National Audit Office

Report
by the Comptroller
and Auditor General

UK Trade & Investment

Investigation into the UKTI specialist services contract with PA Consulting

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Investigation into the UKTI specialist services contract with PA Consulting

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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UK Trade & Investment (UKTI) became concerned about the pricing method used by PA Consulting on a contract to provide trade and investment sector specialists. UKTI commissioned an investigation into PA's charging on the contract and later gave notice to terminate the contract. Our investigation focuses on how PA's pricing method on the contract worked, what representations it made to UKTI, and how well UKTI understood what PA told it.

Investigations

We conduct investigations to establish the underlying facts in circumstances where concerns have been raised with us, or in response to intelligence that we have gathered through our wider work.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk

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Summary

What this investigation is about

1 UK Trade & Investment (UKTI) re-let its contract for specialist services in May 2014. PA Consulting Services Limited (PA), the incumbent, won three of the five lots and Ernst & Young LLP the other two. The lots won by PA were designed to provide 'sector specialist services' – specialists in a number of industry sectors (such as nuclear, chemicals, food or healthcare) who work to attract overseas investors to the UK or to facilitate UK companies exporting to overseas markets. PA received £18.8 million in the first year of the contract (11 months to the end of March 2015) and the contract was due to last three years.[1]

2 UKTI let the specialist services contract through a competitive bidding process, and awarded it to PA on the basis of PA's quoted charges. UKTI and PA then agreed to incorporate activity from another contract, thus making a significant change to the specialist services contract. UKTI subsequently pursued with PA moving to a different charging model – which led to PA sharing, and UKTI reviewing, actual costs incurred under the contract, which would not have happened under the existing charging model.

3 In June 2015 the National Audit Office was notified by UKTI that it had concerns about the way PA had priced the contract and, in particular, whether it had represented its charges transparently and accurately. UKTI commissioned RSM UK Consulting LLP (RSM; at the time, Baker Tilly) to investigate the contract. RSM produced a draft report in September 2015, which contained the finding that PA had "consistently made incorrect and misleading representations relating to £3.9 million of the overheads charged".

4 This led UKTI to suspend payment of PA's invoices and to terminate the contract. The contract came to an end in January 2016.

1 All financial figures quoted in this report are exclusive of VAT.

5 PA disputed RSM's findings, stating that it had invoiced according to the agreed charging mechanism. The purpose of RSM's investigation was to inspect PA's financial records and consider the accuracy of PA's charges. RSM's report did not give full details of the representations that PA made about its charges to UKTI. We had also been told that UKTI's procurement of the contract fell short of good practice. We therefore decided to launch this investigation to ascertain:

- what representations PA had made to UKTI about its own costs and about what it would charge;
- whether and how UKTI had agreed those costs and charges during the procurement and management of the contract; and
- whether PA had represented its costs and charges transparently and accurately, and whether PA had overcharged UKTI in relation to the contract.

6 We have not sought to assess the value for money of the contract.

Key findings

7 Understanding exactly what happened in letting and negotiating this contract is difficult due to the lack of proper documentation, the disagreement between parties and, now, the absence of a number of people who were involved on either side. From our analysis of the evidence and facts that we have been able to piece together (set out in the main body of the report), we make the following summary observations.

UKTI's governance of the procurement

8 UKTI's governance of the procurement was weak.

- It is not clear that there was an agreed-upon commercial strategy.
- The procurement team had a poor understanding of the bid and requirement.
- There was no effective handover to the contract management team.
- There is no evidence that a number of key decisions were approved by any formal UKTI decision-making body.
- There is no evidence that UKTI received proper external advice.

9 UKTI did not maintain the minimum documentation necessary to support a procurement, leaving it exposed to not understanding what it had agreed to.

- Core documents, such as the business case, were not available to the contract management team.
- Key decisions and agreements with PA were not formally recorded.

Clarity of pricing

10 It is not clear how the contract was, or was meant to be, priced. As a result, UKTI was unable to understand the commercial deal it had struck, the allocation of risk between UKTI and PA, how changes would affect the economic balance of the contract or, therefore, the value for money of the contract.

- The contract states that UKTI wanted to buy trade and investment outcomes. UKTI agrees that PA performed well against those outcomes.
- The main service under the contract was the provision and management of individual specialists with trade and investment expertise. The contract is overly long and complex for a relatively simple requirement.
- UKTI's template for bidders was not clear about whether costs should be fixed or variable, or what should be entered in each line.
- PA's bid, answers to questions, and the resulting contract were self-contradictory about central elements of the pricing structure – such as whether prices were fixed or variable, and whether itemised costs included PA's profit or overheads.

Negotiation of a significant change immediately after the competition

11 UKTI and PA agreed to negotiate a significant change to the contract after the bids were submitted and before the contract was awarded.

- UKTI was procuring the contract under the 'restricted procedure', whereby the contract should be awarded on the basis of the bids provided by those invited to the competition. There should have been no further negotiation.
- UKTI and PA agreed to transfer resources from another contract, the Foreign Direct Investment Services contract, to the new contract. In substance, this acted to extend that part of the other contract beyond its allowed term. It also changed the terms under which PA was paid for the transferred specialists from a cost-plus basis to a banded day rate.
- UKTI decided to award the specialist services contract on 30 April 2014, on the basis of the bid provided by PA, despite having negotiated volume and price changes. PA sought assurances that the contract would be varied and UKTI issued a letter of comfort to this effect.

12 UKTI's handling of the procurement breached good practice and the principles of good procurement in several ways.

- The negotiations before contract award gave the impression of UKTI not wanting to reopen the competition to other bidders by awarding the official contract on one basis, while agreeing to act on another.
- These actions bring into question compliance with the public procurement regulations, and whether or not these changes were a **material** change to the bid and contract. PA sought assurances from UKTI that they were not considered a material change, suggesting that PA was concerned they may be viewed as such.
- UKTI was negotiating on key issues after bids were submitted, therefore restricting competitive tension and exposing it to a risk of significantly reduced value for money from the deal.

Renegotiation of the price

13 The negotiation on the contract outside of competition led to an increase in both PA's revenue and its profit from the contract.[2]

- After announcing PA as preferred bidder, UKTI agreed a new staff mix and volume of activity that increased PA's revenue on this contract from £14.1 million to £18.8 million in the first year. The change in staff mix significantly increased the proportion of PA employees with a corresponding decrease in the proportion of subcontractors, compared to PA's original bid. It is not clear that UKTI understood that the pricing model gave a 55% mark-up for overheads on PA's directly employed staff but not on the subcontractors, which increased PA's gross profit on the specialist contract by £1.4 million in the first year. PA told us there was a consequential decrease in its revenue and recovery of overhead on the Foreign Direct Investment contract, arising from the transfer of specialists between contracts.
- PA's new proposed rate card added £0.9 million of cost in the first year to the variable day rates. PA called this a 'subsidy' and its explanations of this, which have varied over time, imply this was to make up for its loss having underbid for the fixed-price elements of the contract. Our reading of the contract is that PA should have borne this cost. UKTI does not appear to have understood the implication that this 'subsidy' was a direct increase in PA's net profit.
- PA charged £0.34 million more than stated in the contract for the fixed-price elements in the first year. It is clear that the two parties were discussing revisions to the contract pricing but, due to the poor documentation, we do not know if UKTI had agreed to this increase.

2 All our financial analysis is based on the first 11 months of the contract from May 2014 to March 2015. The contract would extend for another two years, with an annual inflation adjustment for each year. The impacts described here would have carried forward to all three years of the contract, had UKTI not given notice to terminate the contract midway through 2015-16.

PA's transparency over its net profit

14 PA should have been more transparent in how it reported its forecast profit to UKTI.

- In response to a question from UKTI during the competition, PA's answer implied that its forecast profit on the contract was 6.2% based on the data provided in the bid. It later stated, on the rate card agreed with UKTI in the weeks after the contract was awarded, that its profit was 7.03%.
- UKTI did not define what it meant by profit, or how overheads should be treated.
- PA changed the way it calculated the profit between the amount stated in the contract, and the amount it stated in its cover emails to the three iterations of rate card used in the final contract negotiations. The introduction of the 'subsidy' acted to deflate the stated profit by £0.9 million.
- UKTI understood that PA had reduced its profit by £4 per specialist day, not increased it. UKTI thanked PA "for taking the hit on [its] profit".

PA's transparency over the inclusion of overheads in the day rates

15 PA's bid, rate card and explanations did not make clear the amount of corporate overheads built into its price.

- PA's use of total cost absorption to calculate its day rates is normal for professional service firms. Under this system, PA's total estimated costs of running its business (including all corporate overheads) are allocated across its total expected billable hours. This provides minimum hourly and daily rates so PA's partners can decide how much to charge their clients.
- In this contract, PA's use of total cost absorption for the day rates sat alongside the separate itemisation of overheads in the schedule of prices (the 'infrastructure' charge). PA said these items were fixed, implying they were not in the day rates.
- We can find no evidence in the bid, contract or negotiations that PA ever made clear that its rate card included at least £2.5 million of variable corporate overheads in the day rates of its directly employed specialists, in addition to the £1.3 million fixed infrastructure charge, which, PA has since stated, related to overheads for subcontractors.
- We found no evidence that UKTI realised that the costs underlying the agreed banded rates of PA's directly employed specialists included overheads. Internal UKTI emails show it believed that the day rates for all specialists were a pass-through of staff costs and a management fee (that is, it believed the stated staff costs were passed through PA either to the specialist or the tax authorities, only the management fee contributed towards PA's profit, and no overheads were included in the day rates).
- PA made a number of inaccurate and contradictory statements to UKTI about what costs were included in the day rates.

The impact on PA's profit of the separate charge for infrastructure

16 The separate charge for infrastructure is likely to represent an increase in PA's profit on the contract which was not clear to UKTI.

