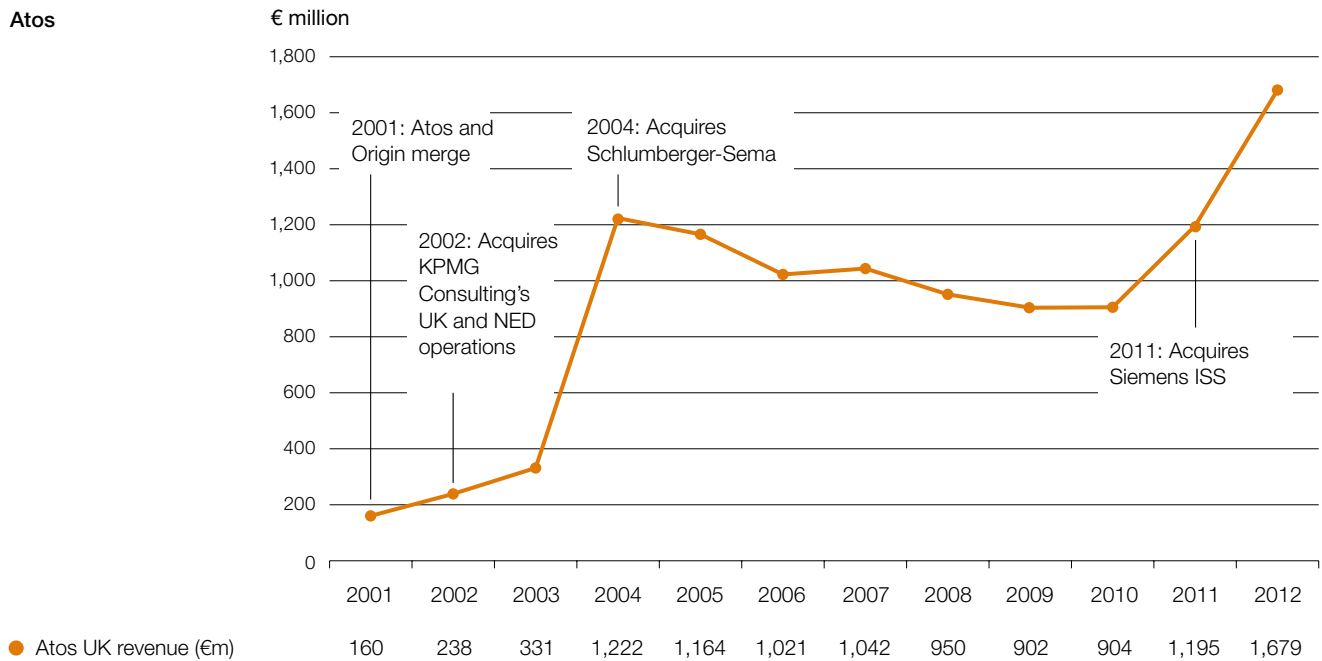
- Prime contracting is where the contract is with a large provider who subcontracts the work to smaller providers and focuses on managing and integrating the service. An example is the way Serco and G4S provide the work programme.
- 'Service integration and management (SIAM) and towers contracts' is the standard model now being rolled out for ICT services. The service is broken down into a number of smaller individual contracts (the towers), with another contractor that manages the overall service (the SIAM). This is designed to stimulate competition and open up markets to new suppliers. All the contracts are directly to the client, rather than subcontracted.

1.15 Working with smaller new providers can bring risks, however, as shown in the example of court language services in **Figure 11b** on page 28. Larger firms can offer financial stability, absorb risk, provide investment and bring economies of scale, which can be valuable in public services.

Figure 10

The four contractors' UK revenues have grown over recent years

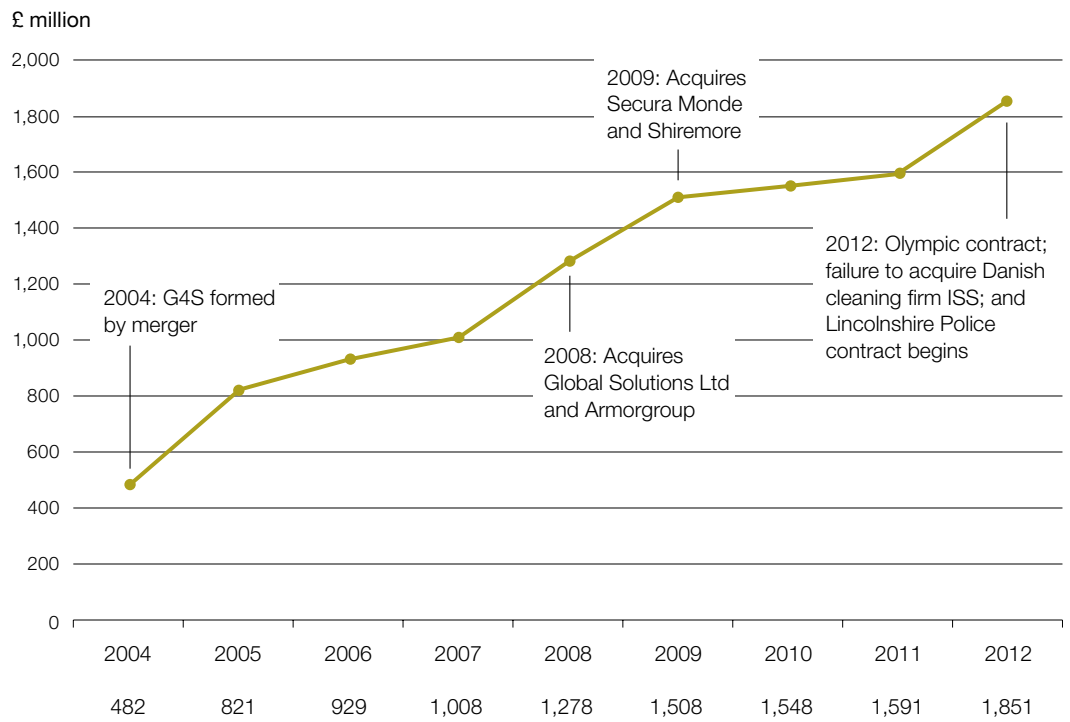
Key events in contractors' growth of their public sector business shown against the growth of their total UK business



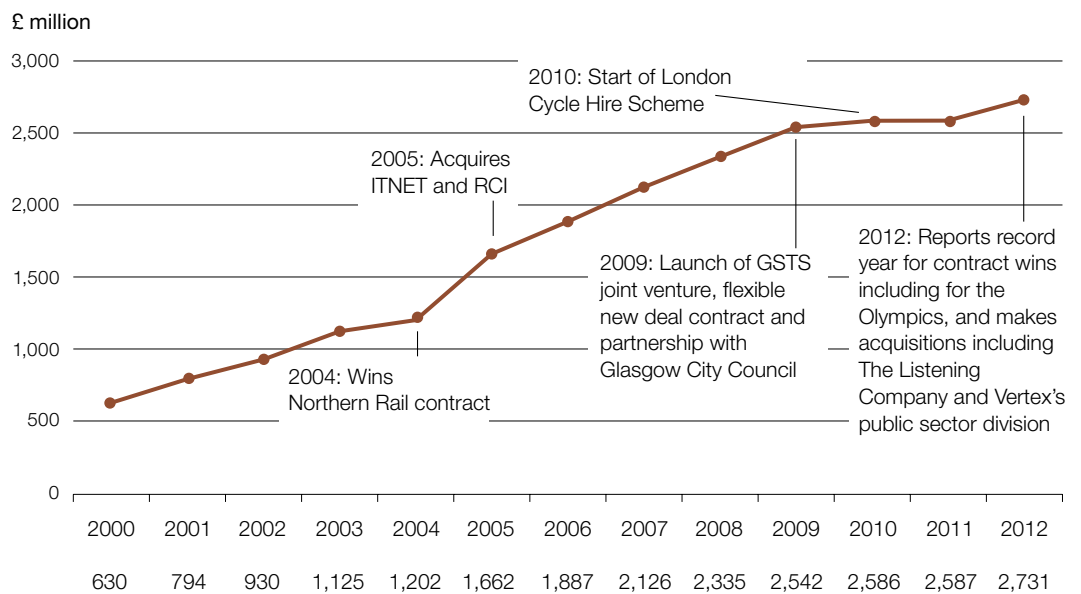
Note

1 Figures before 2004 are total revenue as Capita did not have material non-UK operations.

G4S



Serco



Note

2 All figures are taken from contractors' accounts and have not been adjusted for inflation.

Source: National Audit Office analysis of the four contractors' published financial results

Figure 11

Issues for managing competition in public services

(a) Markets are likely to consolidate

Contractors have acquired other businesses already operating in public service markets.

Figure 10 shows how acquisitions have helped all four firms to grow.

- **Capita** has used acquisitions to enter new markets. For instance, Capita bought a small specialist provider – Applied Language Solutions (ALS) – in 2011, shortly after ALS had won a contract as sole provider of court translation services to the Ministry of Justice (see below).
- **G4S** used an acquisition to improve its own performance. Having won a contract in 2004 to run Oakhill Secure Training Centre, G4S struggled to meet the expected performance targets. In 2008, it acquired Global Solutions Limited, a company that was successfully running two of the remaining four secure training centres. New management from GSL helped improve Oakhill and the acquisition gave G4S 84 per cent of the market. G4S say that this critical mass helps it to deliver a potentially dangerous service properly.
- **Atos** acquired outsourcing provider Schlumberger Sema in 2004, which made Atos the sole provider of the Department for Work & Pensions' medical assessment contracts in the ICT services group.

(b) Risk of bringing smaller organisations into public service markets.

The Ministry of Justice contracted out providing court interpreters to a small company and the service suffered from early problems.

In 2010 the Ministry of Justice ran a competition to supply court interpreters. This service was previously bought by individual courts based on a national register of interpreters. The Ministry received bids from 12 providers, and from a final three contenders the Ministry selected Applied Language Solutions (ALS). ALS proposed a national service based on a single booking system and call centre. ALS had previous experience of providing interpreters to police services in one part of the country. However, the Ministry's due diligence process during procurement warned that giving such a big contract to the company was a risk. The contract, worth £75 million over five years, was awarded in August 2011. **Capita** acquired ALS in December 2011, one month before the contract went live. The initial rollout had difficulties and in the first three months the service did not provide sufficient interpreters for court bookings, causing delays and rescheduled trials. To address the problems **Capita** committed £3.5 million to improve the service, increasing delivery staff while restructuring operations. At the time we published our report in September 2012,¹ performance had improved. We intend to report on progress since 2012 in the next month.

NOTE

1 The Ministry of Justice's language services contract, National Audit Office, 10 September 2012

Source: National Audit Office interviews with client and contractor staff

(c) The government has tried to create provider diversity

The Department for Work & Pensions attempted to build competition into its Work Programme. It divided the country into 18 areas, and tendered for two to three prime contracts in each (40 contracts in total). After receiving initial bids, the Department felt there was too great a concentration of suppliers, so it limited bidders to one prime contract per area. Because of the change, 18 prime contractors were appointed instead of 11. **Serco** has two of the 40 contracts and **G4S** has three. Once the contracts are running, the Department maintains an element of competition between providers by allocating work (and therefore revenue) depending on performance.

The Department for Work & Pensions intended to encourage prime contractors to work with SMEs and third sector organisations on the Work Programme. Under the predecessor programme, Pathways to Work, prime contractors passed a disproportionate amount of risk to subcontractors. Prime contractors sometimes withheld payments from subcontractors and referred harder-to-help claimants to them. The Department now has a code of conduct (the Merlin Standard) to regulate their relationship, including whether the relationship is equitable. It plans to assess prime contractors against the standard. How far prime contractors use subcontractors varies. **G4S** and **Serco** subcontract all of the work. **Serco** told us that 70 per cent of their support network comprises SMEs.

The Department for Work & Pensions is also trying to broaden the supplier base in its medical assessment contracts. **Atos** acquired the existing sole provider (Schlumberger Sema) in 2004, won the contract again in 2005 against limited competition, and were asked to extend the contract for a further three years without competition in 2010. The Department has since tried to increase the number of providers. In 2012 it ran a competition to establish a framework contract for health assessment providers. The ten providers appointed to the framework could then bid for regional contracts to provide new assessments for the Personal Independence Payment (the replacement to Disability Living Allowance). **Capita** won two of the four contracts, gaining entry to a new market. **Atos** won the remaining two, resulting in an 88 per cent share of the market. **Atos's** model for providing the Personal Independence Payment involves contracting out assessments to new providers including NHS trusts. **Capita** will use a mix of directly employed and contracted health professionals.

