HOUSE OF COMMONS

Public Administration and Constitutional Affairs Committee

Oral evidence: Sourcing public services: lessons to be learned from the collapse of Carillion, HC 748

Tuesday 24 April 2018

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Watch the meetings

Members present: Mr Bernard Jenkin (Chair); Kelvin Hopkins; Dr Rupa Huq; Mr David Jones; David Morris.

Questions 495-610

Witnesses

I: Sir Amyas Morse KCB, Comptroller and Auditor General, National Audit Office.

II: Margaret Stephens, former Partner on Private Finance Initiative at KPMG, and Paul Davies.

Written evidence from witnesses:

– Margaret Stephens

- Paul Davies

Examination of witnesses

Sir Amyas Morse KCB.

Q495 **Chair:** I welcome the Comptroller and Auditor General to this session on lessons from the collapse of Carillion for sourcing and outsourcing in Government. Can I ask you to confirm your identity for the record, please?

Sir Amyas Morse: I am Amyas Morse. I am the Comptroller and Auditor General.

Q496 **Chair:** We are looking at the way that you audit all these contracts and learn from them. What confidence should Parliament have that the Government are making rational decisions about whether to outsource and making decisions based on evidence rather than preconceptions?

Sir Amyas Morse: If I might respond to that by framing the issue a little bit differently, I think there are a lot of areas where Government does not have the capacity to do anything else but outsource. The Government are not set up to deliver all these contracts themselves, and that has been the case for a number of years. Therefore, the capacity, the volume of resource they would have to have internally to do this work, is not there, and has not been there for some time. Not only that, but in many parts of government, the capability of even acting as a prime contractor is not necessarily there. That is not a fault. It has been a choice that parts of government have made over time.

I think that is quite important, Chair, because when you are thinking about typical outsourcing of contracts, where you are thinking about a way of taking costs down and then outsourcing, applying that norm to the Government, because they do not have the capacity to do it in-house in many cases, and have not had for a long time, does not necessarily work in every case. I do think it is a good idea to raise the question of whether you should not have taken costs down before you outsourced, which is the universal wisdom of outsourcing contracts. In the private sector, I would have told anyone that that is what you do. You do not give a problem to a contractor and tell them to take the costs out. However, you do have to apply that wisdom with a degree of moderation when you are thinking about Government.

Q497 **Chair:** We have been given evidence from local authorities, where facilities contracts and services, which have long been outsourced, are being brought back under the control of the local authorities. There are examples in government, too; the prisons management contract that Carillion had, for example, which has been brought back in-house. Shouldn’t there be some kind of procedure, or at least a submission of some kind to the Minister, saying this is why we have decided to outsource this contract rather than complete it with an internal proposal?

Sir Amyas Morse: There should be clarity. There should be a business case that makes it clear, and in many cases there is.

Q498 **Chair:** But how confident are you that a conscious decision to make or buy is being made?

Sir Amyas Morse: The trouble is that we are talking at such a general level. There are, no doubt, cases where I would not be happy with the amount of logic or consideration that had gone in, but there are others where I would say that it had.

May I pick up on prisons? I would add that if the Government are the only purchaser in a sector, and the only consumer, as with prisons, there is something to be said for having a mixed economy. In prisons there is a mixed economy, which is really quite helpful, because it means there is comparison, and there is some quite edgy competition, between state-run prisons and private sector-run prisons. I think that produces a relatively healthy tension and probably helps to drive improvements because they eye each other. I know this from talking to prison governors.

Q499 **Chair:** How would you improve the decision making about whether to outsource or not?

Sir Amyas Morse: I would want to see that the logic was better, and I would like to see that there was deeper insight into the companies that take on the outsourced contracts and what they will actually perform.

Q500 **Chair:** How should the officials present decisions about whether to make or buy?

Sir Amyas Morse: When they put a case for one or the other, they should have a fuller explanation of what the consequences of the outsourcing are likely to be. I am sorry that that sounds very high-level, but what I am trying to say is that it is about developing more understanding.

Chair: It makes sense.

Sir Amyas Morse: I give credit to John Manzoni's team. They are developing more understanding of the corporate sector they are interacting with. They still have, in my view, a considerable way to go, and that is illustrated by the Carillion case but not just by that. Instead of saying, "We don't really understand what happens in the private sector; we will just see them as a counterparty" there is a more insightful approach. I think that needs to develop further.

Q501 **Chair:** We have been outsourcing major services and projects since the 1980s.

Sir Amyas Morse: Yes.

Chair: Why do you think the learning on this has been so slow?

Sir Amyas Morse: I do not go back to the 1980s myself, but I do think there has been learning. However, there is increasingly structured analysis—not to be immodest about it—that you see in our own work, and if you look at the succession of reports, we certainly, when we are reporting, look back at and across Government at the record and make historic comparisons.

Q502 **Chair:** Of the kind of learning that you think has been positive?

Sir Amyas Morse: The progression towards understanding more about business is a result of that learning. Even if I go back to PFI, you will remember that the original PFI contracts had no clawback for financing gains and then they developed a clawback. When you look at it, there definitely is a process of something that starts in a somewhat simple model, criticism builds up over the loss of public value, and there is a reaction, but it would be nice if more of that happened by the Government generating the analysis themselves, and self-correcting, rather than waiting to be criticised by us, or nowadays of course, which is an improvement, also by the IPA—the Government have two bodies that look at what they are doing and provide them with some independent critique and some comparative critique. That is better.

I also think the Government commercial service has strengthened significantly, and the Crown representative structure; all of those are signs that learning is happening. There is the fact that senior civil servants go on project management courses and there is a project management academy and all of that. I am sorry for the long list, Chair, but there are signs. It is not fair to say there is no progress being made, because there has been.

Q503 **Dr Rupa Huq:** Our evidence has been that there can be tension between the Government being a market steward and customer. How competitive do you think the market is for Government contracts? We have all heard about the Carillion, Serco and Capita scandals. How has it changed over the last 10 years?

Sir Amyas Morse: The problem is that the Government are such a powerful customer in some areas that it only attracts bidders who feel they understand being a counterparty to the state. It tends to attract them. I do think there has been an unhappy and unhealthy tendency for market concentration to happen and I do not think the Government have done very much to prevent it. In many of these contracts, there are change of control clauses, which I almost never see being exercised. My view of it would be that if the Government want to have contracts that are not just competitive on price but competitive in imaginative approach, and they want a wider field of candidates, they need to be more intelligent in their contracting strategy than they have been. Up until quite recently, you would see very considerable contractor concentration.

The most extreme example, if you look for a long-term historical example, is what has happened in defence, where we used to have quite a lot of British defence companies and now there are very few. Whenever an outsider won a contract, they would be taken over, and we saw exactly the same thing with some of these other companies. To name Serco, for example, they have literally hundreds of subsidiary companies, and the reason they have them is because for a long time they were able simply to acquire companies that had won contracts and the Government seemed to be relatively comfortable with that. I am not suggesting they are now, but, if you look at the landscape, it had been developing in the way that it is now for a long period of time and the Government have been relatively quiescent sponsors of that.

Q504 **Dr Rupa Huq:** Rail is another example where there seem to be a lot overseas companies bidding in for our franchises. Do you think there is something of a dependency? The CBI, for example, has said that there is a sort of monopoly relationship with certain people who always get these contracts. What do you think are the main barriers to new blood, new entrants, coming into the public service market?

Sir Amyas Morse: I can understand why companies might not want to come into public service markets because of some of the unique features of the way those contracts are put together and the fact that they contain features that are politically sponsored rather than simply business features.

Q505 **Dr Rupa Huq:** Not always profitable; often unprofitable?

Sir Amyas Morse: Maybe being done in a timescale that you really would rather not have to do and you are left saying, "I am either going to bid for this contract or I am not, but I am being asked to do it very quickly. I would not have chosen to do that. Now I have to make my mind up whether I am going to go in for a competition that I think is a bit odd". There are two ways you can look at it. You can either go and take part, and hope to improve the contract by negotiation once you have won it, or you can say, "This all looks a bit tricky; I don't really fancy this". There are quite a lot who take the second path.

Q506 **Dr Rupa Huq:** So you would have longer timescales, less up against the wall?

Sir Amyas Morse: What I am saying is the timescales are not determined solely by considerations of efficiency; inevitably they are also influenced by the political landscape. That must be true. If you are a Minister who is keen to get something done, and you think of yourself as having a relatively short period of time in which to see that happen, you are tending to push things. We have commented on this very considerably in the early years of universal credit, where it was perfectly obvious that the reason things were happening so quickly was because of a desire to be able to report rapid progress. In fact, unfortunately, what happened was the reverse of that.