- Because PA's total cost absorption methodology is intended to allocate all budgeted overheads across the billable hours of its internal staff, and it included overheads in both its day rate and its separately itemised fixed-price 'infrastructure' charge, PA has charged more for its corporate overheads than it budgeted it would spend on these corporate activities.
- PA told us these separate fixed-price overheads related solely to the subcontractors, who represented an increase in PA's headcount of approximately 5%. It said the subcontractors do not have any allocation of PA overhead in their day rate and their engagement was not taken into account in the budgeting of corporate activities (such as IT, HR and finance).
- PA showed us that it overspent on its corporate activities and told us this was partly as a result of engaging the subcontractors. However, PA was not able to demonstrate how engaging the subcontractors would have increased its corporate overheads by the £1.3 million a year charged to UKTI. It is not clear to us why the itemised costs would not be, in the main, fixed costs of running PA's business.

The discovery of the problems

17 The problems with this contract only emerged due to the tenacity of the UKTI contract managers brought in after the contract had started.

- UKTI's new contract management team found it challenging to manage the contract because the contract and pricing structure were unnecessarily complex. They found it impossible to properly reconcile invoices with the contract because the documentation was poor and the agreement between UKTI and PA unclear.
- The team asked PA to move towards a 'cost-plus' approach to pricing the contract, which they believed would be more transparent and easier to manage. In analysing the cost-plus model that PA subsequently produced, they identified inconsistencies in PA's explanations of its costs which made them question the original basis of the contract's pricing.
- The team brought these concerns to the attention of UKTI management. The Managing Director for Investment led a series of 'challenge' sessions where he asked senior PA representatives to explain and justify the existing and proposed charges. PA's responses failed to allay UKTI's concerns. The Minister of State for Trade and Investment asked that Cabinet Office lead on a review of the contract.
- UKTI then gave notice to terminate the contract (not for breach) and transferred the specialists to its direct management.

Conclusion

18 It is clear that, on this contract, both UKTI and PA have fallen well below the standards expected in managing public money. UKTI should have been in control of the procurement and understood the pricing; PA should have been more transparent in its dealings with UKTI. UKTI's decision to negotiate a significant change to the contract after the bids were submitted and then award the contract on a basis it had already agreed to change was extraordinary. It raises the question of whether it followed the procurement regulations. It was unfair to other suppliers, and was commercially naïve. In moving to a different charging model, UKTI should have been able to rely on PA to be transparent regarding changes in its pricing and how it was disclosing its profit on the contract. PA's lack of transparency led UKTI to take false assurance that there was no impact on the value for money of the contract arising from the negotiations, when that was unlikely to be the case.

Timeline of key events

Date	Event
10 September 2013	UKTI issues invitation to tender for framework and call-off contracts.
21 October 2013	Tender deadline. Bids submitted by PA and four others.
21 November 2013	PA submits responses to UKTI's bid clarification questions.
10 December 2013	UKTI announces PA as preferred bidder.
Late 2013	UKTI and PA agree to transfer a number of specialists from another PA contract to the specialist contract, significantly increasing the volume of provision on the specialist contract.
1 March 2014	Framework contract commences.
Early April 2014	UKTI emails show that it does not understand what the specialists' day rates include.
25 April 2014	In response to a request from UKTI for details of specialists' direct remuneration, PA sends new rate card and states that the 'cost' shown is "what they are paid". The rate card includes the 'subsidy' for the first time.
29 April 2014	PA sends UKTI revised pricing schedules reflecting the increased volume of provision.
30 April 2014	UKTI sends signed call-off contract to PA. The contract does not reflect the increased volume of provision and UKTI issues a letter of comfort.
1 May 2014	Call-off contract commences.
Early May 2014	UKTI contract management team (two people) take up post.
16 May 2014	PA sends new rate card to UKTI, which UKTI accepts by email.
October 2014	UKTI and PA agree to move to a cost-plus pricing model from 2015-16.
13 February 2015	PA sends initial cost-plus model to UKTI.
25 March 2015	UKTI identifies issues in the cost-plus model which cause it to become concerned over PA's transparency and implications for the existing 2014-15 pricing mechanism.
30 April 2015	UKTI emails PA expressing "a number of serious concerns" arising from the data in the cost-plus model.
4 June 2015	UKTI and PA hold half-day 'challenge' session. PA agrees that the reference to "what they are paid" in the email of 25 April 2014 was erroneous and that the figures in the first cost-plus model were inaccurate.
1 July 2015	RSM commences an investigation into the contract on behalf of UKTI.
17 September 2015	RSM sends its draft report to UKTI.
14 October 2015	UKTI, Cabinet Office and RSM meet PA and share a partially redacted copy of RSM's draft report.
16 October 2015	UKTI writes to PA giving three months' notice that it is terminating the framework and call-off contracts with PA.
9 November 2015	PA meets Cabinet Office and submits a report challenging RSM's findings.
27 November 2015	Cabinet Office writes to PA stating that PA's report did not satisfy the "very serious concerns" of Cabinet Office and UKTI.
16 January 2016	UKTI's contract with PA terminates.
May 2016	UKTI and PA reach an amicable settlement.

Note

1 A more detailed timeline is given at Appendix Two.

Source: National Audit Office

Part One

The contract and its investigation by RSM

The contract between UKTI and PA was for specialist services

UK Trade & Investment

1.1 UK Trade & Investment (UKTI) is a non-ministerial department funded jointly by the Department for Business, Innovation & Skills and the Foreign & Commonwealth Office. It provides a network of advisers across the UK and 100 other countries to support and assist exporters of goods and services, and a network of experts to help overseas-owned firms locate and build their business in, and from, the UK. In 2014-15 UKTI had net expenditure of £264 million and 1,904 civil servants.

PA Consulting

1.2 PA Consulting Services Limited (PA) is "a consulting, technology and innovation firm". It is based in the UK and is part of the PA Consulting Group which operates globally. The group employs some 2,500 people, and had a turnover of £423 million in 2014.

The contracted service

1.3 The contract provides for 'sector specialist services'. The contract describes specialists as a diverse range of commercially aware and networked specialist resources covering a variety of industrial sectors such as automotive, nuclear, aerospace, financial services and retail. These specialists work to attract overseas investors to the UK or to help establish UK businesses in overseas markets. Some are employed directly by PA, but the majority are subcontractors to PA. The specialists work under the strategic direction of UKTI staff but are operationally managed by PA, normally either in UKTI's offices or on site with clients internationally. In 2014-15 the contract provided 186 specialists.

The contract

1.4 UKTI's sector specialist trade and investment advisers have been outsourced since 2006. Originally the services were packaged in three separate contracts covering different specialisms. PA won all three in 2010. In 2014, UKTI established a bespoke framework agreement and reconfigured the three contracts as five work packages (call-offs) under the framework. Part of the rationale for this was to reduce UKTI's reliance on a single provider. Three were awarded to PA, the other two to Ernst & Young LLP.

1.5 The contract was originally intended to run for three years from 1 March 2014, although it did not start until 1 May 2014. UKTI paid £18.8 million (excluding VAT) for the first 11 months of the contract.

UKTI procured for outcomes, but the services were managed as inputs

1.6 UKTI's procurement focused on the outcomes it wanted to achieve. For instance, UKTI's invitation to tender (ITT) stated "the purpose of this procurement is to buy outcomes but UKTI is looking for specialist providers who can make the most of our existing resources within UKTI and complement them with specialist expertise and services". However, the substance of the services provided under the contract and the way that UKTI paid for them was primarily about inputs. The specialists were operationally managed by PA, but under the strategic direction of UKTI. UKTI determined what specialists it needed, interviewed each specialist sourced by PA and chose where to deploy them.

1.7 Most of the payments in the contract are structured around the input, with more than 70% of the invoiced amounts being for the day rates of the specialists provided. However, the ITT set out a proposed incentivisation scheme, whereby the provider would be paid between 90% and 117.5% of what it would otherwise be due, depending on the number of trade and investment 'wins' achieved by the specialists each year. PA's bid in response to the ITT welcomed the 'payments by results' approach and focused on the 'value added' that PA would provide.

1.8 The specialists performed well. For example, in 2015-16 specialists deployed by PA helped support UK exports of more than £6.3 billion and helped secure investment into the UK which created or safeguarded 29,010 jobs.

1.9 However, the contract left the incentivisation scheme on the trade side still to be determined. The achievement of the incentivisation on the investment side became part of the dispute with UKTI.

1.10 The result is a complex contract of 596 pages that is difficult to read, understand and use, for a relatively simple service. The contract incorporates the ITT and bid, both of which are focused on the outcomes and how they will be achieved, and not on the way the contract would actually be run and charged for. Furthermore, the bid and contract are not clear on important aspects of the pricing and are often self-contradictory. We discuss the lack of clarity about pricing further below and in Part Four.

The contract was priced primarily using a day rate for each specialist, a fixed rate for managing the contract, and expenses

The pricing mechanism

1.11 The pricing under the bid, contract and subsequent changes and invoices are set out in **Figure 1**. Although the contract is unclear, all agree that there are three parts of the contract price structure:

- **PA charged UKTI a set fee for each day a specialist worked.** There was a different fee (day rate) for each specialist. Each specialist was allocated to one of three bands, based on their level of expertise. This represented more than 70% of the overall price as set out in the contract.
- **There was a fixed-price element (irrespective of volume of activity) comprising three parts.**
  - Back-office costs: the ongoing costs of the people within PA who managed the contract and the specialists.
  - Infrastructure costs: according to the contract, these were meant to cover the running costs of the contract (such as computers and accommodation).
  - Other costs: these included the one-off costs of mobilising the contract and providing a specific ICT tool for the contract. These other costs were small, comprising 1.3% of the contract value in the first year.
- **The specialists' and back-office staff's expenses were charged to UKTI in full as a 'pass-through cost'.**

Figure 1

Simplified breakdown of the price of the contract – comparison between bid, contract, rate card and invoices