The government is trying to encourage new entrants into the market for public sector ICT, by breaking up traditional large contracts. The government's ICT strategy now favours a new type of contract where services are disaggregated into 'towers', which are tendered individually, while a separate contractor is recruited to provide service integration and management (SIAM). **Atos** had provided ICT services to the Highways Agency under a traditional contract since 2007. A competition for a new, traditional, contract begun, but the Cabinet Office intervened in 2012 to require the use of the SIAM and towers model. **Atos** was given a temporary contract extension to act as SIAM for one year followed by a further year to transition to the new model. The remaining services will now be contracted as six 'towers'. The first of the towers has been let but was won by another large provider rather than an SME. There are a further five contracts to be let by 2014. The Agency currently expects the total cost of its ICT to be lower under the new model, even accounting for the two-year delay.

Part Two

Can we see whether contractors' profits reflect a fair return?

2.1 This part of the report examines transparency in contractors' tax and profits and the link between risk and reward. It covers:

- contractors' profits (pages 31 to 39);
- risk and incentives (pages 40 to 41); and
- tax (pages 42 to 43).

Contractors' profits

2.2 Contractors need to make a profit to stay in business and contract for work. It is difficult, however, to assess what constitutes a fair profit. In essence the profit is meant to be in proportion to:

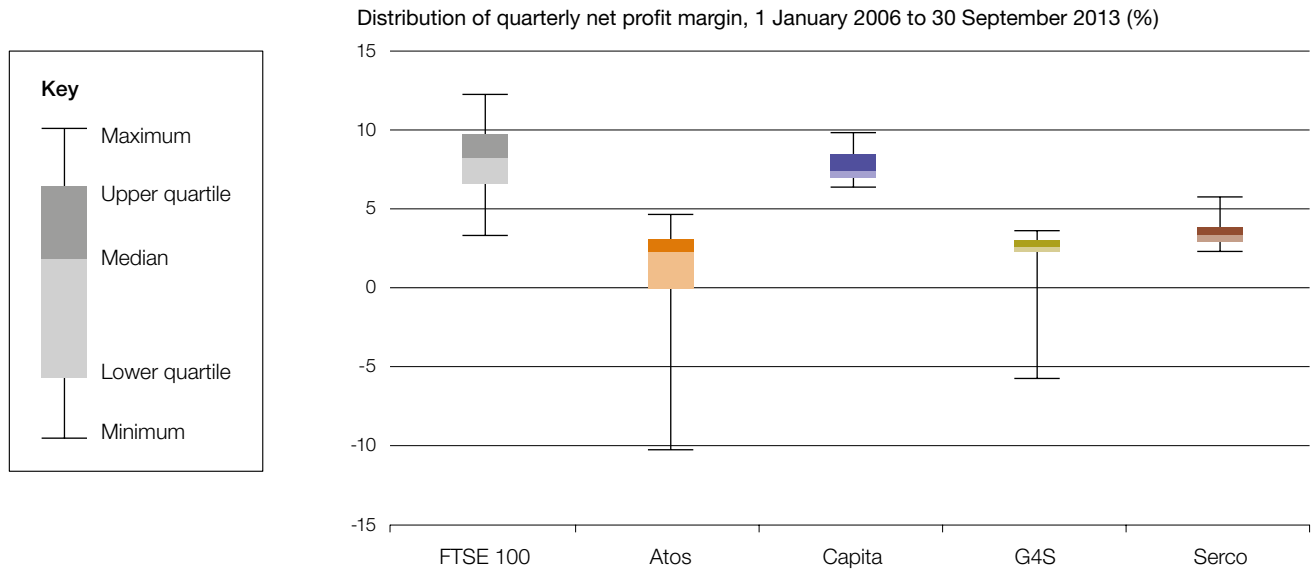
- the risk that the contractors take on;
- the innovation that they bring – both intellectual property and any competitive advantage the contractor has over rivals; and
- the level of prior investment that needs to be paid for (particularly where current profits are matched by prior year losses).

2.3 Generally contractors manage their profit across a portfolio, targeting an overall level of profit. Low margins are often established during the bidding process, but can increase during the contract lifetime. These are offset by losses on other contracts.

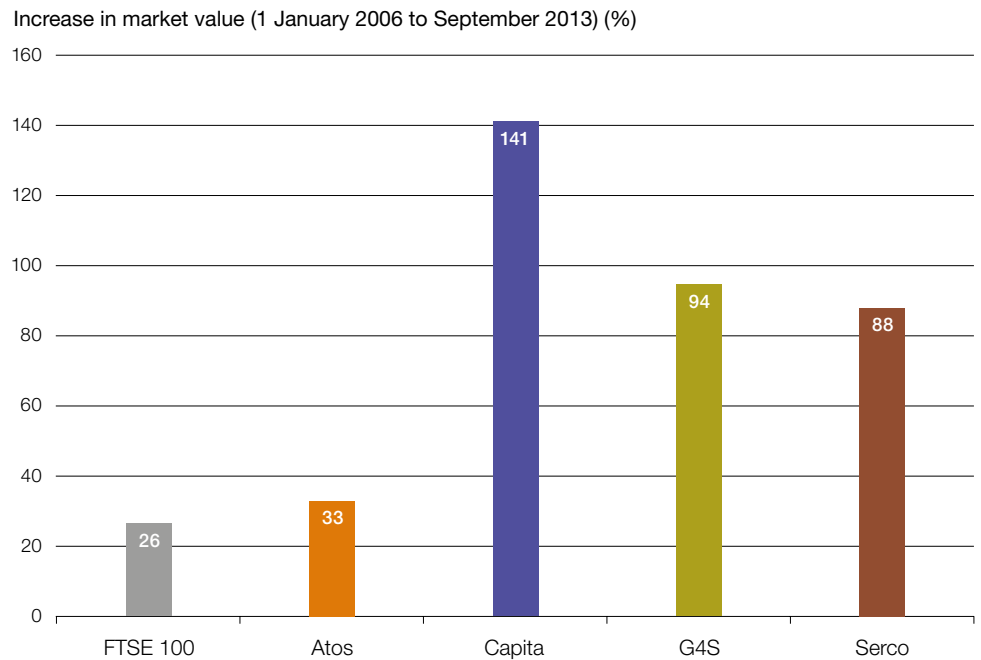
Figure 12

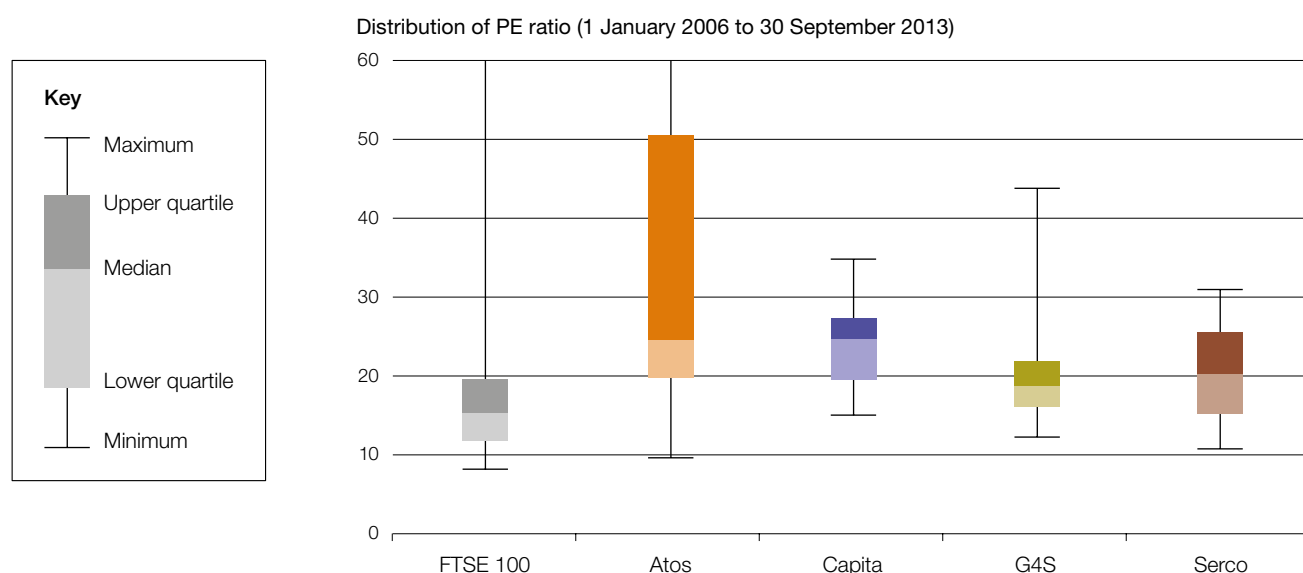
Market view of the contractors

The four contractors have generally had low profit margins compared to the FTSE 100



The stock market values of the four contractors have grown well over the last decade



High PE ratios imply the market assumes that the contractors will grow in the future**Notes**

- 1 PE ratios based on earnings excluding exceptional items, averaged over a trailing 12-month period. The maximum value for the FTSE 100 and Atos are not shown. They are high because the PE ratio increases when losses are reported, because the 12 month earnings per share falls towards zero.
- 2 We have used January 2006 as our baseline because G4S was created at the end of 2004 and it takes 12 months to generate a PE ratio because it averages the earnings per share over the previous 12 months.
- 3 Distribution of net profit data shows results over the contractors' global business in half-yearly intervals.

Source: National Audit Office analysis of Bloomberg data and market commentary

Why investors value these companies

2.4 As a general rule the stock value of contractors like these four have grown well over the last decade (**Figure 12**). This increase in their market value has been driven by good quality (steady) returns and growing revenue (Figure 10 page 26). High price earnings ratios imply that the market assumes that they will continue to grow in future. This makes the companies' stock price particularly vulnerable to announcements that can be interpreted by the market as threatening future work.

2.5 Growth has compensated for relatively low profit margins compared to the overall FTSE 100. These margins reflect, in part, the long and dependable nature of the income generated by government contracts. There have also been a few periods where Atos and G4S have reported losses, including a net loss of 5 per cent for G4S in the first half of 2013.

Understanding the profitability of public sector work

2.6 All of the contractors publish comprehensive information on their overall profitability in their annual report and accounts. However, it is difficult to isolate the profit relating solely to their UK public sector work. They rarely separate out their public sector work as part of their segmental reporting.

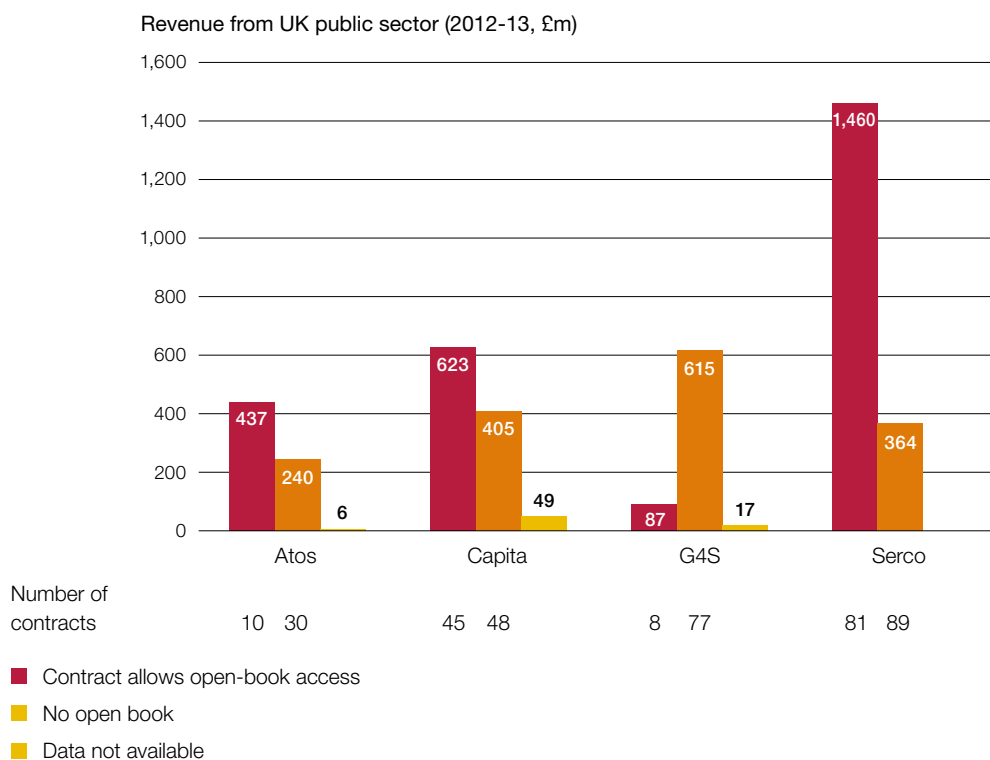
2.7 The government only has access to information on the profits contractors make where 'open-book arrangements' are written into contracts. Open-book arrangements either require the contractor to update the client department regularly on their costs and profit, or allow the client to audit those costs and profit on an ad hoc basis. We found that use of open-book access rights varies. Some public bodies do not try to see data on contract profits. Comparing profit levels from the open-book arrangements we reviewed also posed challenges as contractors vary in how and when they allocate central overhead costs against profits from contracts.