If you look across the landscape of contracting, the pace at which things move is not always simply dictated by what I would call normal considerations of contracting. You now have Crossrail held up as an example of contracting, and of a successful contract, but it is important to remember that for a long time, Crossrail was very severely delayed because of the inability to reach agreement and the fact that the Government could not intervene to force it to move forward and, therefore, they were forced to work out the whole contract properly. It worked rather well once it did go into effect, but after several years of delay. I do think timescale is a factor.

Q507 **Dr Rupa Huq:** In the Carillion post-mortem, it has been criticised as being a big monster with tentacles in many areas; it had libraries in Ealing. What do you think the advantages are for the Government in contracting with large companies that run a number of different public services—so the other side of that?

Sir Amyas Morse: There should be advantages. There should be advantages in that a company that runs some public services is not naive about what the Government may want and what the Government's characteristics are as a customer. That would be quite logical. If I suddenly went into an industry with a dominant buyer and I did not know anything about them and I had never contracted with them before, my risk would be higher, so there should be some advantages for both sides there.

What you are doing, though, from the Government's point of view, when you do that, is concentrating your risk a bit. You need to understand that. Of course, having a big counterparty when you are letting a big contract is generally a good idea. If your single contract is an enormous contract for a relatively small contractor, that ups the risk of failure, so there is something to be said, in any commercial situation, for having a counterparty that has enough assets to really underwrite the project they are undertaking with you, so that they can afford to invest in it, can see it through, and are not coming to you for more and more money all the time; they are not at risk of going bust. That is obviously an advantage, supposing that that contractor has a strong balance sheet.

That does lead you to a question, however, and it is quite important. I find it very interesting, looking at Carillion, that their balance sheet had considerable indebtedness on it, which was nothing to do with the public sector. They came to the public sector as a contractor with a substantial amount of debt and they grew their business by buying other businesses that were relatively low-margin businesses, also by incurring debt. Looking at their balance sheet, although they were very big, some of the advantages I have talked about were not actually arguably available.

Q508 **Chair:** Which suggests the only advantage for outsourcing is where the Government have proper understanding of the contractors' balance sheets.

Sir Amyas Morse: I think that is right. I am sorry—I am going to say something positive again—I do think Government are moving towards that and I am really very keen to encourage them to be more curious and intrusive. They were too respectful of the EU contracting competition rules and not intrusive enough, but they are getting more so. I don't think Carillion is altogether a bad story for Government; I really would not present it that way. The Government were actually getting involved and asking a lot of questions in Carillion quite early on, and I would like them to be earlier and more intrusive.

Chair: Did you ask about barriers to new entrants, Rupa?

Q509 **Dr Rupa Huq:** I did: timescales and artificial things, but we did not really talk about public services being unprofitable, which I thought was what you were going to say.

Sir Amyas Morse: They can be. The intention is that in selecting contractors, it is supposed that the winner of a contract will be selected on the basis of a balance of economic advantage, not just price.

Q510 **Chair:** What is your reaction to the Prime Minister's very understandable point, made repeatedly immediately after the collapse of Carillion, that the Government are customers? It is more a corollary to that relationship in contracting, as we are discussing it now.

Sir Amyas Morse: I do not think the Government are just customers. In some sectors, they are the only customer. Over 40% of Carillion's turnover was with the Government. It is a bit similar to saying that if you are in the supply chain for M&S, they are just a customer, but they turn up and tell you how the internal design of your buildings should be, what level of hygiene you are going to have and a whole lot of other things that you would not accommodate from any other customer but, in order to supply them, you do.

Similarly, the Government are not just a customer and if they think of themselves too much, if they minimise their role, that is not safe for Government; it means that Government does not do enough, does not assert itself enough, to protect itself. How you protect yourself in government is not the same way as you do if you are a relatively small customer buying on contract from a big supplier, for example. When you are a whale in the marketplace, you make the conditions.

The other point is, if you put funny conditions in your contracts, people are going to accept them, or they are more likely to accept them, because they realise they want to transact with the Government, so what they are doing is accepting conditions, or accepting low prices, and then hoping to get a return by working up the margin in the contract over time. That may or may not work, and in fact as the Government get more switched on commercially, it gets harder to do. So when they take on a contract they probably do not regard it as realistic, in terms of return on capital employed and so on, and afterwards they are trying to improve their position. I don't think that is very satisfactory.

Chair: That leads brilliantly to the next question.

Q511 **Mr David Jones:** You, I think before the Liaison Committee, referred to the hamster-wheel effect.

Sir Amyas Morse: I did.

Mr David Jones: Is that what you were just describing?

Sir Amyas Morse: I was describing that, but I was also describing something else, more an accounting point, which is that there is a tendency of companies that have a lot of long-term contracts to take rather more profit at the beginning than turns out to be the case in the end. While accounting standards try to militate against that, it is still a well-known problem. If you are front-ending your recognition of profit, the only way you will keep your profit record going is by taking on more contracts that you can also front-end. There is a bit of that. After all, for many years the outsourcing contractors were experiencing enormous growth and now it has more or less stopped but, during that period, they were set up to seek out new contracts all the time and the machine they had for doing that probably just continued performing for rather longer than was healthy. That is what I am describing as a hamster-wheel effect.

Q512 **Mr David Jones:** Has the hamster-wheel effect increased or decreased over recent years?

Sir Amyas Morse: It is probably beginning to decrease now, because you are starting to see these companies counting the cost of taking on business that is not inherently as profitable as it should be.

Q513 **Mr David Jones:** How well do you think the public sector understands the implication for the public sector as customers of the business models you have just described?

Sir Amyas Morse: How well is it understood?

Mr David Jones: Yes.

Sir Amyas Morse: Do you mean by—

Mr David Jones: By the public sector.

Sir Amyas Morse: It is becoming better understood, but it does not prevent particular mistakes from being made in particular contracts.

Q514 **Mr David Jones:** You said a few moments ago that you thought the Government had been too scrupulous in adhering to European procurement regulations; I take it in the case of Carillion.

Sir Amyas Morse: It is not so much that I think that they were too scrupulous in adhering to them, but they allowed those regulations, which are about providing open competition, to cast a chill over their inquiries. They should have pushed the envelope on those regulations rather than saying we will gratefully accept the limitations they impose, if I can put it that way.

Q515 **Mr David Jones:** Has that happened in the case of other contracts, other than Carillion?

Sir Amyas Morse: Yes, it has. If you take Carillion, the value of what I am saying, which I suspect the Chair agrees with, is that if you are a major contractor to the Government, and you have weaknesses in your balance sheet that may have nothing to do with the public sector, the public sector nonetheless really needs to know about those in assessing whether the contractor is acceptable as a supplier. They may be limited as to what they can do about that, because of EU contracting rules, or whatever other fair competition rules there might be, but at least they need to know; they need to see it as a risk factor and seek means to mitigate it.

Q516 **Mr David Jones:** Some of the large contractors have complained to us that the Government have exploited their power within the market to force down prices. Do you see any evidence of that?

Sir Amyas Morse: On occasions. I think it is easy to interpret it that way. The Government generally apply the basket of economic benefits methodology, and it may be that that can be seen as going for the cheapest price, and that is seen as the popular wisdom—that the cheapest price normally wins. Probably, even though there is a basket of benefits, that is the one that may well have a lot of weight. I guess I would say, yes, I think it probably does. The Government should have power as a big customer, but I think they need to be a bit more curious about the pricing model of the people who are bidding to them.

In other words, if you are trying to negotiate with someone who is proposing to provide something, you need to try to work out what their cost base is, what their overheads are, and what margin they need to make to wash their face on your contract, and if they are bidding for below that, you have to ask why. There might be reasons, but you need to ask those questions rather than just assuming that it is good news. It is not necessarily good news for the Government because it may turn out to be unsustainable and then you have a clean-up job.

Q517 **Mr David Jones:** The Government have, in many respects, the status of a monopoly buyer. What effect do you think this has had on the market as a whole?

Sir Amyas Morse: Of course, there are different markets. The Government are not a monopoly buyer in some cases. In others, they may be a monopoly buyer if you see the market as being the UK, but of course it isn't, not for everything. If you go back to train supply, a lot of the suppliers of trains or of major engineering are global operators and they will look at the UK and what is on offer from the UK public sector and they will either take it not take it. In some cases, even though the UK Government are the contractor for rolling stock, let's say, nonetheless, it is still a world market and the UK marketplace is only a moderate size compared to the world market. It is less clear that the Government are in a monopoly position than one might at first think.

Q518 **Mr David Jones:** What about other sectors, prisons for example?

Sir Amyas Morse: They are in that position for prisons; they are the sole customer for prisons. Yes, you are quite right about that. Therefore, where you are in a position where you do not have competitive pressures, you need to think about how to use your power in a balanced way. That is what I am saying about understanding the cost base, understanding what you are getting. You need to be very careful.