Element of price	Description	Bid (First 13 months to 31 March 2015) (£)	Bid (Extrapolated cost for 11 months to 31 March 2015) (£)	Written contract (11 months to 31 March 2015) (£)	Rate card (Version 11) (11 months to 31 March 2015)[1] (£)	Amount invoiced (11 months to 31 March 2015) (£)
1 Variable costs	a Cost of specialist subcontractors	10,172,475	8,607,479	7,912,942	8,599,121	7,751,687
	b Cost of specialist employees	1,672,871	1,415,506	1,357,985	4,722,959	4,817,340
	c Disclosed profit	1,088,804	921,296	872,225	1,076,387	1,058,383
	d Subsidy	–	–	–	913,280[2]	859,486
	Total variable costs (price of specialists)	**12,934,150**	**10,944,281**	**10,143,152**	**15,311,747**	**14,486,896**
2 Fixed costs	e Back-office	1,475,058	1,248,126	1,217,289	N/A	1,388,034
	f Infrastructure	1,312,103	1,110,241	1,113,628	N/A	1,279,907
	g Mobilisation costs (one-off)	96,462	96,462	94,590	N/A	96,465
	h ICT tool (added after contract went live)	N/A	N/A	N/A	N/A	153,205
	Total fixed-price element	**2,883,623**	**2,454,829**	**2,425,507**	**N/A**	**2,917,611**
3 Pass-through costs	i Expenses and other items	1,890,973	1,600,054	1,530,304	N/A	1,347,552
Total (excluding VAT)		**17,708,746**	**14,999,164**	**14,098,963**	**N/A**	**18,752,059**
Days worked	Subcontractors	20,380	17,245	16,162	17,239	15,297
	Employees	3,254	2,753	2,762	10,035	9,976
	Total days worked by specialists	23,634	19,998	18,924	27,274	25,279[3]
Number of specialists[4]		195	195	195	156	186

Notes

1 The rate card figures reflect the specialists transferred in from another contract.

2 Subsidy in V11 does not equal 34 times the number of days as no subsidy was allocated to two specialists. V11 rate card as sent in May 2014 did not contain any details of fixed costs or expenses.

3 Numbers of days in invoice do not total due to six days not being classified as subcontractors or employees. Other numbers do not total because of rounding.

4 The numbers of specialists may not be comparable as some (contract and bid) are full-time equivalents, the rate card figure is the total in post at the beginning of the contract and the 'as invoiced' figure is the total number of specialists who worked on the contract over the 11 months.

Source: National Audit Office analysis

Banding

1.12 The banding of the specialists was new for the 2014 contract. PA had proposed the banded rates as part of its bid, and UKTI accepted this proposal. Within each band, there was some cross-subsidisation between specialists; so the price paid by UKTI for person A might be lower than the cost to PA of providing that person, while the price for person B might be higher. The rationale was that it would reduce variations in the prices paid by UKTI for specialists with similar levels of experience, and that certain budgets within UKTI would not bear an excessive cost because of the high cost of specialists in their particular area of expertise.

Management fee

1.13 The bid and contract also set out a management fee as part of both the specialist day rate and the back-office fixed charge. This was meant to reflect the profit to PA under the bid pricing model. This management fee was not included in later iterations of the rate card or the invoices, in which PA disclosed its profit solely as a variable rate linked to the day rate.

UKTI became concerned about the transparency of the contract

Lack of transparency and control over costs and changes

1.14 The UKTI contract management team began to have concerns about the complexity, transparency and manageability of the contract soon after coming into post in May 2014. These included:

- **A lack of transparency over the costs of specialists**

  UKTI budget holders found it difficult to understand the budgetary impact of moving individual specialists onto or off the contract, because of the banded specialist rates and the cross-subsidisation between specialists. PA managed its cumulative margin by adjusting the 'cost to PA' compared with the 'price to UKTI' on a case-by-case basis. For example, if a 'profitable' (for PA) specialist came off the contract, PA's overall margin would fall below the 7.03% agreed. It would then look to reinstate its overall margin through adjusting the day rate of future recruits.

- **Poor control by UKTI over the management of changes and requests**

  UKTI budget holders were negotiating independently with PA about recruiting specialists, and there was no overview or scrutiny of the overall level of resource or the prices of individual specialists. There were some instances of different people in UKTI and PA agreeing different rates for the same specialists, and a few occasions where specialists were charged to UKTI at an incorrect rate. When these were raised with PA, PA corrected the errors.

1.15 The contract management team introduced a single point of contact for all commercial discussions with PA, and a requirement that any proposals for new specialists must be signed off by a UKTI director and an approval panel. The contract management team negotiated all day rates and the price of each specialist was agreed with PA in writing. They also approached PA to discuss changing the charging system.

‘Cost-plus’ discussions

1.16 In autumn 2014 UKTI and PA agreed to discuss moving to a simpler ‘cost-plus’ pricing model, whereby the price UKTI paid would be the direct cost to PA of engaging each specialist, with a mark-up to cover overheads and profit. The aim was to provide greater transparency and a more direct link between cost and price.

1.17 In February 2015 PA sent a model (a spreadsheet) of how it might price a cost-plus approach. The model included details of the proposed changes and underlying costs. Analysis of the model caused UKTI to become concerned that costs presented as ‘salary’ in fact included some recovery of overheads. This caused UKTI significant concern about its understanding of the contract’s existing charging model and about how accurately PA had represented its costs in the contract, particularly the allocation of PA’s corporate overheads within the day rates.

1.18 UKTI’s concerns increased over March to May 2015. On 28 April 2015 PA suggested moving to the cost-plus model as drafted in February, to enable UKTI to realise projected savings of £2.7 million in 2015-16, while the two parties continued to negotiate a final solution. On 30 April, UKTI responded by informing PA that they had “serious concerns” with aspects of the February cost-plus model, particularly regarding the component costs of PA employees’ day rates. Ensuing discussions between senior managers on both sides failed to resolve the issues. PA admitted that part of the model was inaccurate and that their explanations of the model had not made sense. PA sent a second cost-plus model to UKTI in May 2015, with projected savings of £1.6 million. PA told us they now consider that neither of the cost-plus models can be relied upon. No changes were made to the contract on the basis of the cost-plus models discussed.

UKTI engaged RSM to investigate the contract

1.19 UKTI felt its concerns were not being fully addressed by PA, so it decided to commission a contract investigation to consider the accuracy of the charges levied by PA and the proposed variations. The investigation was undertaken by Baker Tilly, now known as RSM UK Consulting LLP (RSM). RSM began work on 1 July 2015.

1.20 At the request of the then Minister of State for Trade and Investment, UKTI set up a government scrutiny group to oversee RSM’s investigation. The group was chaired by a representative of the Cabinet Office. The National Audit Office (NAO) attended the group as an observer.

RSM's findings

1.21 RSM submitted its draft report to UKTI on 17 September 2015. The Cabinet Office met with PA on 8 October to discuss RSM's findings, and a partially redacted copy of the report was sent to PA on 14 October. RSM made the following conclusions:

- "PA Consulting has consistently made incorrect and misleading representations relating to £3.9 million of the overheads charged."[3]
- "The contract's value for money is challenged by the high level of overheads."
- "There is uncertainty as to the legally valid basis for charging."
- "There are lessons to learn for procurement and contract management at UKTI."

The dispute

1.22 PA met with the Cabinet Office in early November 2015 and submitted a detailed report challenging RSM's findings. The Cabinet Office responded to PA, stating that PA's report did not satisfy the very serious concerns it had over the contract.

1.23 The NAO wrote to both parties in November 2015 to inform them that, having read RSM's report, we had decided to conduct an investigation to establish the facts around what had happened, what representations PA had made and how UKTI and the Cabinet Office had managed the situation.

UKTI terminated the contract and withheld payment

The termination of the contract

1.24 Following RSM's investigation, UKTI decided to terminate the contract on the basis that it no longer considered the contract to represent value for money. UKTI wrote to PA on 16 October 2015, giving three months' notice of the termination, and the contract terminated in January 2016. The contract was not terminated for breach. UKTI decided that it could terminate the contract on notice without prejudicing its ability to later terminate the contract for fault and claim damages from PA. PA cooperated fully with the transfer of staff to UKTI so services were not disrupted.

3 This was an extrapolated figure for the first 16 months of the contract (when RSM's report was produced) based on analysis of the £2.67 million of overheads in the day rates in the first year of the contract.

UKTI withheld payment

1.25 UKTI withheld more than £5.1 million of payments against invoices submitted by PA to account for the additional overheads and profit charged over the life of the contract. This equated to the £3.9 million reported by RSM for the first 16 months, extrapolated to the full term of the contract until it was terminated in January 2016.

Settlement

1.26 Both parties attempted mediation in March 2016. These talks failed to result in agreement. UKTI and PA continued to discuss a commercial settlement to the dispute. At this point discussions expanded to include both contracts UKTI held with PA. The second contract (for Foreign Direct Investment Services) was subject to an ongoing audit and UKTI and PA were in dispute as to the interpretation of a number of clauses.

1.27 In May 2016 a commercial settlement was amicably agreed between UKTI and PA to resolve the disputes on both contracts on a no-fault basis. Under the settlement, it was agreed that the value of the outstanding invoices owed by UKTI to PA would be reduced by £3.0 million.

UKTI's projected savings from managing the contract itself

1.28 UKTI has managed the specialist services since January 2016. It now forecasts that it will make significant savings in managing broadly the same service as PA provided. We have not assessed the extent to which this is a like-for-like comparison with PA's costs. UKTI also expects to make further savings through reducing the deployment of specialists.

Part Two

UKTI's procurement of the contract

UKTI's management of the procurement was weak

2.1 UK Trade & Investment's (UKTI) management of the procurement fell significantly short of good practice. As a consequence of the way UKTI managed the procurement, it is very difficult to know exactly what was agreed between PA Consulting Services Limited (PA) and UKTI, and the current staff at UKTI do not have a full understanding of what happened. We set out UKTI's weakness of governance and management below.

The contractual approach was confused between an input- and an outcome-based contract

2.2 The invitation to tender stated that the purpose of the procurement was to buy trade and investment outcomes. PA has described the contract to us on a number of occasions as outcomes-based. The contract allowed for an incentivisation scheme, whereby PA would receive a bonus payment if the specialists met certain trade and investment targets. For trade specialists, PA agreed to waive these payments for the first year of the contract as a result of budget constraints within UKTI. The nature of the services is primarily input-based in substance; the specialists work under the strategic direction of UKTI but their performance is managed and supervised by PA to achieve the outcomes. The new UKTI team managing the contract told us that they saw it as an input-based contract, and the majority of the key performance indicators set out in the contract relate to the provision of specialists (inputs) and to contract management.