2.8 We do not have direct audit rights over government contractors. It is normal, however, for government contracts to require the contractor to give us information and help when we audit that public service and government entity. Where there are open-book accounting arrangements with the government (**Figure 13**), then this includes making those available to us.

2.9 Contractors are often wary about putting information on costs and profits into the public domain. They believe that such information is commercially sensitive and would harm their economic interests, as competitors could use it against them. In theory, all contractors could be required to disclose their costs and profits on every contract, to remove the risk that one contractor is singled out. However, this could be difficult, as the contractors also compete with the same services in the private market against competitors who do not contract with the government.

Figure 13

Open-book accounting covers much of the contractor's revenue

**Notes**

- 1 'Data not available' includes where small contracts with revenue individually below £1 million have been aggregated.
- 2 G4S figures exclude contracts relating to the Olympics, which were not open book.
- 3 The number of contracts is subject to some interpretation as open book clauses vary and there can be multiple contracts per service.

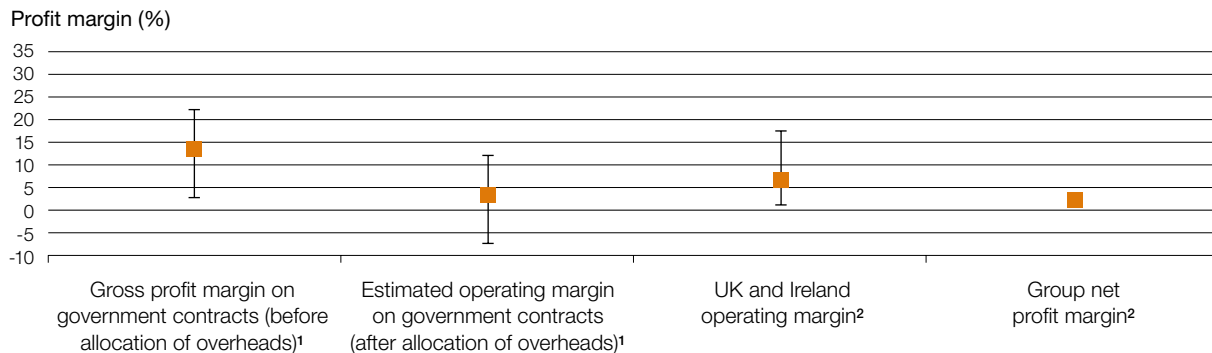
Source: National Audit Office analysis of contractor data

Request to see contractors' profits

2.10 We asked the contractors for information on their revenue and profits, for all their UK public sector contracts. The contractors volunteered different levels of information about their overall profitability, including information not in the public domain.

2.11 We have not been able to do a full audit on the information the contractors provided because we do not audit the companies. For example, we did not verify spending back to original sources or undertake a detailed review of how overheads were allocated.

Figure 14
Atos profit margins



Notes

- 1 All UK central government contracts, showing variation by department. Lower end includes brought-forward losses.
- 2 1 January to 31 December 2012. Range shows variation by operating segment.

Source: National Audit Office analysis of Atos data

Atos's profits

2.12 Atos has made an average net profit margin of around 2 per cent over the past decade, rising to 3 per cent in 2012. However, it has also reported substantial losses in the UK, from integrating Schlumberger Sema (2004) and KPMG Consulting (2002).

2.13 The information that we saw at Atos indicates the following:

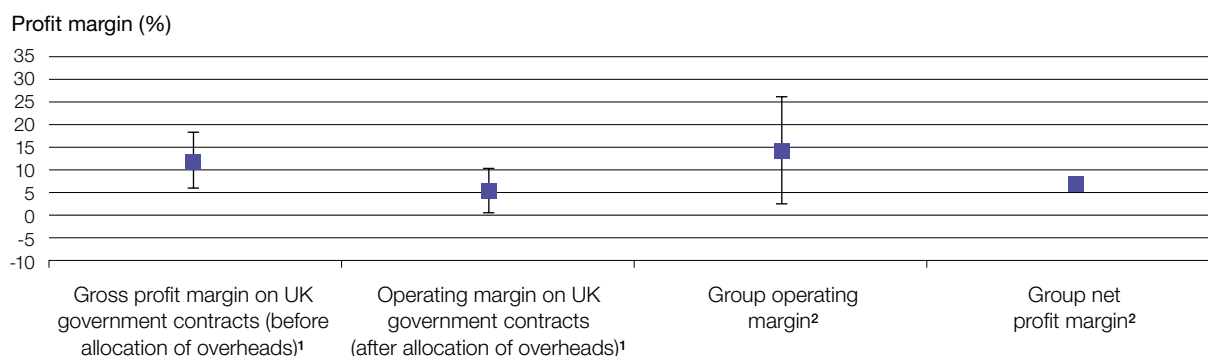
- Its public sector work generally has a margin before both regional and global overheads of between 3 and 22 per cent, falling by an estimated 10 per cent once UK overheads are included. The 3 per cent lower end of this range refers to one contract purchased from another company. Atos has included an apportionment of previous losses in this number.
- A small number of Atos's public sector contracts made a loss in 2012. This mostly reflected new contracts that were starting, with early investment being made.
- The contract with the highest margin is subject to a 'gainshare' mechanism, which returned one quarter of profit above 19 per cent to the government. Atos told us this contract was more profitable because it was towards the end of its life.

2.14 Atos only showed us information on contracts that had open-book clauses where the government client had exercised its open-book access rights to request information from Atos. This included Atos's three largest government contracts and excluded three where the government client had never used open-book access rights. Atos chose not to show us information on contracts that were not open book. It said:

"A number of these contracts will be re-bid over the next two years and release of the information could harm our ability to compete."

Figure 15

Capita profit margins

**Notes**

1 Latest available data for open-book contracts that have started. Range shows variation by operating segment.

2 1 January to 31 December 2012. Range shows variation by operating segment.

Source: National Audit Office analysis of Capita data

Capita's profits

2.15 Capita has been profitable for many years. Its accounts allocate its activities to 11 operating segments according to the nature of the services provided. All of these operate globally and contain at least one public sector contract as well as UK private sector and overseas work.

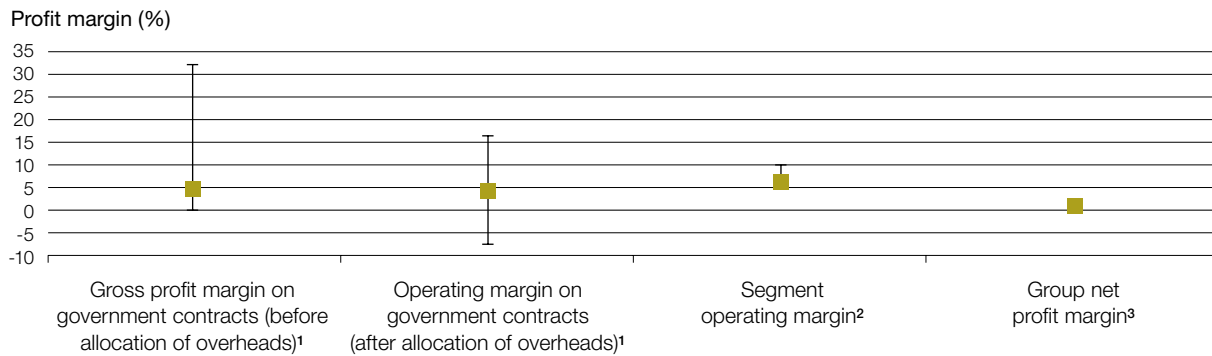
2.16 The information that we saw at Capita indicates the following:

- Public sector work generally has a margin, before both divisional and global overheads, of 6 to 18 per cent, falling to between 1 to 10 per cent once overheads are included. Capita told us that its other public sector contracts would be similar, but that they were 'doing better' in the private sector.
- Two contracts reported a loss. Capita said this was because costs such as investment were being incurred at the start of the contract. Capita told us they expected these contracts to achieve a whole-life gross margin of at least 15 per cent.
- Some contracts had higher margins. Capita told us these were older contracts, some of which had made losses early on.

2.17 Capita only showed us information on contracts that had open-book clauses. They believed that most of their clients regularly use open-book access rights. It said:

"We do not distinguish between public and private sector contracts in our internal management information systems and it would be additional work for us to make available the information in a comparable format."

Figure 16
G4S profit margins



Notes

- 1 All UK public sector contracts, 1 April 2012 to 31 March 2013. Range shows variation by department.
- 2 1 January to 31 December 2012 for Secure Solutions. Other point on range is operating margin in the other operating segment, Cash Solutions.
- 3 1 January to 31 December 2012, from accounts.

Source: National Audit Office analysis of G4S data

G4S's profits

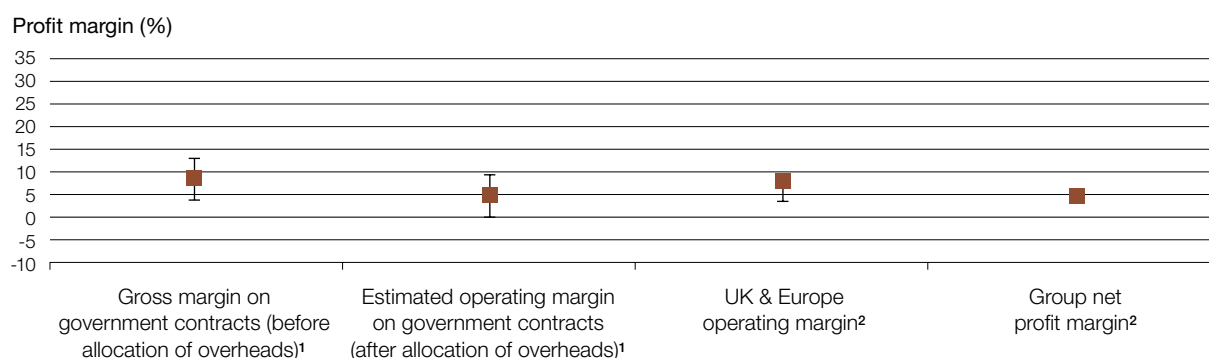
2.18 G4S has generally been profitable but made a loss in the first half of 2013 when it wrote down the value of some of its assets. Its accounts allocate information to two segments. 'Cash Solutions' operates in the private sector, and 'secure solutions' includes all of G4S's UK public sector work but also operates in the private sector and globally.

2.19 The information that G4S provided indicates the following:

- G4S was generally making gross margins of between 0 and 32 per cent. Once overheads were included, many of G4S's public sector contracts reported an overall loss in 2012-13. The overall range fell to -8 to 16 per cent once overheads were included.
- Contracts at the higher end of the range tended to be longer term. G4S told us that its contracts let since 2010 also had significantly lower margins. G4S considers that contracts must be sufficiently long, so the contractor can reduce its costs enough to recover the initial investment, and that some of this benefit would pass to the client when the contract was rebid.

2.20 G4S has very few contracts that include open-book clauses. In some cases there were arrangements for sharing some information, without being fully 'open book'.