For example, if you have a contract that says, "I require you to do the following things, I would like to get the following results, payment by results, but I am not going to specify any standards for how you deliver", you may find it quite embarrassing later on what you get back for that.

Some years ago there were examples of that. There are standards of service that are unacceptable to the public sector. You need to be aware of the fact that you have to think through the scenarios of what the contractor may do to maximise profit.

Q519 **Chair:** Of course, with what is happening in the market, Capita has announced another £700 million capital raising and that they are reorienting their business away from the UK because they regard the UK market as too high-risk, not lucrative enough. What are the Government going to do to stop the reduction in competition in this market?

Sir Amyas Morse: I have read the papers on Capita, like you, Chair. I guess my reaction is that business is generally rational, so they will come and bid for a contract if they think the terms of the contract are attractive. While they may say they are going to do more business out of the UK—they are very concentrated in the UK at the moment, so that makes sense for them—they are absolutely not seeking my advice but I would say to them, from a commercial point of view, why not have a model where you are not dependent on one Government and how much money that Government are spending?

That makes some sense, if you are at scale, and they are at scale, and they have been successful in raising that money. The proposition must appeal to the investors, I guess. I would not ever believe anyone who said, "I will never come and take another Government contract". If the terms are attractive and well thought through, you will probably find plenty of people who are prepared to come through and offer for it. Business is always driven by opportunity.

Q520 **Kelvin Hopkins:** The Treasury's Green Book says that risk should be borne by "the organisation that is best placed to monitor and manage it". That is pretty opaque to me. What evidence is there that this means anything to Departments, in practice?

Sir Amyas Morse: I do think that what the Treasury says is right, and it is also significant but not always followed. What they are saying is, if I make you take a risk that you cannot control, that you can have nothing to do with, if I ask you to sign a contract to take costs down and I make you responsible for the case flow under that contract, and I say, "If you don't get any more cases, you still have to deliver the same service and I am not going to up the price per case that you can charge", and I hold you to the contract and I make sure it is on very restrictive terms, I am simply making it impossible for you to be successful in the business. I am transferring to you a risk that I should manage. That is the sort of thing that has happened in the recent past.

It is not clever to make a contractor responsible for a risk that only the courts and the Government can affect. You are just putting an impossible risk on them. If you say, "I expect you to handle military recruitment" and, "I expect you to produce X number of recruits" but actually, in the meantime, the appetite for recruits goes down enormously in the country, for whatever reason, I cannot necessarily manage that. It is right to say you should only ask someone to contract and manage a risk they can competently manage.

Q521 **Kelvin Hopkins:** There is a big debate, of course, about whether many risks in the public sector can actually be transferred at all. When things go wrong, it comes back to this House and questions to Ministers, and they say, "We're responsible".

Sir Amyas Morse: That is true.

Kelvin Hopkins: What are the consequences of Departments failing to implement the guidance that has been given by Treasury?

Sir Amyas Morse: When they do that, they should be held to account for it and I do my best to do that. They should listen to the advice they get from the IPA, they should be held to account for not doing so, and the Treasury should criticise them for it as well.

Q522 **Chair:** That is rather after the event, isn't it? How should Departments know whether they are doing this?

Sir Amyas Morse: This comes back to a question of who is pushing. If it is being pushed at a political level, then Departments may find it difficult to resist. If it is being pushed by officials, then Ministers and others should be challenging them as to why they think transferring this risk is a good idea.

Q523 **Kelvin Hopkins:** After Carillion, how much can the public sector rely on the private sector to determine what risks the private sector can or cannot bear? It is not just Carillion. I think we go back to earlier failures as well, 10 years ago.

Sir Amyas Morse: If I may say so, I think Carillion did not fail because of the public sector. It is not clear to me that the evidence shows that, at the very least. Carillion failed because they had a massive debt structure. They were relying on getting more business in Arabia, which they did not get. They took a punt on that; it did not work out. I suspect they also thought that they might be bailed out by the Government when they got into financial difficulties, and I am pleased to say that that did not happen, which I give credit for, by the way.

Q524 **Mr David Jones:** We have touched on this already. In 2015, your office reported that a reasonable profit is difficult to define and varies between types of service, the risk to supplier, and the market. When you are auditing contracts, how do your auditors assess the difference between a good-value price and an unrealistically cheap price?

Sir Amyas Morse: It is not our job to do that but if we were doing it, here is what I would look at. I think I said something about a realistic price or an unrealistic price earlier. I would want to understand: at what rate for the job could any organisation be expected to be able to fulfil this contract—not this particular one, but any one that is out there?

A particular one may have their own cost problems, and if they bring them into the situation, that is their problem, not something the Government should pay for, but if you said, "I want you to provide me with a service where I am going to pay you less than the direct costs you have", then it is clearly not viable. Even if I say, "I want to pay you a rate for a service which may cover your direct costs but makes very little contribution to your central overheads, far less giving you a profit", again, it is not really viable and it is not really going to be sustainable in the longer term. If, as a bidder, I went for a contract like that, I would probably be doing it because I hoped to renegotiate once I was in the contract or because I thought I could achieve some strategic result by getting a very big market position.

Q525 **Mr David Jones:** How frequently is it the case that Departments fail, or refuse, to accept the lowest-priced bid? Is it a common state of affairs or is it usually the case that they go for the cheapest price?

Sir Amyas Morse: It is certainly not unusual. If I look at the East Coast franchise, the reason the consortium has given up that franchise is because they cannot make money at it. They guaranteed to put a certain amount of capital into it and, after that, they were not going to continue with it. It is a good example.

Now, am I blaming someone for that? We are doing a report on it, so I don't want to spoil that, but what I am saying is that it quite clearly was the case that in the hands of that company, they judged that they cannot make a reasonable return.

Q526 **Kelvin Hopkins:** Chair, may I intervene on that? The East Coast main line, for five years, was in the public sector and made a profit of £1 billion for the Treasury and ran a very good service. What went wrong with the private franchise?

Sir Amyas Morse: Read the report, please.

Kelvin Hopkins: I shall read it with interest.

Sir Amyas Morse: I cannot synopsise that quickly.

Q527 **Chair:** There is a great deal happening on rail franchising at the moment that shows the same perhaps overconfidence of the Government that the private sector can reduce costs and carry risk. Would you agree?

Sir Amyas Morse: In trying to find the right point as to how hard to push, it is a bit of an experiment and not all the experiments have worked out. Yes, I guess I agree.

Q528 **David Morris:** You have just produced a major report on PFI1 and PFI2. What lessons do you draw from the UK's experience with PFI for the rest of outsourcing?

Sir Amyas Morse: One of the lessons I draw is that PFI is not undilutedly a bad thing. In other words there is, for example, the fact that in PFI you have to get independent financial bodies to produce the finance, and they just will not let you have the money unless you have done a reasonable job of evaluating the cost of the contract, so there have been quite a lot of successful builds and actual launches.

As far as it being a good deal for the Government, there have been some areas, with the admitted benefit of hindsight, where we have ended up paying too much to transfer risk. For example, if I take a simplified example in my head of building risk, let's say a PFI on a hospital. You are building a hospital and there is a certain premium deemed to be attached to building risk. I have always asked myself, "Is it really that expensive to cover yourself for building risk?" When people build hospitals and other places, they take out insurance on the building during the project. The builders take out insurance. I am finding it a little difficult to know whether that really was quite realistic or just terribly clever people in government assuming they understood the commercial sector and not understanding it quite as well as they might. So there is that.

The other assumption in a lot of PFI was that they really needed to have maintenance and other contracts all put in place, all locked in for a long period, otherwise the assets might not be properly looked after. I think, with hindsight, that turned out to be a bit naive, and it created another tradeable cash flow that people cashed in on. The main lesson of this is: don't try to be too clever by half when you are dealing with the private sector, because they are probably better at contracting than you are.

Q529 **David Morris:** In your report you say that the Government decided to reduce its entitlement to share in gains from refinancing PFI2 deals from 50% to 30%.

Sir Amyas Morse: Yes.

Q530 **David Morris:** Because that would make them less likely to appear on balance sheets in the national accounts. How can this be in the public interest, in your opinion?

Sir Amyas Morse: It is an interesting point, isn't it? I think a lot of judgments are made by the Treasury on the relative importance of short-term value for money, as against public sector borrowing requirements and nobody is privy to how the logic for that goes except the Treasury. I would like that to be more publicly accountable.

Q531 **Chair:** We will write to the Treasury with that question.

Sir Amyas Morse: It is quite likely it will come again, I think, in the course of our work, Chair. It is not to say that they not right, but you have Treasury spending representation across the portfolio and to say, "At a certain point we will say we think this matters more than that" must be susceptible to some sort of analysis, I would have thought.