The main users of the contract were not involved in its procurement

2.3 UKTI is divided into Trade and Investment Groups. The Trade Group had been the main user under the predecessor contracts. However, after PA was selected as the preferred bidder for this contract, UKTI and PA agreed to move a number of specialists engaged via another PA contract (the Foreign Direct Investment contract) to this contract, which would create greater demand under this contract from the Investment Group. The procurement negotiations were led by a director from the Trade side, who was the procurement's *de facto* senior responsible owner, working closely with two directors from the Investment side. The Trade director was supported by a project manager, and the team included a procurement specialist from UK Shared Business Services Ltd, whose role was to ensure compliance with procurement rules. Shortly after the contract commenced, all members of the procurement team either changed roles within UKTI or left the organisation altogether.

The contract management team were not involved in the procurement

2.4 The team who were to manage the contract were new to UKTI and joined in the two weeks after the contract commenced. The new contract management team were not involved in the negotiations with PA about the pricing mechanism.

The process to evaluate the contract price was confused

2.5 UKTI and PA do not have a consistent understanding of exactly what was meant to be included within the different elements of the price within the pricing template, bid evaluation, contract schedules and subsequent negotiations. We received different explanations of the way the contract was priced from different members of the UKTI procurement team.

UKTI varied the volume and price of the contract outside of competition by agreeing to the transfer to the specialist contract of existing work undertaken by PA on another contract

2.6 Prior to signing the contract, UKTI and PA agreed that the volume of work they would deploy via the contract would be significantly higher than had been set out in the invitation to tender, on which basis the bids had been prepared. Rather than including the amended price and volume in the contract, UKTI wrote to PA with a letter of comfort "to acknowledge that the volume of specialist activity required under the contract … has increased since UKTI went out to tender in September 2014 and to provide assurance that all agreed processes will be followed to accommodate this and any future variation in the utilisation of specialists". UKTI also followed this up with an email specifying the revised number of specialist days and the consequent cost of the specialists. Talks on the rate card for the specialists continued even as the call-off contract was signed on 30 April 2014 by UKTI and on 1 May 2014 by PA. We set out the consequences of this in Part Three.

UKTI did not properly understand or challenge PA's costs

2.7 UKTI gave insufficient challenge to PA's costings, bids and negotiations. For example, it did not challenge PA when elements of the price that had previously been described as 'fixed' were changed, or when PA introduced a new element ('subsidy') to the pricing mechanism. UKTI did not define what it meant when it asked PA about its profit levels, and did not ask PA what the basis of its quoted profit figure was.

Key communications between UKTI and PA were not formally documented

2.8 UKTI and PA were used to working with each other and much of their communication regarding the procurement was by email and relatively informal. Significant changes, such as the agreement to vary the volume and price of the contract, were not always recorded more formally as contract variations.

UKTI and PA did not successfully establish governance to jointly manage the contract

2.9 This led to immediate problems with control (paragraph 1.14). Once problems between UKTI and PA had become apparent, there was no formal means of escalating the problems beyond those involved in the day-to-day running of the contract, other than internally within each of the parties. PA told us that it had asked UKTI to set up regular contract governance meetings, but that this did not happen. While there was no active higher-level governance on this contract, there were regular contract management meetings at a working level.

Part Three

The change in volume and price

UKTI and PA negotiated a significant change to the contract after PA submitted its bid

Use of the restricted procedure

3.1 UK Trade & Investment (UKTI) chose to procure the contract using the restricted procedure. This is one of four available procedures under the public procurement regulations, and is recommended for use for simple procurements. Under the restricted procedure, the buyer advertises the contract opportunity and screens those who ask to bid using a pre-qualification questionnaire. It then asks the selected bidders to submit bids. It should evaluate the bids against its pre-defined and stated criteria and award the contract on the basis of the bid. It can ask clarification questions of its preferred bidder before it signs the contract, but it should not negotiate any further.

3.2 PA Consulting Services Limited (PA) submitted its bid in October 2013 and was awarded preferred bidder status for three of the five work packages in December 2013.

3.3 Another bidder challenged the methodology used by UKTI to evaluate the bids. UKTI wrote back to that bidder in January 2014 rejecting the bidder's claims and the issue went no further. However, handling this dispute contributed to the delay in awarding the contract, from the intended start of March 2014 to May 2014.

Negotiation during the procurement

3.4 After PA was selected as the preferred bidder, UKTI and PA agreed to move a number of specialists engaged via another PA contract (the Foreign Direct Investment contract) to the specialist services contract. This meant that there would be a considerably larger volume of specialist input under this contract than UKTI had indicated in its invitation to tender.

3.5 The Foreign Direct Investment specialists had been provided on a cost-plus basis (that is, the cost of the specialist plus a mark-up). The Foreign Direct Investment contract had been running since 2011 and, after being extended twice, ended in March 2016. UKTI and PA started to negotiate on the price of these specialists for this contract, introduce other staff and change the day rates in the bid.

UKTI asked PA to sign a contract based on its bid, rather than the revised terms

The negotiations continued after the contract was signed

3.6 UKTI and PA wanted to agree the contract by 30 April 2014 when the predecessor contracts came to an end, believing that if they did not sign the contract by then, the specialists' jobs would be at risk. We have not seen any evidence that they considered another temporary arrangement.

3.7 UKTI and PA were still finalising the required volume change, the staff mix, the specialist day rates and the fixed prices at the time UKTI signed the contract on 30 April 2014. PA provided a revised rate card titled Version 9 on 25 April (paragraph 4.12), just before the contracts were signed. The ongoing negotiations went through a further two iterations of the rate card. PA sent Version 10 of the rate card to UKTI on 30 April and Version 11 on 16 May. Version 11 was used for the first contract invoice at the end of May 2014 and all invoices since then, with changes as specialists came onto and off the contract agreed by PA and UKTI through the specialist approval process set up by the new contract management team (paragraph 1.15).

3.8 PA submitted a revised pricing schedule to UKTI on 29 April 2014, which reflected the agreed increased volume of activity. However, UKTI asked PA to sign a contract based on PA's bid provided in October 2013, modified to take account of the delay in the contract's start, but not reflecting the increased volume. PA asked for a letter of comfort to reflect the changes they had negotiated so far. UKTI wrote to PA on the morning of 30 April with a formal letter of comfort, acknowledging that the volume of specialist input would be significantly higher than set out in the invitation to tender. PA considered the letter of comfort was insufficient and sought further assurances from UKTI, including whether the changes constituted a material change to the contract. UKTI sent a further email on 1 May, setting out the commercial terms of the number of specialist days expected and the amount UKTI expected to pay. This referenced the figures in the pricing schedule submitted by PA on 29 April. PA signed the contract on 1 May 2014.

Lack of agreed record of the contract

3.9 UKTI and PA did not formally record the outcomes of these negotiations. The contract says any change needed to be agreed in writing and signed by both parties. We have not seen any such agreement. The contract was not updated to reflect the new schedule, and we have not seen evidence that UKTI approved the new rate card through any formal governance process. UKTI emailed PA on 16 May 2014, saying "this all seems highly reasonable to me, thank you for taking the hit on your profit". This was the last correspondence between UKTI and PA that we have seen on the negotiations over the rate card.

3.10 We are not certain what the exact contract between PA and UKTI is in relation to all elements of the pricing. Under English law, a contract does not need to be written down or signed, but may be deemed to have been agreed by behaviour. UKTI paid invoices on the basis of the Version 11 rate card (as had been informally agreed by email, and with subsequent agreed changes) from May 2014 through to August 2015.

Following the transfer of activity from the other contract, the price of the specialist contract went up from £14.1 million to £18.8 million a year

3.11 The impact of the changes negotiated before the contract was signed was that the number of specialist days in the first year went up 34%, from the 18,924 forecast in the contract to 25,279 actually invoiced for; and PA's revenue from this contract went up 33%, from £14.1 million to £18.8 million (Figure 1). There was also a decrease in PA's revenue on the other contract.

3.12 The bulk of the increase in revenue was a result of the increase in specialist days. However, the average price per specialist day also increased. We have analysed the day rates of the 52 (36%) individual specialists who were named on the Version 11 rate card who were also named in the contract. The average of the day rates for these specialists rose from £498 in the contract to £640 in Version 11.[4]

3.13 Comparing the average day rate of all specialists in the contract with the average for all specialists in Version 11, each weighted by the number of days worked, shows an increase from £536 in the contract to £561 in Version 11. The equivalent figure from the invoice is £573 per specialist day – £37 higher than in the contract (**Figure 2** overleaf).[5] Within this average, the mix of staff changed, some individuals' rates went up and some went down, and a new band of junior account coordinators was added. The invoiced number of subcontractor days reduced by 865 from the forecast in the contract, and the number of days for PA's directly employed specialists went up by 7,214, which was largely due to the transfer of specialists from the Foreign Direct Investment contract.

3.14 The impact of this was to increase the allocation of general overheads in the specialist contract under the internal cost rate system by about £1.4 million.[6] The inclusion of overheads in the pricing is discussed in Part Four. PA told us that much of this additional recovery of overhead would have occurred under the Foreign Direct Investment contract anyway, up to the point that contract was due to expire in March 2016.

4 The average day rates in paragraph 3.12 are calculated as the sum of the individual day rates of each of the specialists appearing in both the contract and the Version 11 rate card, divided by the number of specialists who appeared in both lists.