2.21 G4S showed us all the information we requested on its public sector contracts.

Figure 17**Serco profit margins****Notes**

1 UK central government contracts showing variation by department and segment, 1 April 2012 to 31 March 2013.

2 1 January to 31 December 2012. Range shows variation by operating segment.

Source: National Audit Office analysis of Serco data

Serco's profits

2.22 Serco has been profitable for many years. Its accounts split its activities between four segments, three of which are geographical and one, Global Services, which operates globally across both public and private sectors. Serco's UK & Europe division is the largest and most profitable, and the newer Global Services division is the least profitable.

2.23 The information that we saw at Serco indicates the following:

- Public sector work generally has a margin before regional and global overheads of between 4 to 13 per cent, falling to a range of 0 to 9 per cent once overheads were included.
- Around ten contracts were reporting a loss before overheads. This was mostly for new contracts. Serco told us that these were because it had not yet had time to make changes to improve the service.
- Some of the smaller valued contracts were making higher margins. In general, these were also older contracts. Serco told us that these would have made a lower margin in earlier years and that the profit margin also reflects the nature of the risks taken on.
- Serco told us it manages its contracts across a portfolio, and requires a 10 per cent contract margin to contribute towards its overall target operating margin of around 5 per cent.

2.24 Serco showed us information on its central government contracts, including many without open-book clauses. It did not show us profits on local government contracts within its Global Services as it believed it would be legally obliged to seek permission from each authority to disclose such information.

Risks and incentives

2.25 Contractors' profits are meant in part to reflect the risk that they take on. When things go wrong with public services, it is ultimately the government's responsibility to ensure the service is provided to citizens. It is not possible, therefore, to fully transfer risk to the contractor. However, it is possible to incentivise contractors by ensuring that they take a financial hit if they fail to manage a risk that is within their control, or make a gain if they manage it well.

2.26 A lot of the risk transferred and incentives are reflected in how the contract is priced. For example, different contracts require clients to do one of the following four:

Pay a fixed price

- Fixed prices that are too low can result in reduced service quality but can also act as incentives to redesign the service. (For example, the National Savings & Investments contract has fixed-price elements intended to encourage Atos to move users to go online.)

Pay on the basis of costs plus a margin

- This remunerates the contractor for inputs, but the government has less certainty over price. There needs to be another way to ensure that only necessary work is carried out, such as open-book accounting and a cost adviser.

Pay based on volume

- For example per health assessments. This can encourage the contractor to drive take-up among end users. Such contracts can be entirely self-funding, for example Capita's 'Gas Safe' contract passes the cost to the user.

Pay for results

- These contracts are structured to incentivise the provider by linking payment to achieving outcomes. Such contracts include the work programme contract with Serco and G4S.

2.27 The original allocation of risk in the contract often changes once the contract starts. For instance:

- Contractors will often pass risk back to clients who do not fully enforce or carry out their part of the contract. The government department therefore needs the appropriate skills to manage the type of contract it is using.
- The original understanding of the risks in the contract may prove to be wrong. This can lead to the contract being terminated (**Figure 18**) and risks that the government thought the contractor would manage returning to the public sector.
- The government sometimes ignores the commercial terms and risk allocation in the contract when trying to settle a dispute or vary the requirement. Instead, it can put political pressure on the contractor and threaten their reputation.

Figure 18

Case studies on risk and incentive

The allocation of risk should be designed to incentivise performance

The Health and Safety Executive's Gas Safe registration scheme contract passes revenue risk to the contractor. Since 2009 Capita has been responsible for administering the Gas Safe registration scheme which is intended to improve consumer safety. Capita's revenue comes direct from fees charged to the businesses and engineers joining the scheme. An outcome focused performance regime also focuses Capita's incentives on raising consumer awareness and customer and engineer satisfaction levels. Contract revenues average £18 million per year, with profits capped through contracted contributions to the Gas Safety Charity and a gainsharing fund which distributes excess revenue to the Charity, other gas safety purposes or to subsidise future membership registration fees at the discretion of HSE. Penalties charged for failure to meet key performance indicators are paid into the same fund.

Risk sharing can allow the public sector to gain the benefits of private investment

The establishment of a joint venture to deliver education support services in Staffordshire allows the council to share risks and rewards with the contractor. Staffordshire County Council's education support services (specialist education services, outdoor education, learning technologies, facilities management and catering services) needed to respond to declining central funding and the increasing autonomy of schools to buy such services from alternative providers. The Council saw the need for a new approach, bringing in outside investment while remaining involved in shaping a business that could improve educational attainment and contribute towards economic growth in the area. After a competitive procurement the Council chose Capita to create a joint venture to deliver future support services. For an up front payment of £31 million over three years,¹ staff, assets and existing contracts were transferred to Entrust, a new company owned 51 per cent by Capita and 49 per cent by the Council. Entrust has a new 20-year service level agreement with the Council, mitigating some of the revenue risks the joint venture is taking on. The bulk of its revenues will come from sales to schools across the county and growth of the business outside Staffordshire. Current plans are to invest in new services and increase annual revenues from £75 million to over £300 million in the first ten years. The Council will benefit from growth through its 49 per cent share in any distributed profits, with the business remaining headquartered in Staffordshire.

The original allocation of risk does not always work

Capita took on volume risk when it won the contract to provide the Driver and Vehicle Licensing Agency's (DVLA) enforcement services. Failures in forecasting resulted in losses for the contractor and the re-tendering of the contract. In 2011 Capita won a five-year contract to provide DVLA's enforcement services – clamping and confiscating vehicles that do not have road tax. Capita won the contract using a concession model, with a plan to run the service more efficiently and maximise revenues from clamping release charges and increased disposal of confiscated vehicles. The contract transferred large risks, as the contractor's income came entirely through clamping release charges and revenue from disposing of unclaimed confiscated vehicles. During bidding, legislation changes resulted in the time allowed before vehicles could be clamped increasing from 30 to 60 days. Capita adjusted its forecasts, reducing expected enforcements from 90,000 to 75,000 per year, which Capita felt still provided a viable business model. However, the change in regulations meant that in the first two years of operations only around 50,000 vehicles per year were subject to enforcement action, making the business case unviable. As a consequence, agreed service levels were not met and Capita lost £9 million over the two years they ran the contract. The Agency opted to terminate the contract three years early on a 'no fault' basis and run a fresh competition rather than varying the contract's terms. The new contract model transfers lower levels of risk to the new contractor.

Note

1 £24.9 million upfront with further payments of £6.5 million across the three years.

Source: National Audit Office interviews with those responsible for putting together the business cases

Tax

2.28 The profits on individual contracts quoted in the previous section are before tax. It is appropriate, when assessing the costs of contracted-out services, to deduct the corporation tax from the cost, to arrive at the net cost to the Exchequer.

2.29 All the contractors recognise a tax charge in their accounts but we estimate that only Capita and Serco made any UK corporation tax payments in 2012 (**Figure 19**).

Figure 19

Tax

| | Atos (£m) | Capita (£m) |
|-----------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Worldwide tax in 2012¹ | | |
| Profit before tax | 330 | 290 |
| Tax charged to income statement | 103 (31%) | 54 (19%) |
| Tax paid (cash) | 74 | 62 |
| UK corporation tax¹ | | |
| Total UK profit before tax ³ | Not disclosed | Not disclosed |
| Total UK tax charged to the income statement ¹ | Not disclosed | Not disclosed |
| Total UK tax paid (cash) | Not disclosed | 56 |
| Estimated UK tax paid² | | |
| | 0 | 50–56 |
| Location used for UK profits and overheads | All UK work booked in the UK. Global corporate overheads paid to French parent. | All UK work booked in the UK, with some tax due in overseas jurisdictions for offshore work. |
| Contractors' explanation for amount paid being below statutory UK corporate tax rate on accounting profit | <ul style="list-style-type: none"> • Contribution to employee defined benefit pension schemes that are in deficit. • Previous tax losses carried forward. • The use of allowances for capital investment in ICT equipment in the UK. | <ul style="list-style-type: none"> • Adjustments in respect of prior years. • Previous tax losses carried forward. • Pension scheme contributions. |

Notes

- 1 As disclosed in audited 2012 group accounts. Total cash paid in 2012 includes amounts from previous years. While the UK corporation tax paid by individual UK subsidiaries is disclosed in individual companies' accounts, neither a list of these companies nor a single consolidated figure for the group's UK tax is disclosed.
- 2 Estimated UK tax paid is based on conversations with the contractors and we have not verified it to underlying documents held by the contractors or the authorities.
- 3 Serco's profit before tax is stated net of a non-taxable gain of £51 million arising from the acquisition of the remaining 50 per cent of an Australian joint venture during 2012. Including this gain increases Serco's worldwide profit before tax to £302 million without changing the tax expensed or paid.

Source: National Audit Office analysis of contractors' financial accounts and conversations with the contractors

2.30 Although the official rate of UK corporation tax is 24.5 per cent for the 2012 calendar year, the corporation tax payments contractors actually pay on the profit they make on their contracts may be lower due to adjustments required under UK tax law, including:

- allocating global overheads, such as finance charges, through transfer pricing;
- timing differences between the accounting period and the tax bill (particularly relevant for deductions from taxable profit due to capital investment and pensions contributions); and
- offsetting taxable profits with losses brought forward from previous periods.

G4S (£m)**Serco (£m)**

175

251

36 (34%)

56 (22%)

85

53

Not disclosed

Not disclosed

6

Not disclosed

Not disclosed

Not disclosed

0**25**

All UK work booked in the UK.

All UK work booked in the UK.

- Interest deductions on group borrowings.
- Availability of statutory tax reliefs for specific items such as capital investment and Research & Development.
- Pension scheme contributions to defined benefit schemes in deficit.
- Utilisation of tax losses.

- Statutory tax benefits including for research and development, international shipping, overseas branch profits.
- Using allowances for capital investment.
- Pension scheme contributions.
- Statutory deductions for share options.
- Excluding taxable profit arising from disposing subsidiaries (substantial shareholdings exemption).

Part Three

How can we know whether contractors are delivering?

3.1 This part of the report focuses on the accountability arrangements for contracted-out services. Traditionally, the emphasis of these accountability arrangements has been on the client's contract management. This fits with the public sector client's responsibility for the service. However, these accountability arrangements also depend on the arrangements within the contractor itself. This part includes:

- the standards expected of public services and the sources of assurance (pages 44–47);
- corporate governance (page 48) ;
- management review (page 49);
- whistleblowing (pages 50).
- public reporting and transparency (page 52)
- contractual reporting (page 54)
- independent regulation and inspection (page 54);
- user feedback (page 56); and
- staff feedback (pages 56);

Assurance that the contractor is meeting standards

3.2 Parliament expects all public services to meet certain standards (**Figure 20**). The government's guidelines (as stated in *Managing Public Money*)² stipulate that departments retain ultimate responsibility for the services that they contract out. This includes ensuring that arrangements for contracting out contain appropriate accountability for using public funds.

Figure 20**Standards expected of all public services**

Honesty, impartiality, openness, accountability, accuracy, fairness, integrity, transparency, objectivity, reliability. Carried out:

- in the spirit of, as well as to the letter of, the law;
- in the public interest;
- to high ethical standards; and
- achieving value for money.

Source: Managing Public Money

3.3 Companies are accountable to a range of stakeholders for different things. Their main accountability is to their shareholders and, under the terms of their contracts, to their clients. Thus the contract is the main way for the government to ensure that contracted-out services contain appropriate accountability arrangements and meet standards expected of all public services.

3.4 Public contracts contain a range of standard clauses that support standards and accountability, including audit requirements, provisions on information disclosure and minimum standards. However, these clauses are limited in what they can achieve:

- Many of the standards expected of all public services do not easily translate into a contract specification. It is not possible, for instance, to contract for 'integrity' or the 'spirit of the law'.
- Achieving the standards expected for public service depends largely on the corporate culture, control environment and ethics of the contractor. It is not easy, however, to use contract negotiations to meaningfully assess and set standards for the contractor overall.

3.5 Government therefore needs to supplement traditional contractual mechanisms with other means of ensuring the expected standards are met. In particular, they need to ensure that the companies' own corporate governance, management and control environment are aligned with taxpayers' interests. This requires both transparency over performance and incentives to implement the rigorous control environment required, including credible threat to profits and future business if problems are found.