Q532 **David Morris:** Yes, I agree. In 2015, you said that the Government have not monitored the implementation of payment by results. There is a good graph in here that shows that from 1999 to 2010 money was just awash; it was huge, the expenditure in PFIs. How should the Government monitor the implementation of new contractual models?

Sir Amyas Morse: They should start by trialling them before they go into bulk. I am ignoring, again, the political compulsions that might be there, which you can think of just as well as I can. However, I would say that if you set those aside, the right thing to do is to try the contract on the ground in a limited exposure, set up careful analysis of what you would expect the results to be and if it is different, act on what you learn.

I have very often seen situations where those principles were not followed. I have even seen situations where pre-implementation trials were completely ignored, when they showed the wrong message. This is not rocket science; it is seeking to learn before you commit a lot of public money and being prepared to be influenced by what you find when you do the examination.

Q533 **Chair:** Moving on: we talk a lot about the Government abusing their advantage as such a big player in the market, but what about the permanent disadvantage that you talk about that the Government have commercially? Can you explain what you mean by that?

Sir Amyas Morse: What I mean is that the private sector can always pay for, and amass, more expertise in some areas than the public sector has. The gap has got a lot less since I first said that and I have already said that I believe the commercial capability of the Government has got stronger. However, most public servants, if they wanted to be in the business world, would have gone into the business world; most of their primary talent sets are not in hard-nosed negotiations and calculations, and so on, of that kind.

Therefore, when you have someone who spends their life negotiating, outsourcing deals, playing against someone who perhaps does not spend their life doing that, or, the deal having been made, playing someone who spends their time squeezing additional margin out of contract variations against someone who would rather be talking about policy, then the results are kind of predictable. What you have to do about that is get the Government's commercial capability up as much as possible and then draw up contracts that are good, not too-clever-by-half contracts, with which your people are capable of using Government's advantage to equalise with the supplier.

Q534 **Chair:** How true is it still, that the Government—

Sir Amyas Morse: It is still true.

Chair: It is still true.

Sir Amyas Morse: But you do have to recognise that as a factor and plan to counteract it.

Q535 **Chair:** Quantify it, perhaps, on a scale of 1 to 10: where is the capability of the Government, where 10 is equal with the private sector, and zero would be not at all?

Sir Amyas Morse: Seven.

Q536 **Chair:** Seven? And it has come from?

Sir Amyas Morse: Two.

Q537 **Chair:** Since when?

Sir Amyas Morse: When I started in this job, it was pretty patchy.

Q538 **Chair:** That is quite a substantial improvement.

Sir Amyas Morse: I do think it has improved quite a bit.

Q539 **Chair:** Okay. So what further reforms do the Government need to make?

Sir Amyas Morse: I am not sure if they are reforms as in legislative reforms, but they do benefit a lot from bringing business people in in senior posts. Lord Browne did a great job in bringing in non-executives who provide real business challenge. You do need to keep that going. That really helps the Government to perform better.

Having John Manzoni there is a good thing and we need to make sure that he is not a one-off. In key posts, you need people who understand, who really know what they are doing, in these sorts of areas. They then attract and bring in a stream of others who feel that if they are there, it is okay to join. We need similar strength, and I am not sure we have really achieved it yet, in the digital area, which is so crucial to our future.

Q540 **Chair:** How useful should open-book accounting be to scrutinising contractors?

Sir Amyas Morse: It should be very useful.

Q541 **Chair:** How good are the Government at using that information?

Sir Amyas Morse: Again I am going to say that it is getting better but there is a long way to go.

Q542 **Kelvin Hopkins:** You have called for more transparency about contracts. What do you think should be published that is not published now?

Sir Amyas Morse: I would like the Government to be more open about their reasoning. Rather than publishing what they have to publish in terms of the major contracts register and so on, I would like them to be prepared to explain more about why they are contracting in a certain way; in other words, be quite liberal about how they explain their logic. I think that would help them; it would help us to understand them more, and from their point of view, it would help them to improve. I believe that transparency generally improves things, not the reverse.

Q543 **Kelvin Hopkins:** But you need people inside the Government to be able to understand things, to have a very effective in-house understanding.

Sir Amyas Morse: That is right but of course you do have to remember that that always militates against news management. It is quite tough. People are very much in favour of transparency, but less so when they are in government, I find.

Q544 **Kelvin Hopkins:** Talking about digital, this Committee, in a previous Parliament, produced a report on IT failures—the fact that we have had a number of very, very expensive IT failures in the public sector—and said that building in-house capacity to deal with technology was crucial. Is there any evidence that that has happened and it is starting to improve?

Sir Amyas Morse: Yes, there is, but while I am being quite generous about progress in commercial, I think the progress in digital has been less consistent. I am not saying that it is not there—there has been some progress—but I think it has been less clearly consistent and that we need to keep on, because it is such a big driver of the future of government and it is going to determine the future of the way government is delivered in so many areas that you really need to keep pushing that.

Q545 **Kelvin Hopkins:** On a separate question, which I wanted to ask earlier but I will ask now, would you not argue that there is really quite a difference between contracting—having contracts with the Government—and PFI schemes? PFI schemes now seem to be dying a death because none of them are happening now—thank goodness, I would say—but there would still be continuing contracts with private sector companies.

Sir Amyas Morse: Yes, and also some of the components that are in PFI will continue to be needed. If you want to buy a hospital and you want long-term financing for it, you are going to need to negotiate long-term financing for it. You will have to have service contracts; you will have to have maintenance contracts. What you do not need to do is necessarily have them all packaged up in the same package. That is why I think it has not stood the test of time.

Some PFI contracts have worked quite well, but the assumption that packaging all that together will make it better—I am afraid the sum of the parts has not been greater than those parts, in many cases.

Kelvin Hopkins: I will not pursue PFI at this stage.

Chair: David Morris, do you have anything to add to that question? You showed an interest in it.

Q546 **David Morris:** On some of what has been asked—the barriers to increased transparency—we have been talking about how other countries operate in all of this. Who do you think is best at publishing this kind of data?

Sir Amyas Morse: The United States publishes a lot of data. I think they are the most transparent that I am aware of. I don't spend my time studying other countries' approaches, I am sorry to say. I am paddling away as fast as I can but I am not as expert as I ought to be. We know a fair bit about how the Dutch and others do it. They are pretty transparent. I would think the Nordic countries are pretty transparent, and I know the Americans are, but the thing with the Americans is that a lot more of the review processes in the United States are at the budget-setting level. There is much more detailed review there, so you get this front-end examination rather more greatly than we do. Our system is different.

Q547 **David Morris:** Do you think we could learn from their system?

Sir Amyas Morse: Yes, I do, although I think some of the lessons would be about capacity. In other words, it is not so much about these contracts. I do find myself asking the question: is it possible to deliver these services for this level of budget? Is anyone talking about that, really, or is it all incremental? I know they have spending reviews where that is supposed to be being asked, but I am not sure that it is asked in a terribly zero-based fashion—is this enough money to drive this system?—but that is not what you are asking me about. I do think the American system has some interesting things to show us. We could do more in examining estimates, than we do.

Q548 **Mr David Jones:** What could be done to make public services more resilient to the failure of individual contractors?

Sir Amyas Morse: We saw something good in the Carillion case in terms of the partnership structures that were set up where they had multiple contractors agreeing to be mutually supporting on individual contracts. Mostly I think that pick-up has worked rather well, as far as I know. Where Carillion was not able to carry out, someone else has stepped in. I think that is pretty good news.

Who initiated that? Was it the Government or was it the contractors? I don't know, but it is a good innovation. It reduces the risk of provider failure for some of the sort of inherent provider risks—their debt on the balance sheet type of risk. It reduces the risk of the Government having to re-plan. So there are things like that that you can do, that are practical and that make a difference.

Q549 **David Morris:** In the case of Carillion, do you think that was done with a view to the potential of their failure, or do you think it was something that was just done because it was good practice and developing practice?

Sir Amyas Morse: That would be speculation.

Q550 **David Morris:** Okay. How could the Government build contingency planning into its contracts more effectively?

Sir Amyas Morse: It could have more open discussions with bidding contractors about scenario planning and what would happen in certain scenarios. I get the impression that in some of these contracts, the terms are set out, you either apply or don't apply, and there is not a lot of open discussion. In others, there is more. I do think that is really important, that you have the chance to do some brainstorming with the suppliers.

Q551 **David Morris:** You have touched on this and I can guess what your answer will be, but Professor Haslam has told us that there should be more stress-testing of the balance sheets of major contractors as a matter of routine.

Sir Amyas Morse: Yes, there should be.

David Morris: You agree with that.