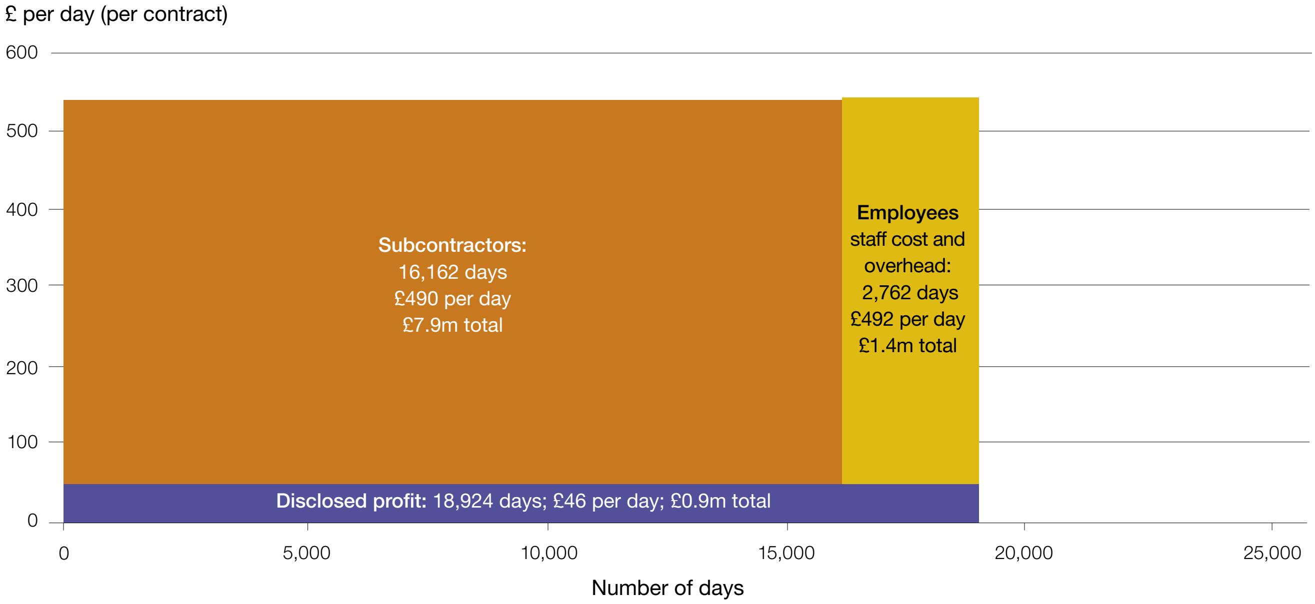
5 The average day rates in paragraph 3.13 are calculated as the total price of specialists divided by the total days worked by specialists, as shown in Figure 1.

6 This calculation assumes overheads are spread evenly across the specialist days of PA employees when, in fact, each specialist attracts a different rate and allocation of overhead.

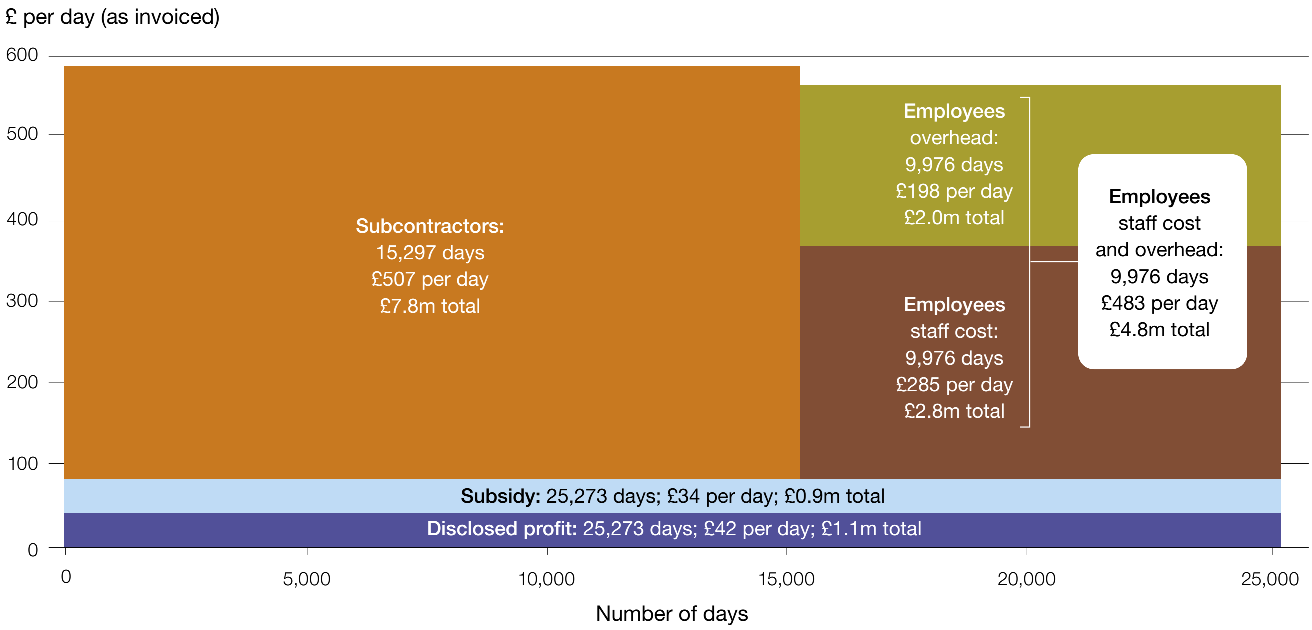
Figure 2

The main difference between contract and actuals is the introduction of the subsidy and the increase in volume

Per contract – total price of specialists £10.1 million



As invoiced – total price of specialists £14.5 million



Notes

1 Areas represent the variable costs of specialists. Horizontal increases represent volume changes and vertical increases represent price changes.

2 This calculation assumes overheads are spread evenly across the specialist days of PA employees when, in fact, each specialist attracts a different rate and allocation of overhead.

3 Does not show fixed or pass-through costs.

Source: National Audit Office analysis

The fixed-price elements of the contract increased

3.15 The contract is unclear, and in places contradictory, about whether some costs are fixed or variable. However, in response to clarification questions during the bid process (incorporated into the contract), PA said that the fixed costs would only go up if the number of specialists rose by more than 50. In the letter of comfort sent by UKTI as the contract was being signed (paragraph 3.8), UKTI said that any subsequent changes in volume would be agreed on the basis of daily rate bands and changes to management and infrastructure costs "in the event that the number of specialists increases beyond 200". The contract assumes 195 specialists and the total number of specialists who actually worked on the contract in 2014-15 was 186.

3.16 The contract agreed at the end of April 2014 quoted the fixed-price fees as:

- £1.2 million for back-office staff;
- £1.1 million for infrastructure costs; and
- £94,590 for mobilisation costs.

In total, the fixed-price elements were £339,000 more in the first year than was stated in the contract.

PA introduced a 'subsidy' which transferred costs it had agreed to bear onto UKTI

3.17 UKTI asked PA to state its forecast profit on its bids for each work package during the bid clarification process. UKTI did not define what it meant by profit, and did not stipulate either gross or net profit.

3.18 PA's response was 5.66% to 6.43% depending on the work package. This implies an overall profit of 6.2% on the contract as awarded. PA updated its forecast profit when it provided Version 9 of the rate card to UKTI on 25 April 2014 (paragraph 4.12) and for each other iteration of the rate card. By Version 11, PA said that it forecast a profit of 7.03% across all three work packages. PA's calculation of profit was not to any recognised industry standard and was stated net of all allocated overheads and the infrastructure charge.

3.19 PA changed the way it calculated the profit from its answer in the contract to that stated within the rate cards it provided to UKTI.

3.20 The Version 9 rate card that PA sent to UKTI on 25 April 2014 included the column labelled 'subsidy' for the first time. PA described this in the covering email as "the allocation of other programme costs to each specialist". We have not seen any earlier mention of the 'subsidy'. No further explanation was provided as to what it represented and we have not seen any discussion of the 'subsidy' at the time. The way the rate card was presented implied that the subsidy was part of the calculation of cost that led to each specialist's daily rate.

3.21 The subsidy was calculated at £34 per specialist per day, and amounted to £0.91 million in the Version 11 rate card and £0.86 million of charges actually invoiced in 2014-15.

3.22 PA's explanations of the subsidy have changed over time (Figure 6 on page 38). It told us that the subsidy represented its forecast loss on the fixed-price elements of the contract and especially the costs of running the back-office programme management function. PA explained that, when it bid for the contract, it priced its bid competitively, with the aim of winning all five work packages. Although it showed a separate amount for programme management for each work package, PA said its total forecast 2014-15 programme management costs of £2.3 million were actually fixed, irrespective of the number of work packages it won. As it won three work packages, PA considered there would be an effective shortfall of £0.93 million (the amount of programme management cost that it had allocated to the other two work packages), which PA would absorb. Dividing this amount by the projected number of specialist days for the year (27,274 at that time) gives an amount of £34 per day.

3.23 The impact of including the 'subsidy' in the rate card was to facilitate the negotiation of an increase in the day rates while reporting a reduction of profit. It meant that PA would no longer absorb the loss on the back-office costs, but fund them through an increase in the variable rate charged to UKTI.

As a result, PA's revenue and profit on the contract increased significantly

3.24 Of the change in the average day rate between the contract and the invoice from £536 to £573 per day, the increased revenue of £37 can be broken down into:

- the introduction of a 'subsidy' of £34 per specialist day;
- a change in the staff mix so that the stated cost to PA of providing each specialist increased by £7 per day on average; and
- a reduction in the reported average profit to PA of around £4 for each specialist per day.

3.25 We thus estimate that PA's overall profit on this contract, including the fixed-price elements, increased by £1.4 million between the contract and the invoicing. This can be attributed to:

- the introduction of the subsidy, which added £859,000 of profit;
- the changes to the fixed cost, which increased PA's profit by £339,000;
- the volume increase, which added £283,000 (had PA made the expected £46 per day profit for each new day); and
- the change in staff mix, which reduced the management fee by £107,000 (£4 per day over the 27,279 days).

3.26 PA told us that it did not gain from this additional profit because:

- its fixed costs increased as a result of the significant increase in the volume; and
- some of the profit would have arisen anyway through the Foreign Direct Investment contract, so there would have been a reduction in profit arising from the reduced Foreign Direct Investment contract.