Current investigations

3.6 Over the past few months there have been several government announcements about control problems within contractors, including allegations of fraud, misreporting and over-billing (**Figure 21** overleaf). In all but one instance, investigations to establish the factual basis of these allegations continue. Until these investigations conclude we cannot report either whether the allegations are substantiated or apportion responsibility between the contractors or their contract managers.

Figure 21
Recent and current reviews of government contracting

| Topic (contractor) | Organisation leading the review | Summary |
|--------------------------------------------------------------------|----------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Cornwall out-of-hours care (Serco) | National Audit Office (published 7 March 2013) ¹ | Whistleblowers raised a number of concerns with the service in 2012. The NAO found both shortfalls in performance and misreporting of information. |
| Suffolk community health care (Serco) | National Audit Office | The NAO is currently undertaking an investigation into this contract. |
| Electronic monitoring contracts (G4S and Serco) | Ministry of Justice ² | The Ministry of Justice identified a number of issues surrounding the way in which it had been billed for monitoring under the current electronic monitoring contracts, and commissioned an independent audit of the billing arrangements under both contracts with G4S and Serco. |
| | National Audit Office | The NAO is currently undertaking a review of the management of these contracts by the Ministry of Justice. |
| | Serious Fraud Office ³ | The Director of the Serious Fraud Office has opened a criminal investigation into G4S and Serco electronic monitoring contracts. |
| Ministry of Justice's contract management | Ministry of Justice ² | A review of contract management across the Ministry of Justice's major contracts, overseen by the Department's lead non-executive director, Tim Breedon. |
| All major G4S and Serco government contracts | Cabinet Office ⁴ | The Cabinet Office has commissioned a cross-government review of the management of major contracts held by G4S and Serco. The review has three aims: <ul style="list-style-type: none"> ● to investigate the management of certain contracts held by Serco and G4S; ● to gather information to form a wider perspective of the contract management of major contracts across government; and ● to inform a programme of improvements to the management of these contracts. |
| Prisoner escorting and custodial services (Serco) | Ministry of Justice/ Metropolitan Police ⁵ | Following complaints from the courts and as part of its internal contract review, Ministry of Justice identified potential irregularities in performance reporting. The Ministry and Serco referred the case to Metropolitan Police. |
| Compass contracts for asylum accommodation (Serco, G4S and Cleare) | National Audit Office ⁶ | The review will focus on the transition arrangements to the new contracts and their early operational performance including supplier and subcontractor compliance with the terms of the contracts, as well as examining the quality of accommodation provided. |
| Atos management of the Work capability Assessment | Department for Work & Pensions (findings announced July 2013) ⁷ | Following concerns from a previous smaller audit, the Department commissioned further audit of over 400 exam reports between April and July 2013. This found 41 per cent of face-to-face assessments completed between October 2012 and March 2013 did not meet the required standards, although the Department acknowledged that this did not necessarily mean recommendations were incorrect. |

Notes

1 Comptroller and Auditor General, *Memorandum on the provision of the out-of-hours GP service in Cornwall*, Session 2012-2013, HC 1016, National Audit Office, March 2013.

2 Available at: www.publications.parliament.uk/pa/cm201314/cmhansrd/cm130711/debtext/130711-0002.htm

3 Available at: www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2013/g4s-and-serco-investigation.aspx

4 Available at: www.gov.uk/government/news/review-of-government-g4s-and-serco-contracts

5 Available at: www.gov.uk/government/news/moj-audit-of-serco-contracts-prison-escort-services

6 Available at: www.nao.org.uk/press-releases/investigation-into-the-home-office-compass-contracts/

7 Available at: www.gov.uk/government/news/hoban-taking-action-to-improve-the-work-capability-assessment

Sources of assurance

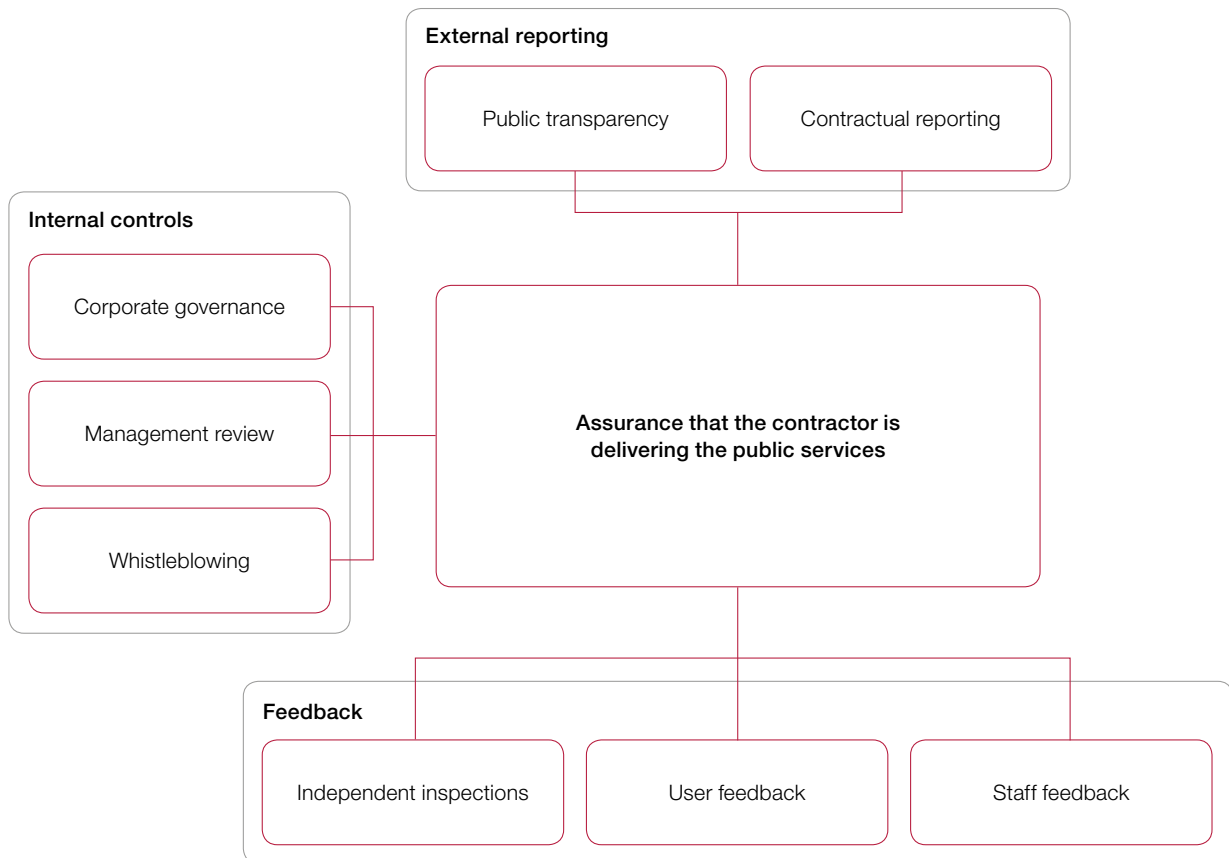
3.7 Whatever the findings from the investigations, it is clear that the government needs to better understand:

- the general control environment that contractors use to manage government contracts; and
- how far senior executives in those companies should understand what is happening within their companies.

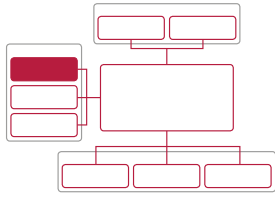
3.8 **Figure 22** sets out a conceptual diagram of the ways in which Parliament and the public can gain assurance on contracted-out services that originate from the contractor. We discuss and illustrate these elements with examples from the four contractors over pages 48 to 57.

Figure 22

Sources of assurance on whether contracted-out services meet the standards for public services



Source: National Audit Office concept mapping



Corporate governance

3.9 As listed companies, each of the contractors has a full set of corporate governance procedures. This includes non-executive scrutiny, risk committees and internal audit. Given the focus of the corporate governance arrangements on shareholder value, the main risks that it is reasonable to expect them to be concerned about are:

- commercial risks that affect the company’s immediate profitability; and
- reputational risks that affect whether the company can retain contracts and grow.

3.10 This can be aligned with taxpayers’ interests, where it focuses the company on ensuring that it meets the operational requirements of their government clients. This alignment requires a culture of openness and transparency, so that reputational risks can only be managed by strong performance.

3.11 Companies that have grown rapidly by winning new contracts and acquiring other businesses face a particular challenge in ensuring a consistent culture of high ethical standards and public service. New parts of the business need to be integrated into the control environment and systems set up to ensure that management have visibility over all parts of the organisation. Government should expect contractors to continuously review their corporate governance arrangements to ensure that they are sufficient (**Figure 23**).

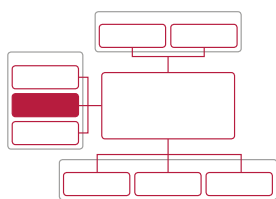
Figure 23

Improving corporate governance

Contractors have responded to failure by reviewing corporate governance

After the contract for Olympics security failed, G4S’s board commissioned PwC to review the company’s performance. This led to changes in the company’s management and governance structures. G4S signed a contract in December 2010 to provide part, and manage all, of the security workforce for the 2012 Olympic and Paralympic games. G4S did not provide enough security staff to achieve this. The review concluded that G4S could have fulfilled the contract, but its project management and risk assessment processes were inadequate for the contract’s complexity. G4S responded by replacing senior staff, and strengthening corporate governance. It added a new board-level chief operating officer, two non-executive directors and refreshed its group risk committee. It also created an annual review for the board of all contracts over £50 million against company standards for risk assessment and project management.

Source: G4S plc, *Review of London Olympic and Paralympic Games Security Contract*, available at: www.g4s.com/~media/Files/Corporate%20Files/Olymp%20Rev%20Ann%20-%2028%209%2012.ashx



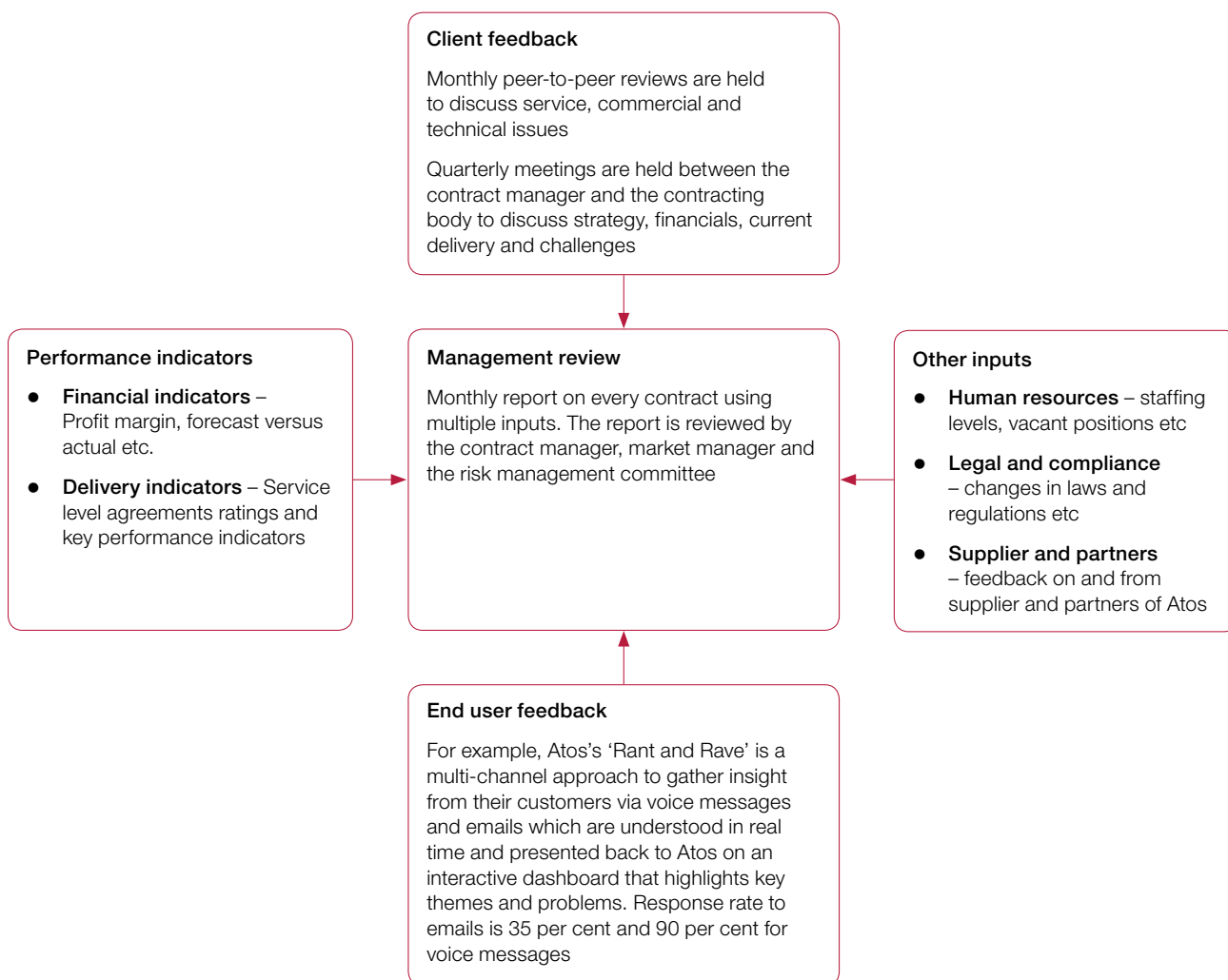
Management review

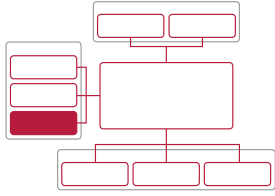
3.12 In addition, all of the contractors emphasise the importance of management review of ‘business as usual’ contracts. They say that this gives their senior managers visibility over all areas of their business and allows them to focus on continuously improving profitability, performance and risk management.

