National Audit Office

Report
by the Comptroller
and Auditor General

Cabinet Office

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

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What this investigation is about

1 On 15 January 2018 the Carillion group of companies (Carillion) declared insolvency and the Official Receiver, an employee of the Insolvency Service, started to liquidate its assets and contracts. Carillion was a British multinational company that provided facilities management and construction services. It operated in the UK, Canada and the Middle East and employed around 45,000 people. At the time of liquidation it employed around 18,200 people in the UK.

2 At the point of liquidation Carillion had around 420 contracts with the UK public sector including direct contracts, sub-contracts and special purpose vehicles to deliver private finance schemes.[1] These included services for hospitals, schools, the armed forces, prisons and transport. Some of these contracts were joint ventures with other companies.

3 The Cabinet Office asked the Insolvency Service to continue to operate Carillion's service contracts through the Official Receiver to ensure continuity of public services. In return, it gave the Official Receiver £150 million of initial liquidity. The Insolvency Service told us that this was the first example of a public limited company continuing to trade while being wound up.

4 Carillion's collapse has triggered several Parliamentary investigations and inquiries by: the Work & Pensions and Business, Energy & Industrial Strategy Select Committees, focusing on Carillion's corporate governance and the consequences for its pensions schemes; the Public Administration and Constitutional Affairs Select Committee and Committee of Public Accounts, focusing on the lessons for government outsourcing more generally; and a hearing of the Liaison Committee.

1 Although these use a variety of private finance funding models we refer to them in the report as 'PFI' schemes for ease of understanding.

5 This report focuses on the role of the UK Government in preparing for and managing the liquidation. We have not assessed the actions of Carillion, its directors, or its advisers. Investigations into the conduct of the company and its board members are being carried out by: the Financial Conduct Authority; the Official Receiver; the Pensions Regulator; and the Financial Reporting Council. This report has five parts:

- Carillion's role in the market for government services (Part One);
- the Cabinet Office's monitoring of Carillion as a strategic supplier (Part Two);
- the government's contingency planning for Carillion's possible failure (Part Three);
- the government's response to Carillion's request for support (Part Four); and
- Carillion in liquidation (Part Five).

6 Our methodology is set out in Appendix One.

Summary

Key findings

Carillion's role in the market for government services

1 **Carillion was a strategic supplier to government with around 420 contracts with the UK public sector.** These included contracts for facilities management, catering, road and rail maintenance, accommodation, consultancy, and construction. By value, Carillion was central government's sixth largest supplier in 2017. Public sector contracts accounted for 33% of Carillion's total revenue and 45% of its UK revenue. However, its total government revenue was not growing, and was lower than it had been before 2012 (paragraphs 1.2 to 1.5 and Figures 1, 2, 3 and 4).

2 **The value of Carillion's public sector contracts varied widely, from those that were highly profitable to those that incurred significant losses.** Carillion's business unit which provided facilities management services to central government was only just profitable (1% operating margin projected in 2017). However, its local government contracts were generally more profitable (13% to 15% operating margin). Set against these were several high-profile PFI projects expected to incur significant losses. In 2017 Carillion faced estimated annual losses of £91 million on its joint venture project to build the Aberdeen bypass, £83 million on building the Royal Liverpool University Hospital and £48 million on building the Midland Metropolitan Hospital (paragraphs 1.6 to 1.7 and Figure 6).

The Cabinet Office's monitoring of Carillion as a strategic supplier

3 **Government monitored Carillion as part of its risk management system for strategic suppliers.** Up to August 2017 the Cabinet Office had rated Carillion as either green or amber since it published its risk assessment policy for strategic suppliers in 2012. Since February 2016, Carillion had been rated as amber because of performance concerns on important central government contracts. Since 2013 the Cabinet Office had regularly raised with Carillion its delayed payments to sub-contractors, and the short selling of its shares. The Cabinet Office did not have a crown representative in place for Carillion from July to October 2017. In the meantime, the role was taken on by the Director for Markets and Suppliers, who is responsible for the relationship with all strategic suppliers (paragraphs 2.2 to 2.6 and Figures 7 and 8).

4 **The scale of Carillion's 10 July 2017 profit warning was a surprise to the government.** Carillion's 2016 accounts were published in March 2017 and showed the company as profitable and solvent. Carillion made three profit warnings in 2017: on 10 July Carillion announced a £845 million provision for losses on its contracts; on 29 September it increased this to £1.05 billion; and on 17 November it announced that it expected to breach the terms of its loans. The scale of the losses announced on 10 July came as a surprise to the Cabinet Office as it contradicted previous discussions with Carillion and market expectations (paragraphs 2.7 and 2.11 and Figures 9 and 13).

5 **The Cabinet Office raised its risk rating of Carillion to red in September 2017 but did not raise Carillion's rating to its highest risk category before it collapsed.** The Cabinet Office raised Carillion's risk rating to red in response to the July 2017 profit warning. It took steps to improve its information about Carillion's financial health, including regular access to some of Carillion's internal financial information and it had regular contact with Carillion. Following a further profit warning in November 2017, the Cabinet Office wrote to Carillion to say that it proposed rating Carillion as its highest risk category, 'high risk'. Carillion replied that the Cabinet Office already had access to the financial information required by this rating, and the rating would risk precipitating its financial collapse. The Cabinet Office accepted these arguments (Figure 7, paragraphs 2.5 and 2.13 and Figure 14).

The government's contingency planning for Carillion's possible failure

6 **Carillion announced £1.9 billion of new government work after the 10 July profit warning.** Two joint venture defence contracts had been signed before the profit warning. HS2 Ltd approved two joint venture contracts worth £1.3 billion before 10 July but signed them afterwards. Network Rail confirmed the next phase of one contract worth £63 million after the second profit warning in September. In total eight contracts and variations were announced. None of the contracting authorities believed they had grounds for disqualifying the bids under procurement rules and in all but one case joint venture partners were obliged to finish the contracts if Carillion failed (paragraphs 3.10 and 3.11 and Figure 16).