Sir Amyas Morse: I absolutely do. The comment was made by the Committee earlier that when you contract with the private sector, if something goes wrong, there is a pretty vigorous attempt to transfer the risk back to the Government and sometimes the risk does come back to Government. The credibility of the counterparty really matters. The strength of their balance sheet really matters. If you are in the private sector, thinking about doing a contract, you would ask all these same questions. You would not just say, "Oh, I won't ask you; you might find it intrusive". You absolutely would ask. You would do due diligence on the supplier, if they were such a big supplier, to see if you were happy to have them as a counterparty.

Q552 **David Morris:** To touch on it again, to what extent would you say that the Government really are inhibited by the EU procurement regulations?

Sir Amyas Morse: I believe that if you take the attitude that you need to comply with the regulations but, as far as possible, you don't want them to limit your inquiries, that might take you further forward than they have been. I am just looking for them to take a more aggressive forward posture on all of that, and I think quite a lot more could be done.

Q553 **David Morris:** In addition to the areas we have considered today, what do you think should be the Government's major priorities when it comes to improving the value for money of outsourced contracts?

Sir Amyas Morse: The most significant priority is to look at, and think about, what they will deliver over the whole life of the contract, not simply think about whether you look good for signing a contract at what looks like a marquee price, or a low price, at the beginning. You need to have a very realistic challenge as to what a likely outcome is to be, preferably not by the people who are promoting the contract. What I think is unhealthy is when you get a sort of over-excitable promotion. PFI was over-promoted as a model. Payment by results was over-promoted as the only thing to do in its time.

These are not healthy things. You need to always approach things on a balanced and sceptical basis and not assume that you have developed an atomic screwdriver that is the answer to everything. That is just not realistic.

Q554 **Chair:** Finally, could we ask one or two questions about the response you have given to our "Counting for Democracy" report? We produced a report that was very strongly based on our finding that very few people find the formal accounts produced by Government Departments, audited by you, to be of much use in terms of scrutinising them. What MPs do is: we like looking at value for money and finding out whether policies are actually working. We recommended publishing the cost of services rather than management divisions and publishing the costs of major projects in annual accounts, and publishing information about whether our commitments to save money or spend money have been delivered, so auditing performance information. What do you see as your role, when it comes to helping Parliament get the information it needs out of Government Departments?

Sir Amyas Morse: I am not a search engine, first of all. The reason I have the statutory capability to look at private information in government is because I can use it to make reports, not so I can just regurgitate that information on request to Parliament, and I do not do that. I thought I gave a quite supportive response. I just know quite a lot about the significant function—

Chair: That is why I am asking this question.

Sir Amyas Morse: Okay. Well, let me say this.

Q555 **Chair:** What is your role?

Sir Amyas Morse: My role is to make reports to Parliament to help them hold the Executive to account. I do that by writing 60 value for money reports, nothing to do with published accounts, and another 20 or 30 investigation reports that I also publish. I also publish memoranda and I respond to all MPs' correspondence, sometimes with reports but more often with letters based on doing investigations within government.

I do all of those things, and more recently in the history of my office I was given the job of auditing the Government's financial accounts. The reason I do not think we should start changing the form of the financial accounts is, first, the Government are getting better at accounting. They are preparing their accounts along the same criteria as the private sector and to start diverging from that, I think, would take down the quality of the accounts.

What they are not intended to do is to be an early warning system. It is inherent that they come out after the event, but they are a powerful document of record. If I can give you an example, two years ago I wrote a long-form report on the Department of Health accounts where I said that I did not like a lot of the things that the Department of Health had done to try to stay within their spending limits in the last year. I felt that they could have been argued to be artificial, and, although I did not have enough proof of that to qualify the accounts, I was very concerned about it. I would say we are taking a creative approach to those accounts, to the true and fair view of the accounts, and what we say and report on there.

We also look at regularity, and that stops people using public money for things that it is not supposed to be used for. That is little talked about, but it really does have a considerable effect. We do a whole lot of things other than prepare the financial accounts, but I think it is quite important that those accounts should be prepared in a recognisable form that is according to normal accounting standards. That is not to say that I am not in favour of publishing more information in other ways.

Q556 **Chair:** I am not in favour of diluting. I do not think we make any recommendation that would dilute the effectiveness of the accounts as audited accounts. For example, you audit performance data in the accounts, but how could we make the performance data in the accounts more useful and trustworthy than it is at the moment?

Sir Amyas Morse: Just remember that what we do for the purposes of the accounts is to audit that information up to the point that it is reliable against the materiality of the accounts, which are quite enormous. What we do not do is to assure Parliament that all the performance data is dead right. We do not need to do that. If we were going to start doing that, that would be nothing to do with producing accounts. That would be a different service. If Parliament said to us, "We would like to see all of the performance data of Departments and we would like you, the NAO, to examine it" we would be doing a kind of internal audit type job examining that, and I would say it is probably better for the internal auditors to rise up and do that. But we could do it. It is a different service from the one we do at the moment.

Q557 **Chair:** Okay. We recorded a lot of frustration from people like The King's Fund, the Institute for Government, academics and other MPs.

Sir Amyas Morse: Indeed.

Chair: How should we channel this frustration most productively from your point of view?

Sir Amyas Morse: By saying what it is that you think they should know more of, and then let's see how that can be provided. Governments have the job of providing the information. You should put it to the Government. Let them come forward with the proposals. We are happy to comment on those proposals and we are also happy to examine them from an accuracy point of view, whether it is through formal audit or some other means. We do not have a problem with any of that.

Q558 **Kelvin Hopkins:** There is one significant question, I think. We are now looking at insourcing and work being undertaken in-house. Is there not something to be learned from how public corporations, local authorities and central Government used to operate when they did a lot more in-house rather than outsourcing and contracting? There are some successes.

I will just give one example and I will finish there. Recently, there has been an analysis of electrification in the railway industry, contrasting the

East Coast main line electrification 30 years ago, which was done in-house and managed in-house, with current electrification. Stripping out inflation, the difference in cost is seven times according to this analysis. In one other analysis it is six times—still an enormous difference—stripping out inflation. Something has gone horribly wrong between when it was done under BR in-house and what is happening now. Is it not worth looking at some of those examples?

Sir Amyas Morse: It is always worth looking at examples. I think what I said earlier was that I quite like the idea of mixed economies, but I am not against things being provided in-house. You just need to remember the investment, not just in capability but primarily, that you need to make. If you are saying we are going to start running a lot more things in-house, you need to have a lot of people who are experienced and capable of doing that and a funding and resource structure to back them up. It is a big decision to take, so the answer is probably that if there is a case for insourcing somewhere, fine, there is nothing wrong with that in my view, but you need to understand what you get and what risks you take in moving from where we are now to where that would be.

Kelvin Hopkins: It is crucial to rebuild in-house capacity to do these things.

Q559 **Chair:** Thank you for the response you gave us. We had obviously given you quite a lot of food for thought.

Sir Amyas Morse: Of course, and I appreciate that very much, thank you.

Chair: We appreciate the care that has obviously gone into the response. I think that is it. Thank you very much for a very, very informative session. We will now have our two further witnesses, but we will take a very brief break.

Sir Amyas Morse: Thank you so much.

Examination of witnesses

Margaret Stephens and Paul Davies.

Q560 **Chair:** I welcome the second panel today in our inquiry into the lessons of the Carillion collapse for sourcing and outsourcing. Could I ask each of you to introduce yourselves for the record, please?

Margaret Stephens: My name is Margaret Stephens. I worked for many years with KPMG as an adviser for PFI and outsourcing contracts. I am now independent.

Chair: We should emphasise that although you are a non-executive director of DExEU you are not here in that capacity and you are speaking in an independent capacity.

Margaret Stephens: That is right, yes.

Paul Davies: I am Paul Davies. Again, I have a history in infrastructure. I was a project finance banker for a number of years and then 20 years as a partner at PwC advising in infrastructure and government, principally advising the public sector on procurement.

Q561 **Chair:** Very good. What should be the key advantages of outsourcing and when is it most appropriate to outsource?

Margaret Stephens: My experience of outsourcing as a provider of outsourced services and advising clients seeking to provide outsourced services is that it is where Government need the capability or the expertise. That is my own experience. It should provide cost efficiency. It should provide value for money or it should not happen.

Paul Davies: My context is the same. It is where the private sector has the expertise, the breadth of skills, often doing the same job outside of the public sector, and clearly international precedents. It is the whole of that expertise. They also have cost skills and project management skills for implementation. From the public sector, I suppose the key question is: do we have those skills in-house? If not, it is not a question of whether or not you deal with the private sector, it is on what basis. It is not should I outsource but what is the most efficient way of doing that tends to be the question.

Q562 **Chair:** What should Government not outsource?

Margaret Stephens: I think Government should not outsource where the policy outcomes are not thought through. That would be risky when it is not really sure what it is trying to do. One of the problems with PFI has been inflexibility. That would indicate that you should not enter into long-term contracts when you prize flexibility.