3.13 The contractors review all of their contracts monthly, assessing performance key performance indicators (KPIs), financial information, user and client feedback and staffing indicators (such as sickness and absence) (**Figure 24**). These reviews are generally undertaken by senior managers at the corporate headquarters. The regional chief executive spends one to two days a month focusing on those deemed to be more risky.

Figure 24

Illustration of a contractor’s management review





Whistleblowing

3.14 Staff providing a public service are the most likely to be aware of any shortfall against the expected standards of public service provision. Their ability to blow the whistle on such problems is vital. Whistleblowing can be difficult for staff, however. Research from the Institute of Business Ethics has shown that while one in four employees are aware of misconduct at work, more than half (52 per cent) of those stay silent.³ They are concerned that they will not be protected against retaliation for reporting a concern, that the issue will not be investigated appropriately, and that any ‘wrongs’ will not be righted.

3.15 The contractors all have whistleblowing policies but these do not appear to promote communication up the supply chain:

- Legislation allows contractors to nominate a designated official in another organisation as a person to whom authorised disclosures can be made (and their employment rights protected). None of the four contractors nominate individuals in their client department for whistleblowing in this way.
- Legislation identifies certain external individuals, including the Comptroller and Auditor General, as ‘prescribed persons’ that individuals can make a protected disclosure to regardless of the company’s whistleblowing policy. Only one of the four contractors refers to such prescribed persons in its policies.

3.16 In practice, many individuals choose to take their concerns direct to the media or to Members of Parliament without using formal procedures (**Figure 25**). This can be an effective mechanism for finding out about problems on high-profile issues, but leaves staff without the employment rights the legislation aims to protect.

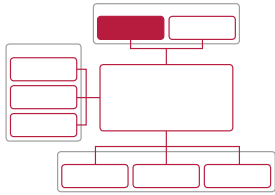
Figure 25

Whistleblowing

Whistleblowing policies are insufficient if organisational culture does not support them.

Whistleblowers raised important concerns about Serco's out-of-hours GP services in Cornwall, though chose not to use the company's internal procedures. Staff working on Serco's £6 million per year contract for providing out-of-hours GP services in Cornwall approached the media in 2012 with concerns about the service. These focused on issues with staffing levels and manipulating performance data reported to the primary care trust. Serco has a whistleblowing policy and a range of channels for staff to raise concern with management. However, the whistleblowers expressed fears about the consequences if they raised concerns internally. Further allegations were then made about verbal threats and locker searches in response to the whistleblowing. Serco acknowledged that it may not have created an environment in Cornwall where staff felt able to raise concerns. However, it has taken steps to implement recommendations from external reviews into the effectiveness of whistleblowing in its health services.

Source: Comptroller and Auditor General, *Memorandum on the provision of the out-of-hours GP service in Cornwall*, Session 2012-13, HC 1016, National Audit Office, March 2013. House of Commons Committee of Public Accounts, *The provision of the out-of-hours GP service in Cornwall*, Session 2012-13, HC 471, July 2013



Public reporting and transparency

3.17 The companies' own public reporting and transparency to the public is important to facilitate public scrutiny and trust. There are a number of different mechanisms:

Companies' publications

- For example, their accounts, corporate responsibility statements and other statements.

Publishing contract awards and details

- The government publishes new public contracts on its website www.contractfinder.gov.uk. However, this only contains recently awarded contracts and very few of the four contractors' contracts are on it. By contrast, the US government website www.USAspending.gov sets out the full contracts and spending on all government suppliers (**Figure 26**).

Freedom of information

- Contractors compile information to answer freedom of information requests asked of their government clients, where they hold the information for the government. The department answers the actual request. Freedom of information does not apply to the contractor's business and commercially sensitive information can be exempt.

Contractually required publication

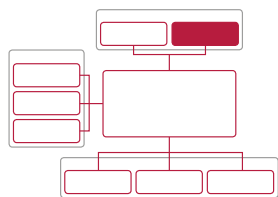
- Some contracts require the contractors to provide performance information for publication. For instance, the Department for Work & Pensions publishes information on the performance of the Work Programme including information by contractor and geographical area.

Figure 26

US government publishes information on supplier spend and contracts



Source: USA Spending.gov



Contractual reporting

3.18 The main way the government can gain quality assurance is through the contractual reporting. This normally includes a set of KPIs that track performance and that are often linked to financial incentives. Together these make up the service level agreement (SLA). These can be used effectively to manage performance (**Figure 27**). However, there are three major risks that mean that contractual reporting is not sufficient on its own to monitor performance:

Risk of misreporting

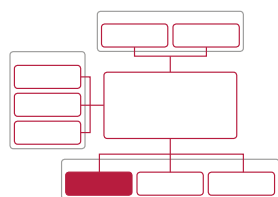
- There have been instances of contractors misreporting performance, including the case of Serco’s Cornwall out-of-hours healthcare contract on which we reported earlier in 2013.⁴

Poorly calibrated KPIs

- These KPIs are either too easy or too hard. This can happen when the contract is poorly specified when let or because of changing expectations. All the contractors told us about instances where poor calibration has resulted in green SLA traffic lights where the client is unhappy or red traffic lights where the client is content with the service. This reduces the SLA’s relevance and can indicate that incentives are not working.

Limits of KPIs

- KPIs give a limited overview of performance. They are normally focused on things that are easily measurable.



Independent regulation and inspection

3.19 Many public services are subject to independent inspection or regulation. In some sectors, such as prisons, this can mean both contracted out and directly provided services are subjected to the same inspection regime.

⁴ Comptroller and Auditor General, *Memorandum on the provision of the out-of-hours GP service in Cornwall*, Session 2012-13, HC 1016, National Audit Office, March 2013.

Figure 27

Approaches to contractual reporting and performance management

(a) Performance regimes can provide incentives for change**Financial penalties and the risk of contract termination on its reputation prompted G4S to turn around its management of Oakhill Secure Training Centre.**

In 2004 **G4S** won a private finance initiative contract to run Oakhill Secure Training Centre – one of four education focused facilities for housing young offenders aged 12 to 18. **G4S** struggled to get the centre to operate well during the first four years of the contract. It repeatedly missed KPI targets, including both minimum levels of staffing and operational standards. In 2008 the Youth Justice Board did not deem it safe to house the full complement of 80 trainees. These shortfalls led to significant penalties and losses for **G4S**. There was a significant risk of the contract being terminated.

In 2008, **G4S** acquired Global Solutions Limited (GSL), which ran two of the remaining Secure Training Centres nationally. New management was brought in from GSL to run Oakhill, leading to a significant improvement in service quality. KPI targets are now normally met, with only occasional shortfalls. The centre has since received joint Ofsted and HMIP inspection ratings of ‘Outstanding’ in 2011 and ‘Good’ in 2013. The Youth Justice Board recognises that **G4S** are driven to perform beyond the minimum standards by the desire to enhance their reputation.

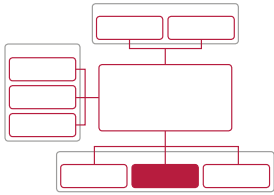
(b) Performance regimes can promote the right behaviour as well as punish underperformance**Managers at National Savings & Investments (NS&I) use the performance regime to try to align Atos’s incentives with their own.**

NS&I’s contract with **Atos** for providing its operational services has a range of 39 KPIs including complaint handling and how long it takes call centre staff to answer calls. Where KPIs are missed, NS&I can reduce the amount paid to **Atos**, and the level of deduction escalates if targets are repeatedly missed. Instead of making the maximum possible deduction, NS&I management prefer to discuss the circumstances of the failure with **Atos** and where NS&I are satisfied that **Atos** took all reasonable action to mitigate the failure the deduction is waived or reduced. This approach is intended to protect the customer by ensuring key elements of the service continue even when it becomes evident that a KPI will be missed. In the last two full years of the contract only £5,500 of deductions were applied. This reflects **Atos**’s performance which, in NS&I’s view, is influenced by the approach to deductions. Both NS&I and **Atos** report a strong sense of partnership on both sides.

(c) Performance regimes can incorporate user feedback**The satisfaction teachers report about their pension provision has become part of Capita’s performance management regime.**

Capita has been managing the administration of teachers’ pensions since 1996 and won the latest contract in 2011. The current performance regime includes the achievement of outcomes including teachers’ and employers’ attitude to pension provision, reflecting the Department for Education’s intention that pension provision be seen both as a valuable part of teachers’ remuneration packages and a means to support effective workforce planning. The performance regime also includes the quality of services delivered, data quality and financial management of the scheme. Since the new performance regime was introduced, **Capita** has provided members and employers with self-service access to pension details and implemented a single point of contact for employer queries and training. **Capita** was paid nearly £15 million in 2012-13 based on its achievement of various targets associated with the outcomes.

Source: National Audit Office interviews with client and contractor staff

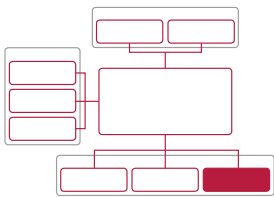


User feedback

3.20 Public service users include the general public (for example, waste collection), public officials using the service as part of a wider service to the public (for example, IT systems) and people who must use the service (for example, prisoners). These users of public services are often not the paying client. They can rarely decide which contractor's service to use and cannot 'vote with their feet'.

3.21 Nonetheless, such users often have both strong expectations as to how services should be provided and valuable insight on how they can be improved. Furthermore, users who feel that they are not listened to can escalate issues through social and traditional media, pressure groups and other means until it becomes a national political issue. This can often have commercial and value-for-money repercussions (**Figure 28**).

3.22 There must therefore be a way to monitor and respond to user feedback. In some instances, user feedback is built into the contract and can even be tied into the financial incentives. In other cases monitoring feedback may fall outside the contract, but be an important part of the client's contract management role.



Staff feedback

3.23 Each of the contractors is a large employer of people who have built careers in providing public services. Many used to work for the public sector, either transferring across to the contractor when the service was contracted out or directly hired by the contractor.

3.24 Engaged and motivated staff are more likely to provide better services.⁵ While many staff resist moving to a contractor, staff engagement within contractors can be high (**Figure 29** overleaf). However, staff engagement survey results are generally not publicly available.

3.25 The number of staff who retain their terms and conditions of their previous employment gives a general indication of the number of staff working for the contractors who transferred to them when the service was contracted out. However, many will voluntarily choose to move on to the contractors' standard terms and conditions of employment, such as when they are promoted.