7 **The Cabinet Office's coordination of contingency planning in case of Carillion's failure began in July 2017, gained momentum from October, and was complete for central government by mid-January 2018.** It started contingency planning within central government as early as July, but first had to carry out additional work to establish a complete list of government contracts. The process accelerated in October, but some departments did not respond until the minister for the Cabinet Office wrote to them in December. The Cabinet Office was still seeking information on schools and local authorities at the point of liquidation. Ultimately, the Cabinet Office received 65 contingency plans from 26 public bodies, fewer than the number sought. We found that 16 public bodies out of 26 (62%) did not provide costed preferred options as requested. Of the £238 million estimate from the others, £147 million related to Network Rail contracts. Network Rail told us that this was a worst-case scenario and it expects actual costs will ultimately be much lower (paragraphs 3.2 to 3.9 and Figure 15).

The government's response to Carillion's request for support

8 **In early January Carillion asked the government for £223 million to help it through to April 2018 and additional support with its financial restructuring.** In December 2017, Carillion's main creditors had told it that they would not give further short-term funding unless Carillion also approached Government. Carillion asked for a £160 million loan or guarantee of bank lending from the Cabinet Office (which could be partly offset if government paid disputed claims of £39 million) and a £63 million temporary deferment of tax. Repayment of the loans and ending the government guarantees was contingent on a successful financial restructuring of the company by April 2018. Carillion also requested help with the longer-term financial restructuring including: asking the Cabinet Office to provide up to £125 million towards the completion of Midland Metropolitan Hospital PFI scheme in return for an equity stake; favourable settlement of claims with public sector customers; and support in arranging a solution for the £2.6 billion pension liabilities with the Pension Protection Fund, Pension Trustees and Pensions Regulator. Not all items were quantified or quantifiable (paragraphs 4.2 to 4.7 and Figure 17).

9 **The Cabinet Office decided it was better that Carillion enter into a trading liquidation than to provide financial support.** The Cabinet Office discussed Carillion's request for support with Carillion and its creditors up to the 14 January, but decided it would not support Carillion because it had serious concerns about: Carillion's business plans; the legal implications; the potentially open-ended funding commitments created; the possibility of setting a precedent, and the concern that Carillion would return with further requests. The Cabinet Office carried out an options appraisal and concluded that the best result for government across a range of criteria would be a trading liquidation – that is, where Carillion entered liquidation, but would continue to provide services until other arrangements could be made for each contract (paragraphs 4.10 to 4.14 and Figures 18 and 19).

10 **The Cabinet Office made final preparations for the liquidation of Carillion before it told Carillion it would not provide support.** The Cabinet Office set up a crisis management centre to handle communications, briefed and received permission from both the Chancellor and the Prime Minister and prepared to inform Parliament of the financial consequences in the week beginning 8 January. Officials made the final decision on 14 January to tell Carillion that it would not provide support but would fund a trading liquidation. When Carillion's main creditors then told Carillion they too would not provide any further support, this left Carillion's board with no choice but to file for liquidation with the High Court on 15 January (paragraph 4.15 and Figure 18).

Carillion in liquidation

11 **Carillion staff continued to provide public services.** The Cabinet Office agreed to fund the continuation of public services and successfully conveyed the message to Carillion staff that they should report for work as usual. Carillion's joint venture partners took over many of the larger construction projects. The Ministry of Justice established a new government company to run the prisons facilities management contract. The Cabinet Office believes almost all services continued uninterrupted. However, some of the construction contracts, including the two PFI hospitals, are mothballed until the PFI investors find alternative construction companies (paragraphs 5.5 to 5.6).

12 **The Official Receiver currently expects all customers to have ended their Carillion contracts or transferred them to new suppliers by the end of June 2018.** On 23 May, 21 public sector contracts remained within the insolvency regime. At the end of May the Official Receiver expected to be still providing support services for a specified period beyond the termination of the contract for a further 31 contracts (paragraph 5.7 and Figure 20).

13 **The Cabinet Office will ultimately pay the loss on the liquidation, currently estimated at £148 million.** The liquidation is expected to make an overall loss mainly because post-liquidation income will not fully cover the cost of the provision of public services. The estimated £148 million loss is subject to a range of uncertainties, and it will take a long time to establish the final actual cost. This £148 million would be covered by the £150 million the Cabinet Office has already provided to help finance the costs of liquidation. The total cost to the taxpayer will be higher than this because some public sector bodies are paying a 20% premium for post-liquidation services and some customers will incur costs in replacing Carillion as a contractor. Many public sector customers, including the special purpose vehicles delivering PFI contracts, are objecting to paying this, and many dispute outstanding invoices relating to the period before liquidation. The £148 million is lower than the rough estimate made by the Cabinet Office before liquidation of £314 million to £374 million (Paragraph 4.9, 5.8 to 5.10 and Figures 19 and 21).

14 **Former Carillion workers, investors and other creditors will also bear losses.** Thirty-one of Carillion's 198 companies are in liquidation. So far, 64% (11,638) of the Carillion UK workforce have been found new work, 13% were made redundant, and the remainder are still employed by Carillion. Carillion's pension schemes will enter the Pension Protection Fund. Carillion's non-government creditors are unlikely to recover much of their investments. However some creditors will be paid because they are owed money by Carillion subsidiaries with positive net assets. The government has not measured the impact on the supply chain, but there has been limited take-up of lending facilities by affected small and medium-sized enterprises (paragraphs 5.7 and 5.13).