Part Four

The inclusion of overheads in the contract price

UKTI was not clear enough about how bids should be priced

4.1 Assessment of the price of bids was weighted as 20% of the overall evaluation. The remainder related to the quality of the bid. Bidders were asked to submit bids for both the framework and each of the work packages on templates provided by UK Trade & Investment (UKTI):

- Bids for the framework would be assessed on the fixed-price infrastructure, back-office and other costs. The templates for the framework bid process were provided by UKTI pre-populated with assumed specialist day rates.
- Bids for the work packages would be assessed on the bidders' costs for all parts of the pricing structure, including the specialist day rates.

4.2 The way the template was set out required bidders to break down their price between different categories of costs. A reasonable reading of the template is that the specialist costs were meant to be the direct costs of engaging the specialists (that is, salaries, employer taxes and payments to subcontractors), because all other costs are separately itemised. However, the cost categories are not fully defined in the template or the contract. The template did not specify whether each category was fixed or variable although UKTI later asked PA Consulting Services Limited (PA) to clarify this. Neither did it specify whether each category was meant to be a nominal charge or a direct pass-through of actual costs.

PA included overheads in both the fixed-price infrastructure charge and the specialists' day rates

PA used total cost absorption to allocate overheads to the day rate

4.3 PA uses total cost absorption accounting for its internal management accounts and to price bids. Total cost absorption accounting is very common among professional service firms. It involves estimating the total costs of running the firm and allocating those costs across the estimated total expected number of hours that will be billed to clients. It involves, at a corporate level, the estimation of forward budgets and judgement about how costs should be allocated across different members of staff. PA calls its total cost absorption rate the 'internal cost rate'. PA's partners are incentivised to ensure that staff are charged out at more than the internal cost rate to achieve profit for the firm.

4.4 The advantage of total cost absorption is that it provides a simple-to-understand minimum hourly or day rate for each member of staff to use to bill clients, thus ensuring firms charge clients enough to cover the full costs of running the firm. The disadvantage of total cost absorption is that it can obscure direct staff costs, does not enable the recording of the other directly attributable costs of the contract, and does not enable the calculation of the actual gross or net profit achieved on a contract.

4.5 PA told us it was its normal practice to price the contract using its internal cost rate as the baseline for staff costs. RSM UK Consulting LLP (RSM) and the National Audit Office (NAO) traced PA's actual charges under the contract to PA's management systems and reconciled the invoices to the internal cost rate. It appears that PA priced the bid using internal cost rates for both the directly employed specialist costs and the fixed-price back-office staff. Of the £14.5 million specialist day rates charged in the first year of the contract, £2.0 million was the allocation of PA's general overheads through the internal cost rate. PA also charged UKTI £1.4 million under the fixed-price charge for the contract's dedicated back-office team. PA described the back-office team costs in its bid as "costs of programme management team including salary and benefits" with no reference to the recovery of overheads within these charges. PA's back-office costs on the contract were recorded as £1.8 million under their internal cost rate, including £0.9 million of PA's general overhead. PA thus charged UKTI for at least £0.5 million of overheads in the back-office charge.

PA also allocated overheads in the infrastructure charge

4.6 The cost components that make up the general overheads allocated under the internal cost rate are broadly the same as those itemised under the infrastructure heading of the bid and contract. The infrastructure fixed running costs part of the bid template was broken down into premises, facilities/office costs, finance, audit, HR, ICT, legal and professional, other, quality (including training), telecommunications, recruitment costs (programme staff), recruitment costs (external specialists), recruitment costs (employee specialists), knowledge management and other software tools.

4.7 PA's explanations of the infrastructure charge have changed over time (Part Five). PA told RSM and the NAO that the infrastructure cost was an estimate of what the internal cost rate on the subcontractors would have been had they been included in PA's system for calculating internal cost rates. The subcontractor specialists are not included in the budgets used to calculate the internal cost rate and are not allocated any overhead.

The charge for infrastructure acts to increase profit on the contract

4.8 UKTI told us that it considers that PA's inclusion of overheads on both the day rate and the infrastructure represents a double-charging of costs. We looked at the methodology PA used to calculate its internal cost rates. Had PA's corporate cost budgets been accurate and had all its consultants met their target utilisation rates, then PA could have fully recovered its corporate overheads without charging the fixed-price infrastructure element on this contract.

4.9 PA disputes that it overcharged overheads for two principal reasons:

- Although it would not have been known to PA when it was negotiating the contract, PA ultimately overspent against its budget for corporate overheads and, across its business as a whole, its consultants did not meet their target utilisation rates. This meant that although the company as a whole was profitable, its management systems show its corporate functions did not fully recover their costs from the frontline business in 2014-15.
- Because the subcontractors were not included in the calculation of the internal cost rate, they increased the actual corporate overheads and were one of the reasons PA overspent against its corporate function's budget.

4.10 PA could not demonstrate to us how the subcontractors increased the corporate overheads by the £1.3 million charged in 2014-15. The charge was broken down into 15 lines (paragraph 4.6). Some are directly attributable costs, such as the laptops and phones received by the subcontractors. However, we believe the majority of the itemised infrastructure costs, such as accommodation, finance and HR would not be significantly increased by the subcontractors on the contract (**Figure 3**). We therefore consider the infrastructure element of the contract is largely a contribution towards PA's profit.

UKTI only realised at a late stage of the procurement that PA's pricing of the specialists was not based on a 'pass-through' of direct employment costs

4.11 UKTI's internal emails imply that staff knew that the previous contract included a significant mark-up for PA's internal staff over and above salary costs. This was described to us as PA staff being more expensive than the subcontractors. In fact, the subcontractors generally cost more than PA's staff, but it is likely that more of the cost to UKTI of using subcontractors is passed to the subcontractor than the cost to UKTI of using PA's directly employed staff is passed to PA's staff.

Figure 3

Breakdown of the components of the infrastructure cost

Cost component	Value in 2014-15[1] (£)	NAO assessment of whether the component would be predominantly fixed or variable in relation to subcontractors
Premises	178,600	Fixed
Facilities	210,400	Fixed
Finance	149,500	Fixed
Audit	0	Fixed
Human resources	159,500	Fixed
Information and communications technology	300,300	Variable
Legal and professional	100,500	Fixed
Other	102,600	Unknown
Quality (including training)[2]	28,100	Fixed
Telecommunications	0	Variable
Recruitment costs (programme staff)	0	Fixed
Recruitment costs (specialists)	0	Variable
Recruitment costs (employee specialists)	0	Variable
Knowledge management	35,600	Fixed
Other software tools	0	Fixed
Total	**1,265,100**	

Notes

1 The infrastructure charge is not broken down into its components in the invoice. The values above are taken from the pricing schedule submitted by PA on 29 April 2014.

2 PA told us that subcontractors do not receive training.

Source: PA Consulting, and National Audit Office analysis

4.12 Less than a month before they signed the contract, emails between UKTI staff show that they did not understand that PA had used its internal cost rate to price its bid.

- At the beginning of April 2014, UKTI staff compared the bid price for each specialist with their cost under the previous contract. On 6 April, an email exchange within the procurement team questioned why current specialists were seeing a variation in their "daily take home rates beyond ±10%" and expressed concern that this "may lead to rapid exits". However, some of the variation was seen as misleading: the email referred to one specialist who was "suffering a change in day rate of over £500", explaining "But actually he is a PA employee – so the main change here is that we are not paying for the full overhead, as in the previous contract".
- On 24 April, the senior responsible owner reported back from a meeting with PA to discuss its bid. He said that PA had explained that "their commercial model was based on a variable PA return on baskets of individual specialists placed into bands – this had been partially expressed as an individual charge against each specialist. The commercial model was **not** 'cost plus'" [his emphasis]. He explained "The model assumed PA would win on some and lose on others per Band – but needed to yield a commercial margin of ~9%". He reported that he had "said that we needed clarity on the direct remuneration that each specialist was receiving" primarily to ensure that there were no substantial or unnecessary changes in specialists' pay. He said PA had agreed to provide the anticipated remuneration and percentage variance for each specialist.
- On 25 April PA provided UKTI with a new rate card, labelled Version 9. This was in a new format. In its cover email, PA stated that the rate card contained "the estimated (this has not been agreed in negotiations yet) **specialist pass-through rate (what they are paid** – column titled 'cost'), the allocation of other programme costs (column – 'subsidy') to each specialist, UKTI cost per specialist (column – 'proposed rate') and the net PA margin on the UKTI cost per specialist (column 'margin %')" [our emphasis]. The rate card did show the pass-through rate for the subcontractors; however, for PA employees, it showed the internal cost rate.

Part Five

PA's explanations of its costs

UKTI accused PA of making misleading representations about the inclusion of overheads in the day rate

5.1 UK Trade & Investment's (UKTI) central allegation against PA Consulting Services Limited (PA) was that it misled UKTI over the inclusion of general overheads within the day rates of PA employees. UKTI sought to recover what it sees as the double-charging of overheads on the contract. We asked both UKTI and PA to provide us with all correspondence and relevant documentation on the pricing of the contract. We reviewed more than 400 documents in total and sought explanations from UKTI, PA and some former staff from both organisations.

On the inclusion of general overheads in the day rate

5.2 We found no evidence that PA had made clear to UKTI that it was pricing its internal staff using its internal cost rate. Our reading of the contract structure is that it implies that the specialist day rates are a combination of their direct employment costs and subcontractor pass-through costs and the management fee (profit). In the cover email to Version 9 of the rate card, PA inaccurately described the 'cost' column as "specialist pass-through rate" and "what they are paid" when, in fact, that column showed the pass-through of subcontractor costs, as stated in the email, but the internal cost rate for PA employees rather than what they were actually paid. We set out key representations made by PA on the make-up of staff costs in **Figure 4** overleaf.

On the infrastructure costs

5.3 We found no evidence that PA had made clear to UKTI that the infrastructure costs related to the allocation of general overheads to the subcontractors. Our reading of the contract is that it implies that the 'infrastructure/running costs' should include all the directly attributable costs of running the contract, except staff costs and expenses. PA's description and explanations of the infrastructure costs have changed over time, from implying that the infrastructure costs are the directly attributable running costs for the contract to them being a notional charge for PA's increased overheads as a result of engaging the subcontractors. PA suggests that these variations might be a result of particular individuals no longer being employed by PA. We set out key representations made by PA on the nature of the infrastructure costs in **Figure 5** on page 37.