5 *The Evidence*, Employee Engagement Task Force, "Nailing the evidence" workgroup, Engage for Success, 12 November 2012, available at: www.engageforsuccess.org/wp-content/uploads/2012/09/The-Evidence.pdf

Figure 28

User feedback on medical assessments for disability benefits

User feedback provides vital information on a contractor's performance, though can also reflect issues outside their control

Criticism of the contractor responsible for providing health and disability assessments has intensified in a period which has also seen eligibility for benefits change.

In 2008 government replaced Incapacity Benefit with Employment Support Allowance (ESA), a new benefit which required medical assessments for all new claimants. Since 2011, existing Incapacity Benefit recipients have also been required to have medical assessments, perhaps for the first time. The change has been controversial and has brought strong public attention on Atos as the main contact for face-to-face assessments for the vast majority of disability benefit claimants.

Atos's performance has been publically criticised. In 2012 the NAO reported that assessments were taking longer than planned to process.¹ In addition, this report noted that 96 per cent of assessments were meeting professional standards against a target of 95 per cent. Furthermore, a one-off Department for Work and Pensions audit in July 2012 found only 59 per cent of completed assessments between October 2011 and March 2012 met the expected standard,² although the Department acknowledged that this does not mean that the recommendation was incorrect. Following the implementation of a quality improvement plan, the Department believes that the quality of Atos's reports have improved significantly.

However, Atos also report operational problems resulting from the increased media and campaign attention on ESA, including protests at assessment centres, non-cooperation in assessments and abuse of staff. While Atos is contractually obliged to collect monthly customer survey data for the Department on ESA, in the context of wider controversy around the benefit reform there are risks around isolating user feedback that directly relates to the performance of Atos itself.

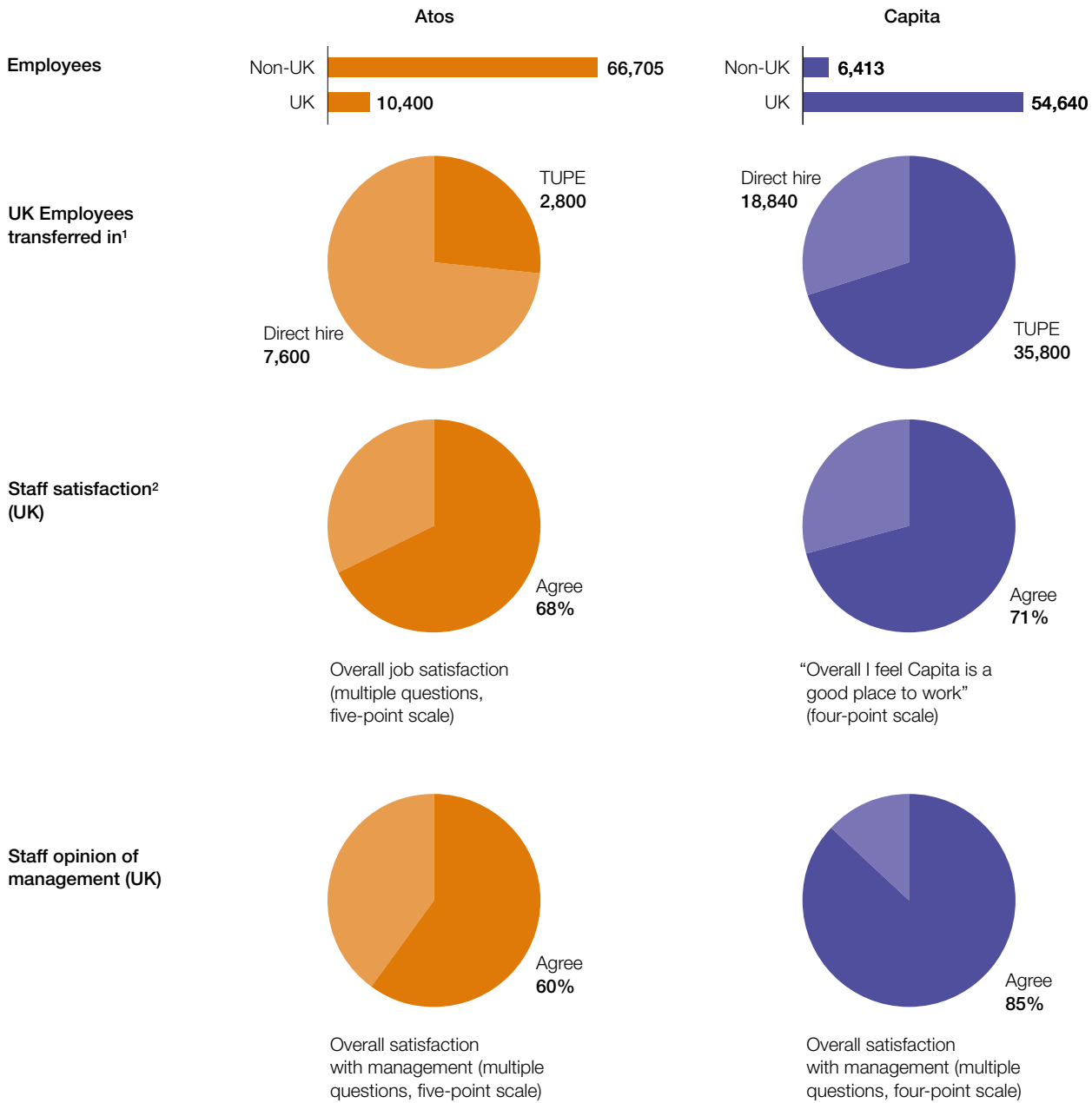
The new Personal Independence Payment benefit (which is replacing Disability Living Allowance) will also require all claimants to have a health and disability assessment. Claimant surveys will be conducted monthly. Atos and Capita have both established stakeholder panels of representative groups to advise on process and guidance provided to the contractors' assessors. It is too soon to judge the effect of this engagement on user feedback.

Notes

- 1 Comptroller and Auditor General, Department for Work and Pensions, *Contract management of medical services*, Session 2012-13, HC 627, National Audit Office, October 2012.
- 2 Available at: www.gov.uk/government/news/hoban-taking-action-to-improve-the-work-capability-assessment

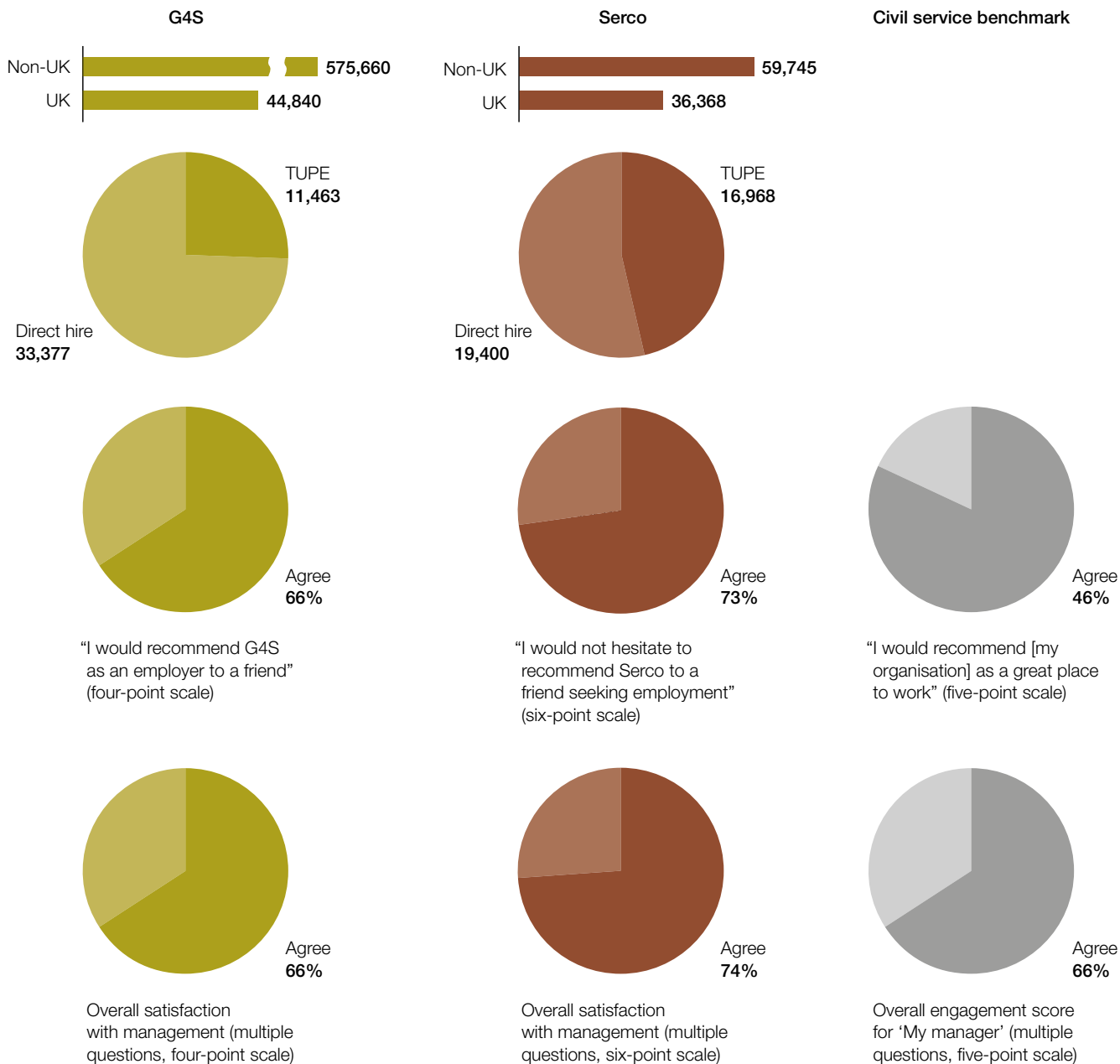
Source: National Audit Office analysis of contractors' financial accounts and conversations with the contractors

Figure 29
Staff employed by the four contractors



Notes

- Using those who retained their terms as a proxy. Employees transferred in from other organisations have their terms and conditions protected by the Transfer of Undertakings (Protection of Employment) regulations (TUPE). The figures here show number of employees taken on under TUPE in the UK, and include staff transferred from private sector as well as public sector organisations.
- Figures shown for Serco include the top three response categories from their six-point scale, which the National Audit Office believes makes the percentages shown more comparable to the other contractors (who use the top two out of four categories). When using their survey, Serco include only the top two categories, giving figures of 52 per cent for staff satisfaction and 53 per cent for staff opinion of management.



These survey results show a general pattern of positive engagement. However, methodological differences to each survey make them not directly comparable.

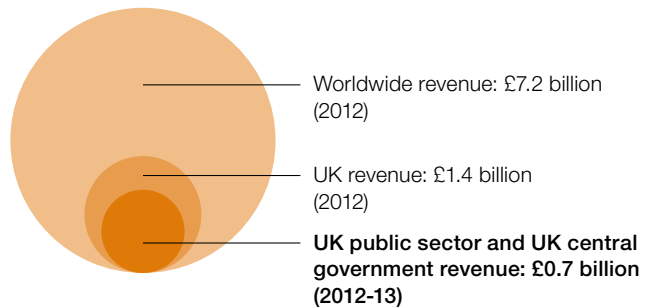
Source: National Audit Office analysis of contractors' and civil service's staff survey for 2012

Appendix One

Four contractors



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.



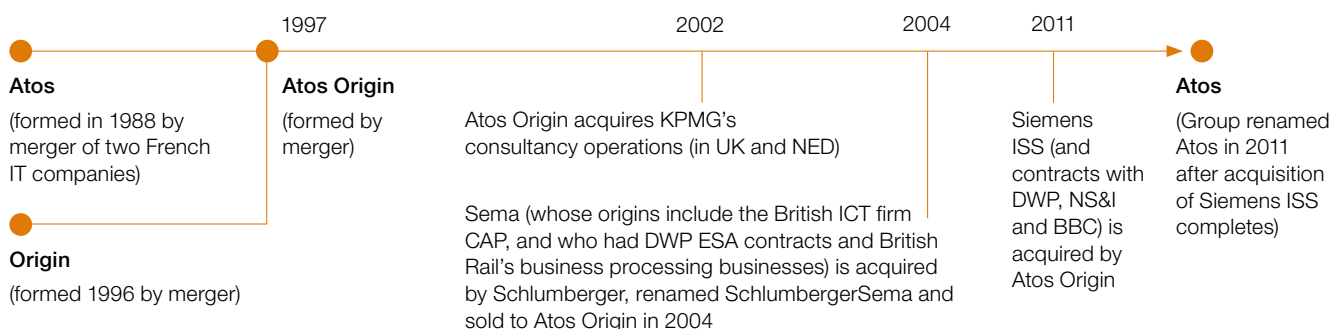
Core markets and key contracts

- Transactional services (such as payment systems).
- ICT middle and back office.
- Worldwide Information Technology (IT) Partner of the Olympic Games and the Worldwide Paralympic IT Partner.
- Disability health assessments.
- Banking platform (particular in Europe), for example National Savings & Investments.