Paul Davies: To add to that, the private sector likes certainty. They like to be asked what to do, know what they are doing, they will price it, and that is what they will deliver. If you, therefore, are not certain, you need a degree of flexibility and you need to change things over time or policy needs to change, then they cannot price that and will find difficulty dealing with it and you would have an incumbent supplier. It is when you have that level of flexibility you want to retain.

Q563 **Chair:** Neither of you have given any indication that there is something intrinsic to Government that cannot be outsourced.

Margaret Stephens: Policy development.

Q564 **Chair:** Francis Maude actually started contracting out policy development, commissioning reports from private sector bodies and institutions.

Margaret Stephens: That would be inputs, would it not, and ministerial decisions would—

Q565 **Chair:** What about something like policing or the intelligence services or the armed forces? There are certain things we just do not contract out.

Margaret Stephens: If the decision cleared all the hurdles of the Green Book, which is a very good framework looking at all the options, all the evidence, considering the intervention over the length of time that it should be in place, and it came out and it looked at all the international examples and really tested it and the best answer was to outsource and that was going to be value for money, I suppose that would be the best answer. That would be a big analysis.

Q566 **Chair:** If Government outsources stuff, it tends to lose the ability to be able to do that stuff itself.

Margaret Stephens: Absolutely.

Q567 **Chair:** What would you say were the activities of central Government that it cannot afford to outsource because it must retain that expertise and capability in-house?

Paul Davies: In theory, one could say you could do anything in the private sector and anything in the public sector, either side could do anything adequately, but it is where you cannot specify in detail what you want that you should not be doing long-term contracts—where there must be a lot of flexibility in the choice. There is also an element here of public perception. Do the public want to be policed by someone who is doing it for a profit motive or do they want to be policed by someone who intrinsically wants to do good policing? At the extremes there are services that to me seem self-evident should be retained in the public sector.

Q568 **Chair:** I suppose it is that principle I wanted to get hold of. We would not privatise the judges, for example.

Paul Davies: Exactly, because one wants to have—some people, I think, anyway—no element of doubt that they have 100% a public ethos underpinning their decision-making process. One of the problems you have with private sector involvement is that people start to doubt the motivations and think it is profit-related rather than the correct outcome. There must be extremes of what should not be outsourced.

Chair: That leads on to Kelvin Hopkins.

Q569 **Kelvin Hopkins:** It does indeed. It leads directly on to my question. This is to Margaret Stephens. In your written evidence, you place emphasis on public trust in the way public services are delivered. Why do you think this is important?

Margaret Stephens: For several reasons. One is if the Government want to have an option of using different procurement options because they might come out best on a value for money analysis, there needs to be trust. For example, we have PFI. Trust has been lost in PFI; therefore, it is not much used now, whether that is the right answer or not—on an analysis, that is not necessarily the case. With outsourcing you could have a public loss of trust in that, because with PFI or outsourcing, when the story becomes the thing rather than the evidence, then you cannot really be confident that Government decision makers are making the best decisions. I suppose loss of trust is also damaging for business, of course.

Q570 **Kelvin Hopkins:** There are a range of views in Parliament, obviously a political range of views. I know I have a particular view myself. There is understandable loss of trust in a lot of the contracting out. There have been a lot of problems with prisons and a lot of mistrust on probation. Do you not agree that some of these decisions have been made not on a commercial basis or public service basis but really on an ideological basis that the private sector is where everything needed to be?

Margaret Stephens: That is not my experience. You mean decisions have been made on an ideological basis about outsourcing?

Kelvin Hopkins: By Governments, yes—and Labour Governments as well.

Margaret Stephens: It is possible. It is not my experience. I do think that excessive profits—and also cases where the private sector makes losses—do undermine trust, and that has an influence on public trust in the different procurement methods that Government might want to use.

Q571 **Kelvin Hopkins:** But isn't it more the quality of the service that is provided and whether that is publicly accountable that people are more worried about rather than necessarily cost?

Margaret Stephens: You mean the consumers or the users?

Kelvin Hopkins: Yes, the population, the electorate.

Margaret Stephens: Absolutely, yes.

Q572 **Kelvin Hopkins:** If they feel that the prisons are in public ownership they can talk to a Minister about them, but if the Minister says, "I am sorry, we do not run the prisons any more because they are run by a private company", it is rather different. Some outsourcing will continue, no doubt, but how can outsourcing inspire more trust in the future?

Margaret Stephens: I said this quite a lot in my evidence: I think by building evidence of benefits. There is a dearth of evidence on looking at the long-term results of outsourcing. The Green Book requires that whatever decision is made on whatever procurement method it is, the position is monitored and evidence is gathered in order to inform further decision making, yet we see in NAO reports that that evidence is not there.

I also refer to an example from my own experience when I was doing a piece of work for the Treasury. The evidence on all the financial models of all the PFI projects was not available. I think the Green Book implies that the evidence and the monitoring is on a contract by contract basis. There is a case for gathering much more evidence to inform better decision making. If, as you are making the point quite rightly, short-term costs lead to poor service, that should not be value for money because of the quality of the service over the life it has been provided. Failures of trust and failures of service end up with higher costs.

Paul Davies: In addition to my evidence, I have recently just done a paper called, funnily enough, "Rebuilding Trust and Strengthening Partnerships", analysing why trust has broken down quite so much. There are a number of features there, but particularly with PFIs, as you said earlier, a lot of those have been done and we are now in an operational phase. You are not seeing, if you like, the benefits one saw of the original delivery. You are seeing long-term, inflexible contracts often bumping along the bottom of the permitted service levels. What the paper recommends is a change in governance from the private sector, avoiding quite a lot of what I would call short-termism, which is re-gearing, refinancing and sucking money out of the company, and having much more of a public sector ethos within private sector companies—a change in their approach to how they deal to be more flexible, retaining more profits within the company and maintaining the assets on a long-term, sustainable basis.

So it is a change in governance from the private sector side, but that also does mean things on the public sector side of how it interfaces not just being about maximum risk transfer and lowest price always trumping all. We will probably come back to that theme. There is work to be done on both sides to re-establish trust—better governance of the private and a better interface with the public.

Q573 **Kelvin Hopkins:** You touched on my final question, which is about the public service ethos. Do you not think that the public, the electorate, want to know that the prime motivation in the public sector is the public service ethos, that people are concerned about doing the right thing, not about profit and loss at the end of the year?

Paul Davies: But doesn't that actually go to who they are seeing and who we are talking about? If we are talking about a PFI hospital, there are two things here. One is building the underlying infrastructure of the hospital, so building the hospital and maintaining it. That has been done on a PFI, and the motivation behind that is to try to get the best life-cycle cost, the lowest cost over the life cycle. That is wholly different from the nurses and doctors who the public would expect to be more likely in the public sector. Going back to the earlier question, on the public side it is about the people who they deal with having public ethos and being seen to be in the public sector.

Q574 **Mr David Jones:** Ms Stephens, you pointed in your evidence to the great bank of experience that the Government have in terms of outsourcing. To what extent has it made use of that experience to inform the current discussion that we are having about what and when to outsource?

Margaret Stephens: From what I know, I think not enough. I think there have been recommendations made over the years about missing evidence. In the NAO's recent report on PFI and PF2, they refer to efforts made to get evidence on the performance of, say, different outcomes from the public sector and PFI. It is not there. As I said, I was aware of the problem with lack of evidence myself.

Q575 **Mr David Jones:** Are you suggesting that Government as commissioner keep making the same mistakes?

Margaret Stephens: It would seem to me, and I said this, that in the absence of evidence the decisions must be suboptimal. It is possible that evidence is collected. I do not know if evidence is collected on the public sector comparator, say the public sector hospital over the life of its performance, all its maintenance, all its rebuilding. I do not know whether that is kept in some place in the health service and measured against a PFI. I would guess it is not. The argument is that in future we need to make our money go further, so we should have the answers to these things. We should know the real answer, not what the last newspaper story is telling us.

Q576 **Mr David Jones:** What should the Government be doing to take better advantage of that bank of experience that you have referred to?

Margaret Stephens: The Government should now set about collecting this evidence and organising it. One of the issues I know that the Committee has considered is that within the civil service there is a lot of movement. People move a lot, so there is not that memory. The evidence needs to be there in order to be readily accessible. It must be very hard trying to comply with the requirements of the Green Book, which are really very onerous, requiring you to look at a long list of all the options and evaluate them all when you do not really have the evidence. I do not know how you would set about doing that.

Paul Davies: Can I just add some perspectives? There is now a huge bank of knowledge, as Sir Amyas was saying earlier, and a lot of that, ironically, love it or hate it, is from PFI practitioners who have come across government and are now working in procurement. I think there is one issue, which is that the model seems to be—this is for major infrastructure—either PF2, which is the son of PFI, or a public sector option. It is quite heavily into high-risk transfer, which will lead to high cost of capital, and getting it off balance sheet. There is a structure and a motivation to make a lot of those projects off balance sheet.