Figure 4

Representations by PA: whether the day rates include an allocation of general overheads

When and where	What PA said	Analysis
21 October 2013 PA's bid *These representations are incorporated into the contract dated 1 May 2014*	In its bid, PA stated that the cost categories 'HR'; 'ICT'; 'legal and professional'; 'quality'; and 'recruitment costs' were "already included in the costings and will not be charged for separately" – it is not clear whether this also applied to knowledge management. However, there were separate charges in the pricing schedule for HR, ICT, legal and professional, quality, and knowledge management. In the pricing schedules for each work package, under the headings 'staff costs and fees' and 'costs of service delivery (employee specialists)', PA inserted into the 'details' column the text "costs of programme management team including salary and benefits".	PA implied in its narrative that some categories of overhead were included in "the costings" – which could be taken to mean the specialists' day rates. However, in the numerical breakdown of its price, it showed separate values for most of these items, implying that they were not included in the day rates. While the phrase "including salary and benefits" leaves the possibility that other costs are also included, this wording implies that all significant categories of cost are itemised in the description and that overheads are, therefore, not included.
21 November 2013 Responses to UKTI's bid clarification questions *These representations are incorporated into the contract dated 1 May 2014*	PA listed categories of cost and said whether each was a fixed or variable cost. Fixed costs were listed as: transition costs; premises; facilities/office costs; finance; HR; ICT; legal and professional; other; quality (including training, development); and knowledge management. Variable costs (those depending on the number of specialists employed) were listed as: staff costs and fees; and costs of service delivery. In setting out the programme management costs for each work package, PA stated "These costs relate to salary plus taxes and pension and associated benefits of employing the programme management staff."	This states that general overhead cost categories are fixed, thus implying that they are not included in day rates. This statement clearly makes no reference to the inclusion of overheads in the day rates.
25 April 2014 Email to UKTI accompanying Version 9 of the rate card	"As requested please find attached below as requested a spreadsheet containing the estimated … specialist pass-through rate (what they are paid – column titled 'Cost') …"	"Specialist pass-through rate" and "what they are paid" both imply there are no overheads included in this column. No further explanations were provided with Version 10 or Version 11 of the rate card, implying that nothing had changed.
12 May 2015 Meeting with UKTI (from UKTI's meeting notes, shared with PA)	PA confirmed that the summation of salary and benefits ie Base, Transport Allowance, Medical and NI for consultants and short-term employees, and the day rate that subcontractors charge PA equates to the 'cost' column in the Specialists List V11, subject to intervening pay or rate increases.	This shows that, for PA employees, the 'cost' column included both salary and other employment-related costs and implies that it did not include other overheads. For subcontractors, "what they are paid" was an accurate description.
4 June 2015 Meeting with UKTI (from UKTI's internal meeting notes)	PA agreed that the statement confirming the 'cost' column was 'what they get paid' was 'sloppy drafting'. They confirmed that, for PA staff, it represents salary plus overheads.	This indicates that, as well as employment-related costs, the 'cost' column also includes other overheads.

Source: National Audit Office analysis

Figure 5

Representations by PA: the make-up of the infrastructure charge

When and where	What PA said	Analysis
1 May 2014 The contract	Infrastructure/running costs are broken down into: • premises; • back-office costs: facilities/office costs, finance, audit, HR, ICT; • organisation costs: legal and professional, other, quality (including training, development), telecommunications, recruitment costs (programme staff, external specialists, employee specialists); and • tools (hosting, support and maintenance): knowledge management, other software tools.	The pricing template format was set by UKTI. Infrastructure costs were presented as relating to the general running of the contract.
18 September 2014, re-sent 18 June 2015 Emails to UKTI	States that, for 2014-15, infrastructure of £1,279,907 has been invoiced, comprising recharges for specialists (£0.848 million), programme team (£0.264 million) and shared service team (£0.167 million). This is in addition to the £1.3 million invoiced for back-office, which was described as staff costs.	This description has never been explained. It could be consistent with the contract, assuming that there are no other overheads charged in the invoice (an assumption later found to be false).
Summer 2015 Discussion with RSM 14 December 2015 Meeting with NAO	Infrastructure costs are for overheads specifically relating to subcontractors. Infrastructure is fixed overhead costs associated with specialist subcontractors only.	There is no indication in the contract that infrastructure costs only relate to subcontractors. These explanations imply that there is an actual cost for attributable overheads.
18 February 2016 Meeting with NAO	Infrastructure is a notional cost representing a contribution in respect of subcontractors towards PA's general overheads. They told us this is necessary as PA's internal cost rate system, which allocates all corporate overheads to employees, cannot accommodate subcontractors but that there were increased overheads due to the large number of subcontractors associated with this contract.	This explanation means that it is either a notional cost or it is part of profit. If it is a notional cost then it represents the allocation of general overheads rather than directly attributable overheads, as was previously stated.

Source: National Audit Office analysis

On the level of profit that PA made

5.4 Throughout the negotiations PA told UKTI it was making a profit in the region of 5.6% to 7.5%. UKTI did not ask if this was a gross or net profit or how it related to the allocation of general overheads. The incorporation of the 'subsidy' in the calculation from Version 9 of the rate card onwards meant that PA reduced the amount it reported as profit, and was able to say that its reported profit margin was broadly consistent, even as it increased its profit during the negotiations. We set out how PA changed its description of the subsidy in **Figure 6** overleaf.

Figure 6
Representations by PA: the 'subsidy'

When and where	What PA said	Analysis
25 April 2014 Email to UKTI accompanying Version 9 of the rate card	"The allocation of other programme costs to each specialist." For each specialist on the rate card, the 'cost' column was shown (see above), followed by 'subsidy' (£34 per specialist), and then 'total cost' (which is 'cost' plus £34). The proposed banded daily rate (price) was then shown in a separate column.	This was the first time the 'subsidy' had been mentioned and no further explanation was given as to what it was. The way the rate card was presented clearly implies that the subsidy was part of the calculation that led to each specialist's daily rate.
4 June 2015 Meeting with UKTI	When asked to confirm, PA informed UKTI that the £34 per day subsidy for subcontractors had been stripped out of the second cost-plus model sent on 18 May.	If the costs had been stripped out, this implies that they were part of the previous charge.
7 August 2015 Presentation sent to UKTI for meeting with RSM on 20 August	The £34 subsidy is described in a cost breakdown as 'Infrastructure (variable)'. The notes to the table give further explanation of this: "Variable Infrastructure used to add flexibility and allow UKTI to be charged on a variable basis."	The description has changed from 'other programme costs' to 'variable infrastructure'. It is not clear how adding a variable cost would add flexibility unless it replaced a fixed cost, and there is no evidence of a fixed cost being removed from the charges.
27 August 2015 Email to RSM	The email refers to "Billed £34 subsidy = (£859,486)".	This clearly states that the subsidy has been explicitly billed.
14 December 2015 Meeting with NAO	PA told us the £34 subsidy was to reflect the fact that subcontractors were using PA infrastructure; it covered IT, HR costs, etc of subcontractors, but was distributed across all staff. This subsidy was never invoiced although it was built into the specialists' day rates.	The statement that the subsidy was never invoiced contradicts the previous statement that it was billed.
14 January 2016 Meeting with NAO	The £34 subsidy was a variable infrastructure cost associated with each specialist. This was never invoiced to UKTI. It was included in the rate card in an attempt to show PA's costs/margin to UKTI.	This is not inconsistent with the previous statement.
18 February 2016 Meeting with NAO	The £34 subsidy was shown in the rate card in order to demonstrate PA's margin, and was not invoiced. When PA bid for the contract, it priced its bid competitively, with the aim of winning all five work packages. Although a separate amount was shown for each work package, the total 2014-15 programme management costs in the bid of £2.3 million were actually fixed, irrespective of the number of work packages won. As PA only won three work packages, there would be an effective shortfall of £929,981 (the amount of programme management cost that had been allocated to work packages 1 and 5), which PA would absorb. Dividing this amount by the projected number of specialist days for the year (27,274) gives an amount of £34 per day.	This is a completely different explanation from those given previously. It could be consistent with the original statement (from 25 April 2014) that it was 'other programme costs'; however, no explanation of its derivation was provided at the time. The explanation is also at odds with a statement that PA made in response to UKTI's clarification questions on the bid. On 21 November 2013, PA stated that one of the cost benefits from delivering multiple work packages would be "Reduced management costs both to PA and to UKTI".

Source: National Audit Office analysis

Appendix One

Our investigative approach

Scope

1 We conducted an investigation into the pricing of a contract between UK Trade & Investment (UKTI) and PA Consulting Services Limited (PA) for the provision of 'specialist services'. In particular, we considered:

- what representations PA had made about its own costs and about what it would charge UKTI;
- how UKTI had agreed those costs and charges during the procurement and management of the contract; and
- whether PA had represented its costs and charges transparently and accurately, and whether PA had overcharged on the contract.

Methods

2 In examining these issues, we drew on a variety of evidence sources.

3 We interviewed key individuals from UKTI and PA to establish our own understanding of the contract pricing; what communications had been made between the two organisations; and what each party understood about various aspects of the pricing model. The people we interviewed included:

- current and former staff of UKTI. These include members of the procurement team who no longer work at UKTI, and the current contract management team; and
- current and former staff of PA. These include staff involved in bidding for the contract, staff involved in managing the operation of the contract, and members of the finance team.

4 We interviewed the lead partner from RSM UK Consulting LLP (RSM), who was engaged by UKTI to investigate the contract, to understand the extent and limitations of its work and how it had reached its conclusions.

5 We reviewed a range of documentation:

- The contract documentation, including PA's bid and responses to clarification questions.
- Approximately 400 emails between UKTI and PA, as well as some internal UKTI emails, between late 2013 and summer 2015.
- RSM's report to UKTI; PA's report to the Cabinet Office responding to (a partially redacted version of) RSM's report; and the Cabinet Office's reply to PA.