General approach

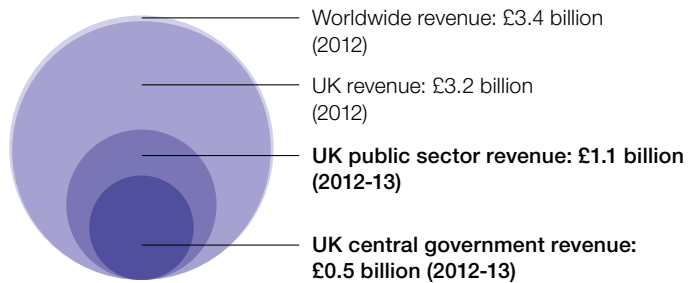
Atos says that it is a 'business technology' company, focusing on IT enabled change and systems design to provide additional benefits to its clients. It has particular expertise in transactional services (such as payment systems).

History



CAPITA

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



Core markets and contracts

- ICT.
- Pension administration (such as teachers' pensions scheme).
- HR.
- Recruitment.
- Financial services.
- Customer services.

General approach

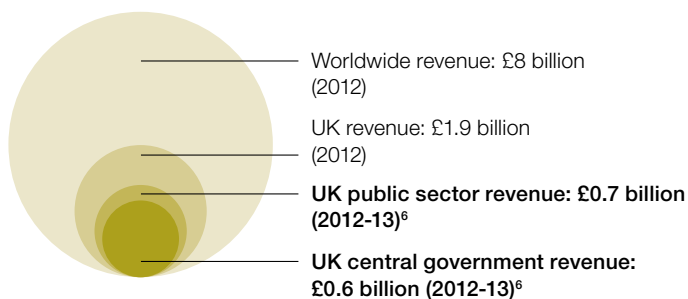
Capita focus on 'white collar' back office administration and customer management, with its generally higher profit margins than the more manual services.

History





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



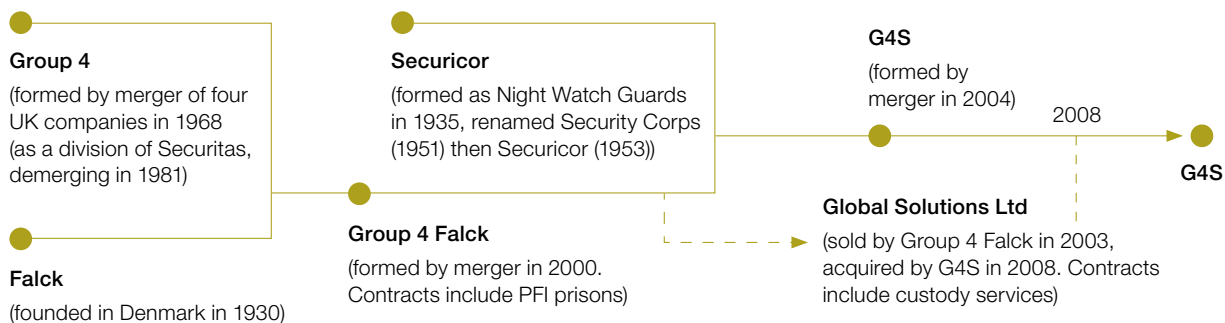
Core markets

- Cash management (private sector).
- Security.
- Custody services.
- Facilities management.

General approach

G4S says it is the leading global security solutions group. Its UK business also focuses on outsourcing and, for the public sector, on custody, transport and facilities management. Its contracts tend to involve a lot of people, and have high revenue but low profit margins.

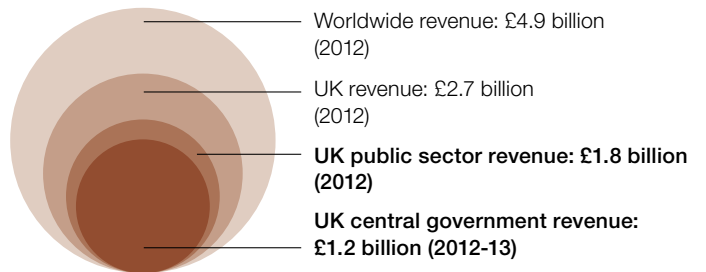
History



⁶ G4S's UK public sector and central government revenue figures exclude £142 million of revenue from contracts relating to the Olympics (before the settlement).



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.



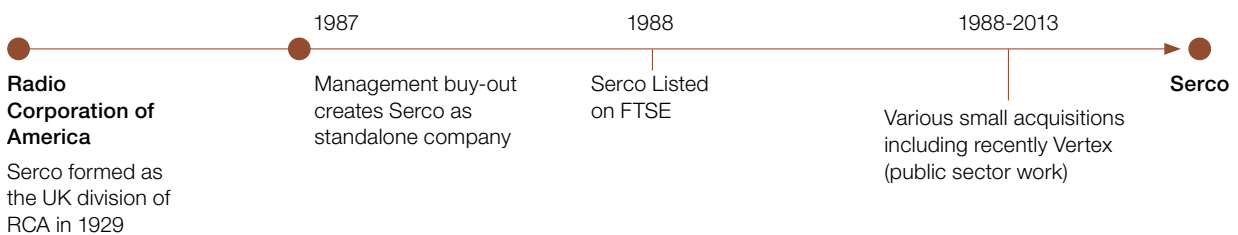
Core markets

- Defence.
- Justice.
- Transport.
- Home affairs.
- Health.
- Scientific services.

General approach

Serco focuses mostly on public sector business and provides services from London bikes to nuclear weapons. Its current strategy is to focus on services where it can build economies of scale in replicable functions.

History



Appendix Two

Methodology

1 This memorandum explores a range of issues identified with government's contracting out of services to the private sector. Our work relied on information from government but also information from private contractors themselves. Atos, Capita, G4S and Serco provided information about revenues and profits, much of which would not otherwise be in the public domain. However, we do not directly audit these companies so have not been able to verify all the information provided to underlying evidence.

2 We collected the following evidence for our work on this memorandum:

An overview of contractor activity

Atos, Capita, G4S and Serco each convened an introductory seminar in which senior representatives met with the NAO team to provide an overview of corporate management and activity.

Further interviews were held with members of the contractors' UK senior management team including chief executive officers, chief financial officers, directors of human resources, and market directors.

Data on revenue levels earned by the four contractors

Atos, Capita, G4S and Serco shared copies of the data returns they send to the Cabinet Office, with revenue data for each individual contract with central government. We used the reported revenue figures for 2012-13.

The contractors also provided additional material for revenues over the same period from other public sector sources such as local government, police services and the NHS.

The data is summarised in Figure 5 on pages 20 and 21. This shows combined revenues of £4.3 billion. The figure is on a cash basis for the 2012-13 year and includes revenues the contractors then passed on to other suppliers in the delivery chain.

Data on profit levels earned by the four contractors

We asked the contractors for information on the profitability of all their UK public sector contracts. The contractors volunteered different levels of information about their overall profitability, including information not in the public domain. Information on what was shared is summarised in **Figure 30** on page 66.

We met with financial staff from the four contractors to discuss their approach to calculating profit information presented in open book arrangements with central government. We did not audit any of the profit figures disclosed in the report back to underlying evidence.

| | |
|--------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Data on tax paid by contractors | <p>We asked the contractors for information on how much corporation tax they paid in the UK in the last year. We met with finance and tax staff from the four contractors to hear overviews of their approach to taxation, as well as explanations for the variations between tax paid and tax expense reported in annual accounts. We did not audit any of the taxation figures disclosed in the report back to underlying evidence.</p> |
| Other data provided by contractors | <p>Other data provided by contractors includes:</p> <ul style="list-style-type: none">● data on contractual relations with small and medium-sized enterprises;● information on corporate policies including codes of conduct, ethics standards and whistleblowing policies; and● data on staff profile and staff satisfaction surveys. |
| Data provided by the Cabinet Office | <p>We reviewed a range of Cabinet Office documents, including Commercial Relationship Board minutes and supplier performance briefings</p> |
| Case examples of services delivered by the four contractors | <p>We undertook a programme of 19 case examples intended to identify and explore some of the key issues arising from government's work with the four contractors. In order to provide a balanced picture, 12 of the case examples were selected by us (including three based on recent NAO work) and seven were chosen by the contractors themselves (marked with asterisks in Figure 31 on page 67).</p> <p>For all new case examples we met with representatives of the government customer and the private sector supplier. In most cases these involved visits to contractors' sites.</p> <p>Departments and contractors were offered the opportunity to comment on the accuracy of case example material presented in the report.</p> |

Figure 30

Information contractors provided on their profits

| | Atos | Capita | G4S | Serco |
|---------------------------------------------------------------------------------|----------------|----------------|-----|----------------|
| Information disclosed in 2012 accounts | | | | |
| Revenue from UK public sector ¹ | x | ✓ ¹ | x | ✓ ² |
| Profit from the UK public sector | x | x | x | x |
| Profit on UK public sector contracts disclosed to NAO | | | | |
| Central government open book contracts ¹ | ✓ ³ | ✓ | ✓ | ✓ |
| Local government open book contracts | – ³ | ✓ | ✓ | x ⁴ |
| Non-open book contracts | x | x | ✓ | x ⁵ |
| Aggregate profit margins across public sector contracts disclosed to NAO | | | | |
| Across all public sector contracts | ✓ | x | ✓ | ✓ |
| Aggregated by department or segment | ✓ | x | ✓ | ✓ |

Notes

- 1 UK public sector revenues can be inferred from its Annual Report in the analysis of global revenue by sector, because most of Capita's revenue is from the UK. This analysis has a different definition of public sector to this report, so the numbers do not match.
- 2 Serco revenue from UK public sector is inferable from information on largest customers.
- 3 Atos disclosed all open book contracts where a report was available. For three contracts the client department had not exercised its contractual rights so a report was not available. Atos does not have any local government contracts with open book.
- 4 Serco did not show us information on local government contracts within their Global Services division as they believe they would be required to seek permission from each authority before disclosing such information.
- 5 Serco showed us information on all their central government contracts including some without open book arrangements. They did not show us information on local government contracts without open book clauses.

Source: National Audit Office

Figure 31

Case examples researched as part of our work

- | | |
|---------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Atos | <ul style="list-style-type: none"> ● Banking and customer service operations (National Savings & Investments) ● Health and disability assessments (Department for Work & Pensions) ● ICT services (Highways Agency) ● G Cloud ICT services* (Cabinet Office) |
| Capita | <ul style="list-style-type: none"> ● Entrust education support services* (Staffordshire County Council) ● Gas Safe register of gas engineers* (Health and Safety Executive) ● Administration of teachers' pensions* (Department for Education) ● Court language services (Ministry of Justice) ● Enforcement services (Driver and Vehicle Licensing Authority) ● Health and disability assessments (Department for Work & Pensions) ● Customer contact services* (Department for Work & Pensions) |
| G4S | <ul style="list-style-type: none"> ● The Work Programme** (Department for Work & Pensions) ● Oakhill Secure Training Centre* (Youth Justice Board) ● Private sector prisons** (Ministry of Justice) ● Police service procurement** |
| Serco | <ul style="list-style-type: none"> ● The Work Programme** (Department for Work & Pensions) ● Out-of-hours GP services** (Cornwall Primary Care Trust) ● Management of Defence Business Services shared service centre (Ministry of Defence) ● Environmental Services* (London Borough of Bexley) |

Note

- 1 Single asterisk indicates a case example suggested by the contractor. Two asterisks indicates a case example based on existing National Audit Office research rather than new work undertaken.

Source: National Audit Office



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