What the experience is not being used for is asking, are there different models, maybe some in the public sector, some in the private sector, with less risk transfer and a different structure? By way of example, Hinkley Point was done, which is new nuclear, a high-risk transfer, a high cost of capital, and the NAO reported on that, compared to Thames Tideway, the new tunnel for the sewage, which has been done on what is called a regulated asset base structure. The risk can get slightly more absorbed by the company structure. It is not a very stark risk to contractors. The cost of capital there is 2.49% compared to 10% at Hinkley, so different models can lead to different results and better value for money.

The problem with some of these models is they may not be off balance sheet, and that has been such a driver in a lot of people's thinking. I would like to see expertise where we think, okay, what is a range of models we could use to procure and which gets the best value for money? If it is on balance sheet, the Green Book at the moment tells you that it must be a public sector alternative, and I think there are times when you could use a private sector model but with lower cost of capital and lower risk transfer. There are other times when we could easily do it in the public sector very efficiently, with a govco like Highways England, but again the push for getting it off balance sheet pushes you in the opposite direction. It would be good for Government to worry less about balance sheet treatment, because ultimately somewhere in the economy we pay for these things, and think about what the best model is in the circumstances.

Just going back to that high-risk transfer that we have had on PFI, clearly we are having this meeting today because of the impact on Carillion. Jarvis had the trouble and obviously went insolvent. Laing withdrew from the sector. Others have made losses. For future large PFIs or PF2s, we would struggle to get a UK contractor in because they have withdrawn from the market because of the level of risk transfer, so something does need to change.

Chair: Thank you for that, very comprehensive. I am going to have to hurry you both along with slightly crisper answers, please, and short questions as well, otherwise we will not get through it and I may pull you up.

Q577 **David Morris:** I will be very brief. How has the market for public sector contracts changed over the last 10 years? What are the risks of an over-concentrated market, if you perceive it to be that way?

Margaret Stephens: The risks of the over-concentrated market are that there is not competition or that there are fewer alternatives for Government. My experience in the past is that the public sector has made efforts to make sure there is competition. They do roadshows and publicity days. They speak to people; they want to bid for projects. That is my experience. The private sector will always want to grow and will always want to do more and to add more value, and there is lots of good in that. What we can see is that Government may lose the capability or may lose a lot of the capability themselves that they need to contract on an equal basis with these big providers.

Paul Davies: Very succinctly, yes, Government have improved immeasurably. Concentration is an issue. There is a problem going forward, which is that the level of infrastructure spending has fallen away so substantially that there is a risk that those skills will be lost in the public and private sector.

Q578 **David Morris:** You believe that we should be investing more in infrastructure projects so that we can retain the skills; not only that but put back into the society that we are here to govern?

Paul Davies: Yes.

Q579 **Mr David Jones:** What impact do you think the Government's power in the market has on their private sector suppliers?

Margaret Stephens: Government are such a big customer that when they flex their power as a whole of Government, say through Cabinet Office guidance or something like that, that is very influential in terms of behaviour. My experience is that when companies are contracting with Government they will often use quite different people to deal with Government than the private sector. There is a specialism to contracting with Government. Government have very long and very onerous tender periods. It is expensive to bid for Government contracts. That is a difficult balancing act. It is very difficult to bid for these contracts.

Q580 **Mr David Jones:** Mr Davies, you told us in your evidence that the private sector has better accounting and costing skills than the public sector and bids based on due diligence, but we have heard from Professor Sturgess that contractors were bidding on stupid contracts, and Rupert Soames has admitted that some of Serco's contracts were ill advised. How can we reconcile these opposing points of view?

Paul Davies: Two things. When talking about outsourcing there is a huge range of what we are talking about, from short-term, smaller facilities management outsourcing to large-scale capital expenditure. My end of the spectrum is large-scale capital expenditure. When we do a large project, before any money is invested, a vast amount of due diligence, independent studies, cost reviews etc. are carried out because the lenders and investors will not put the money in until that has happened.

That never guarantees delivery, as Carillion has just proved, but it certainly gives a very high probability if that is the case. At the other end of the spectrum, bidding for some facilities management where you are trying to buy market share, I cannot comment but I suspect our answers are aimed at different parts of the market.

Q581 **Mr David Jones:** How can we ensure that outsourcing does not become too profitable for the contracting companies?

Paul Davies: At the moment the evidence is pushing in the opposite direction. In one of my recent papers I was saying that it is perhaps too much rather than too little. I would differentiate between two things within PFI—the money made by the financiers within the PFI companies being established, who have been past masters at passing risk ruthlessly down to contractors, and the money made by contractors. There has definitely been a difference between the two historically.

How do you avoid that? The answer is to make sure you have a competitive and sustainable market. At the moment when Government are very transactional in a lot of their relationships, pushing the lowest cost, sometimes you get what you asked for, so we have seen a reduction in the number of competitors because they have been too transactional. One thing Government need to think about is how to make that sustainable so that you have more competitors to choose from in the future.

Q582 **Mr David Jones:** Is that likely? Sir Amyas commented on the same phenomenon in the evidence you have just heard. Is it likely there will be new entrants into the market?

Paul Davies: For large-scale projects, not really because our contracting industry has been contracting. But for smaller-scale projects, absolutely so it may be aiming at that sort of level.

Q583 **Chair:** Mr Davies, in your evidence you say the public sector is overly focused on the transactional outcome, so the public sector is not focused on the health of the contracting industry but focused on who is the cheapest and who will accept the risk, to quote from your evidence, and you call for a more mature relationship with the industry. Can you explain what you mean by this?

Paul Davies: Yes. I advise a lot on choosing the best bidder, and naturally if you are working with a local authority or a Department with austerity kicking in they will always look for the cheapest. I can imagine, for instance, if you are doing contracts and Carillion is coming with a cheap bid it looks attractive, and you are not joining those up.

The question for Government is: should you just say the cheapest is the right answer when looking at a particular bid evaluation? Or should you give guidance, probably centrally, around taking on other factors like what is their governance, what is their long-term asset management regime, are they not going to refinance and pump out profits? Those are behavioural questions that might say you should choose a different bidder, and centrally, if we suddenly have 10 very well priced projects from a particular contractor are we building up our risk on one area, and can that guidance be overriden?

As Amyas said earlier, the trouble there is can you centrally override guidance that from a procurement angle would always push you to the lowest cost as the best value for money? It is not easy, and I am not pretending it is, because if you are at the local level you want the cheapest because you have a limited budget.

Q584 **Chair:** Are there any particular factors in the legal framework for contracting that militate against that kind of more positive behaviour you are describing?

Paul Davies: You are always looking for the best value for money, but the question is: what is best value for money? Normally price is the dominant factor, but you should consider things like robustness, commitment and long-term sustainability. There should be wider factors it allows for, but most people's interpretation of best value for money would be cheapest.

Q585 **Chair:** What do we need to do to the legal framework or the policy framework or the institutional framework to get the public sector to focus on the value for money and sustainability of the market together?

Paul Davies: I would give wider guidance on value for money, so examples of what it means in terms of sustainability, a review of the underlying contractors, guidance that would make people think of those wider factors.

Q586 **Chair:** What does that guidance look like?

Paul Davies: Guidance would be an update to the Green Book or else separate Treasury guidance, trying to say, "These are the models one can consider and these are the main considerations." You could do that by way of a paper.

Q587 **Chair:** Does anything like that exist?

Paul Davies: At the moment people use the Green Book and the business cases you have to prepare under the Green Book.

Q588 **Chair:** What about in other countries? Does something like that exist in other countries?

Paul Davies: That I do not know, I am afraid.

Q589 **Chair:** Is PwC going to write an example of this?

Paul Davies: Again, it is my ex-employer, so—

Q590 **Chair:** Where could we get an idea of what this guidance would look like?

Paul Davies: Some is in two extra papers I have done, but yes, just commission it from people to think through the subject. The key question would be: what is the objective of the guidance? What are we trying to achieve beyond just the lowest price? That could quite easily be written by people in the IPA in central Treasury if that is the brief, to widen out the basis.

Q591 **Chair:** If you wanted to propose that there should be this revised guidance, how could we get an idea of what it would look like so we know what we are recommending?

Margaret Stephens: The Green Book does require looking at all the costs and benefits, and it also requires looking at societal benefits that are not easily quantifiable, so the high-level principles are there. Probably more evidence is needed and more work done on how you calculate value for money. Under the Green Book you are supposed to look at the life of what you are trying to do, not just the short-term, although in their hurry that is probably what people have been doing.

Q592 **Chair:** That is more about skills and training.

Margaret Stephens: It is, yes.