6 We analysed financial information in order to understand the basis of the pricing in PA's bid and what was actually charged to UKTI:

- The pricing schedules in the bid and the contract.
- The contract invoices for 2014-15.
- Data contained in submissions and representations from PA to UKTI.
- PA showed us data drawn from their management accounting system, demonstrating the basis of the 'internal cost rate' used to calculate specialists' day rates.

Appendix Two

Detailed timeline of events and communications

We refer below to some of the significant communications we have seen from UKTI and PA. This is not a full list of all the communications we have reviewed.

Date	Event
10 September 2013	UKTI issues invitation to tender for framework and call-off contracts.
21 October 2013	Tender deadline. Bids submitted by PA and four others.
21 November 2013	PA submits responses to UKTI's bid clarification questions.
10 December 2013	UKTI announces PA as preferred bidder and the standstill period commences.[1]
Late 2013	UKTI and PA agree to transfer a number of specialists from the existing Foreign Direct Investment Services contract to the new specialist contract, significantly increasing the volume of provision on the specialist contract.
24 December 2013	UKTI receives a procurement challenge from one of the other bidders.
27 December 2013	UKTI writes to all bidders suspending the standstill period.
10 January 2014	UKTI responds to the challenging bidder, rejecting its claims.
17 January 2014	Standstill period recommences.
20 February 2014	Action points from a meeting on this date include an action point: "PA to … provide typical direct costs with overheads/management fees separately identified."
1 March 2014	Framework contract commences. The call-off contract is also deemed to start on this date: "This Contract shall commence on 1 March 2014. The Contract Services relating to mobilisation and transition activities shall commence on 1 March 2014. Full Contract Services shall commence on 1 May 2014." Neither contract is signed by either party at this stage.
19 March 2014	PA sends spreadsheet to UKTI regarding action points from 20 February. It shows 'cost rate', 'management fee' and 'billing rate'; no separate identification of overheads.
6 April 2014	Email from UKTI to PA asking "Can you confirm what proportion of the new daily rate bands would go directly to the individual subcontractor or employee and what any residual amount would go on (eg is there any profit margin or management fee within the daily rate, are there any other 'on' costs or are they all dealt with separately)?" Although PA responded to other points in this email, we have not seen any evidence that this question was ever answered. Email from UKTI's senior responsible owner to internal colleagues, clearly demonstrating that he thought the cost figures provided by PA reflected specialists' actual salaries.
7 April 2014	UKTI signs the framework contract.

Date	Event
11 April 2014	Email from PA to UKTI states that it is not appropriate to directly compare day rates of individual specialists between the old and new contracts.
11 and 14 April 2014	Emails from UKTI to PA referring to specialists seeing changes in their pay. This indicates that UKTI did not understand that the day rates included other charges.
15 April 2014	Email from PA to UKTI saying "at a general level [the specialist] rates have been derived by undertaking a banding exercise first and then applying the rate" but does not address the misconception that the cost figures are salaries.
	PA sends UKTI updated costings "reflecting the requirement for additional resources over what was tendered for". This includes changes to the costs of specialists (because of increased days), back office and infrastructure, but no change to the number of specialists.
16 April 2014	Further email from PA to UKTI states that it is not appropriate to directly compare day rates of individual specialists between the old and new contracts.
17 April 2014	PA sends UKTI further updated costings. The only change from the 15 April version is the internal split between Trade and Investment.
23 April 2014	As part of the ongoing discussions about the day rates of specialists and back-office staff, PA emails UKTI saying "we do not believe we can make any further amendments to those we have already made".
24 April 2014	UKTI and PA meet to discuss day rates and other commercial aspects of the contract. UKTI asks PA for clarity on the direct remuneration that each specialist was receiving.
25 April 2014	PA sends 'Version 9' of the rate card to UKTI. The covering email says the 'cost' column is 'what they are paid'. The 'subsidy' appears on the rate card for the first time; the email describes it as "the allocation of other programme costs". Profit quoted as 7.49%.
29 April 2014	PA sends UKTI revised pricing schedules reflecting the increased volume of provision.
	Internal email from UKTI senior responsible owner says "The contract that I hope will be signed tomorrow will show the original bid price so it is in line with the amount announced to framework bidders..., but PA want an additional comfort letter that reflects their calculations of these latest costs." [costs as sent on 17 April].
30 April 2014	Weekly email bulletin from UKTI to its stakeholders announces that the new contracts with PA and Ernst & Young will start on 1 May.
	PA submits revised pricing schedules at the request of UKTI, which update the figures from its bid submission to reflect the later contract commencement date, but do not reflect the agreed increased volume of provision.
	PA requests a letter of comfort from UKTI to reflect the agreed increase in volume of provision and contract price.
	UKTI sends signed call-off contract and letter of comfort to PA. The contract contains the pricing schedules submitted by PA earlier that day. The letter of comfort is not specific regarding the increase in volume and price.
	PA responds to UKTI saying the letter of comfort should state the contract price according to the financial information submitted on 29 April.
1 May 2014	UKTI emails PA to confirm anticipated number of specialist days required in 2014-15 is 27,274 and price of those specialists is £15.3 million, along with other details. "I hope these clarifications will allow PA to sign the contract."
	PA signs both the framework and call-off contracts.
	Call-off contract (full contract services) commences.
	PA sends 'Version 10' of the rate card to UKTI. Profit quoted as 7.38%.

Date	Event
Early May 2014	UKTI contract management team (two people) take up post.
16 May 2014	PA sends 'Version 11' of the rate card to UKTI. Profit quoted as 7.03%. Lead UKTI directors for Trade and Investment each send an email accepting 'Version 11' of the rate card and thanking PA for "taking the hit on [its] profit".
End of July 2014	PA's monthly invoice to UKTI includes changes to the amounts being charged for infrastructure and back-office costs.
July/August 2014	UKTI introduces tighter controls around deploying new specialists and negotiating day rates, including a single point of contact between PA and UKTI on commercial issues. UKTI and PA begin to discuss moving to a cost-plus pricing model.
18 September 2014	PA sends 'overhead analysis' email to UKTI. This includes a note saying that part of what has been invoiced as 'infrastructure' is actually 'management'.
October 2014	UKTI and PA agree to move to a cost-plus pricing model from 2015-16.
1 November 2014	PA send a weekly update email to relevant UKTI and PA staff, including "Agreement to progress on all sides with Cost Plus model looks to be clear and we are now working on this approach".
29 January 2015	PA presents high-level summary of proposed cost-plus model to UKTI directors.
13 February 2015	PA sends Cost-Plus Model 1 spreadsheet to UKTI.
25 March 2015	UKTI identifies 'hidden' columns in Cost-Plus Model 1, raising concerns over transparency and the make-up of the overhead element of day rates, including implications for the existing 2014-15 pricing mechanism.
Late March/ early April 2015	UKTI contract management team escalates their concerns internally.
March to June 2015	UKTI and PA continue discussions about the detail of the proposed cost-plus model. UKTI seeks clarity about the make-up of day rates. PA makes several offers to talk through the model on a line-by-line basis. UKTI often does not initially accept these offers as it wants PA to respond to its concerns in writing in order to establish a full audit trail.
28 April 2015	PA emails UKTI suggesting they "move to the Cost Plus model as drafted now to begin to deliver these savings to you immediately".
30 April 2015	UKTI emails PA expressing "a number of serious concerns" arising from the data in Cost-Plus Model 1, and wishing to clarify whether there is any impact on the 2014-15 charges. It asks for explanations and information from PA.
7 May 2015	PA sends a presentation to UKTI, aiming to answer some of UKTI's questions about the proposed cost-plus model. The presentation states that "The model presents a form of reality only".
12 May 2015	UKTI and PA meet. PA confirms that quoted 'cost' figures for PA employees include items other than salary.
18 May 2015	PA sends Cost-Plus Model 2 to UKTI. In response to a request from UKTI for a breakdown of specialists' day rates, PA raises data protection concerns regarding salary details.
22 May 2015	UKTI informs PA that it intends to commission a contract investigation.
4 June 2015	UKTI and PA hold half-day 'challenge' session. PA agrees that the reference to 'what they are paid' in the email on 25 April 2014 was erroneous and that the figures in Cost-Plus Model 1 were inaccurate.
18 June 2015	UKTI and PA hold a further challenge session. They agree on the need for a contract audit.

Date	Event
22 June 2015	UKTI informs PA that it has instructed RSM to undertake the contract audit.
1 July 2015	UKTI and RSM sign contract, and RSM commences its audit.
Summer 2015	PA tells RSM that ‘infrastructure’ relates only to subcontractors.
20 August 2015	UKTI, RSM and PA hold meeting and discuss RSM’s emerging audit findings. PA admits to “a number of PA communications which were incorrect or unclear”.
17 September 2015	RSM sends its draft report to UKTI.
21 September 2015	UKTI, Cabinet Office and RSM meet Lord Maude, Minister of State for Trade and Investment, to discuss the audit findings. Lord Maude asked that RSM’s findings be escalated to the Comptroller and Auditor General.
8 October 2015	Cabinet Office meets PA to discuss RSM’s findings.
14 October 2015	UKTI, Cabinet Office and RSM meet PA and share a partially redacted copy of RSM’s draft report.
16 October 2015	UKTI writes to PA giving three months’ notice that it is terminating the framework and call-off contracts with PA.
9 November 2015	PA meets Cabinet Office and submits a report challenging RSM’s findings.
27 November 2015	Cabinet Office writes to PA stating that PA’s report did not satisfy the very serious concerns of Cabinet Office and UKTI.
11 January 2016	RSM sends its final report to UKTI. There are no material changes from the draft report.
16 January 2016	UKTI’s contract with PA terminates.
May 2016	UKTI and PA reach an amicable commercial settlement.

Note

1 In procurement, a standstill period provides for a short pause (of at least 10 calendar days) between the point when the contract award decision is notified to bidders, and the final contract conclusion, during which time bidders can challenge the decision. It is a legal requirement.

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