Paul Davies: It is already permitted, but it is just about having more examples and people intelligently making those decisions.

Q593 **David Morris:** What do you think the advantages and disadvantages of PFI have been, with the National Audit Office finding that PFI costs more to the public sector than conventional procurement? The Government lack data on the benefits of PFI. How do you think that could be overcome?

Margaret Stephens: The advantages of PFI that have been rehearsed are the delivery on time to budget, and the other point the NAO makes is that a lot of expenditure by an NHS trust or local government would not have happened if they had not had the PFI available to them, so it has allowed projects to go ahead that could not otherwise have gone ahead.

There is an argument often made on intergenerational equity, that it matches the use of the asset with the life of the asset rather than paying up front. The other thing I would say in its favour is that it is tried and tested and a lot of work has been done. There are standard contracts, sharing of equity, sharing of refinancing gains. It has been well understood, although the generation of people who negotiated them has dissipated a bit.

Paul Davies: I will add that it is not at the moment trendy to say, but PFI has delivered over 700 projects to time, to budget, as it was set up to do, and it was there to make sure they were long-term and affordable projects. They delivered it with a degree of expertise not seen before.

The negatives that are now in the operational phase are that people look at the cost of capital, and the reason that was high was because of the high-risk transfer. They say it was so expensive we could have done it cheaper. Government's cost of capital is cheaper, but what are their delivery skills, would they have taken the risk and would they have done a life cycle?

At the moment there are not a great deal of people standing up and saying how marvellous PFI was, for reasons that escape me, but it has delivered a vast amount. It is still a model that can be used in particular circumstances where the private sector has the skills and you can transfer the risk. I have argued in other circumstances that we can look at different models with lower risk transfer and lower cost of capital, but there are horses for courses. It is still a model that works and you can use in certain areas, and certainly we are going to be using them in a few projects over the next few years.

Chair: Have you finished David?

David Morris: I just have one more question, Chair, but please carry on.

Q594 **Kelvin Hopkins:** The Government imposed a self-denying ordinance on themselves some time ago, saying we cannot borrow and we have to use the private sector to keep public borrowing down. But there is an enormous difference between borrowing for investment where there is a return that pays for itself and borrowing for revenue spending, which clearly cannot go on forever. The Government mixed those things up and did not distinguish them.

Margaret Stephens: It was Treasury and the Government who devised a method for deciding whether PFI projects would happen. The NAO has questioned the Treasury on this. The Treasury has defended itself. But that kind of issue is not the private sector's fault. The private sector will bid for whatever contracts are offered to it.

I think there is an issue that if the Government come to decide they are not happy with the outcomes of contracts they have put out to the private sector, to keep on doing it does damage the private sector because in the public mind they have come to be damaged and not trusted, when what they were doing was bidding in good faith for contracts that were offered to them under EU rules and regulations and they did everything they could have done.

Q595 **David Morris:** You both described in evidence different models that embrace a more long-term public sector ethos or use of Government-owned companies. Can you give us examples of these models and what has been learned about their advantages and disadvantages?

Margaret Stephens: It is very striking that Crossrail and the Olympics are seen as good examples, and they were outsourcing models. While they were using lots and lots of private sector contractors, they do not appear to have suffered from the lack of trust that can be the fate of the direct private sector contractor with Government.

One of the other noticeable things is the way that Crossrail and its chair, Terry Morgan, engage with the public and the media and politicians to explain and talk about the project—the good things, such as apprenticeships. Often that does not happen, so the media and the public do not have a very full, rounded view of the complexity of what is going on.

Q596 **David Morris:** How do you think the Government should decide which model is most appropriate in cases like this? Do they have some kind of measure of how to proceed or is it just luck, like the Olympics or Crossrail that were very well managed?

Margaret Stephens: A full range of models should be well set out and available to be used—the good things and bad things. I might have mentioned that Scotland has developed some models, not-for-profit type models, of something called a hub model that has a lot of consortia of contractors, a charity, and the private sector. It seems easier to hold public trust with these types of models, so there is a case for using them.

Paul Davies: You just asked for examples of things working well, but to give three quick examples: at Allenby Barracks, a £1.8 billion PFI procurement, the managers of the two sides sat in the same office throughout that contract and the working relationships were close and partnerial throughout. Birmingham Airport is majority-owned by the public sector but has private sector owners, and when they bought in, because I was advising at the time, we sent out a number of points of public sector ethos that we would expect them to look to, like long-term growth for Birmingham, expanding the airport and so on. They signed up to that public ethos and the partnership has been long and fruitful.

Again on a PFI, the M25 widening at the moment has been going successfully and it has been widened. They have just done a refinancing because once it has been completed they have been able to raise cheaper debt. They shared that refinancing gain with the Government, with benefits to the Government in the hundreds of millions, just a couple of weeks ago, so things can work well.

Q597 **Chair:** Moving on to the question of skills, everybody seems to say we need more professionals in government doing procurement. Mr Davies, you say that in your evidence, and Margaret Stephens, you say in your evidence, that there has been a hollowing out of expertise, rather contrary to what the Comptroller and Auditor General was saying earlier that things are getting better. What are the skills we lack?

Margaret Stephens: There are two points. I think it is impossible to turn the clock back. A lot of older contractors will remember the times when people carried long memories of how things were done. For the younger generation, I spoke to a young civil servant I know recently and I put this question to her. She said, "I don't want to do that. I don't want to be years in the same job. I want to move around". This goes back again to the data bank and the evidence, and I think Government need to be realistic. People are changing. They do not stay in jobs for so long. They move around a lot more. They expect that diversity of experience.

Q598 **Chair:** Can I just challenge you on that? I would describe it as chronic in the civil service, but the private sector does leave people in the same jobs for much longer periods. Why is the civil service not capable of managing that?

Margaret Stephens: Going back to David's question, with the Crossrail or Olympics models of publicly owned delivery, those kinds of structures could hold people in longer-term career structures with training. Sir Amyas mentioned John Manzoni's desire to build the functional expertise, the commercial expertise, the procurement expertise. These are important things to do.

Q599 **Chair:** You would have supported Bernard Gray's GOCO proposal for defence procurement to contract the whole thing out to a Government-owned company that would operate outside the traditional culture of Whitehall like a delivery authority.

Margaret Stephens: I would not say I would support it without having done my due diligence on it, but I think the Government are establishing the Submarine Delivery Authority, which is intended to do just that sort of thing. In procuring the next generation of submarines you need people to be in place for a long time. I think there are signs that the Government are being sensible there.

Q600 **Chair:** What skills should the Government invest in, and how should they invest in those skills?

Paul Davies: My view is that the Government have invested in pockets of excellence. You see the IPA; the DfT has a great corporate finance department, there is the Scottish Futures Trust, Transport for London, so there are excellent people around Government, a lot of them taken from the private sector, who are procurement specialists.

I would personally recommend not so much a GOCO but more just the Government recognising that as a profession across Government, and people could move within that profession across Government. That would lead to more sharing of ideas. You asked earlier about understanding better models and options. The more we share those skills across Government the better it will be, so make it a career across Government.

I believe that procurement people should sit in the Departments they are procuring for, however. I do not think we should have a central procurement unit in Treasury or something similar. I think their allegiance needs to be in the spending team, but maybe their career over time could be across Government so that those skills can be shared much more readily across Government.

Q601 **Mr David Jones:** The failure of private sector providers is obviously not unprecedented. What, if anything, do you feel the Government should be doing to safeguard against corporate failure in the future?

Margaret Stephens: I think the lesson has to be learned very hard about how you re-let contracts that are already held, the rights and information, and the communication plan that needs to be in place so that is building resilience. I think there is probably a point around over-dependency, in the sense that if very big providers that hold an awful lot of contracts go bust, that is a big, big risk for Government. It is a big shock, as in the case of Carillion.

On the other hand, however much due diligence you did of the balance sheet of Carillion, had the Government said, "We are not going to award you contracts because we are not happy with your balance sheet", the consequences of that for Carillion could have made it go into liquidation faster than it did. For the Government to be driving their suppliers—

Q602 **Mr David Jones:** Would that necessarily have been a bad thing if, in fact, Carillion had failed sooner than it did? The warning signs were there?

Margaret Stephens: For the Government to be agents of the collapse of one of their listed suppliers, I think that would be—

Q603 **Mr David Jones:** But surely the Government do not have to keep feeding contracts to a company that has shown all the signs of failure.

Margaret Stephens: I suppose it depends on the processes the Government have. When you are evaluating bids you are more likely to look at the delivery capability of, say, Carillion to fulfil its contractual requirements. As we said earlier, the balance sheet of Carillion was a separate matter.

Paul Davies: On my side I think there are three things that strike me. First, I saw questions such as, should Government try to predict corporate failure? I do not think, whatever resources Government puts at it, they will predict any better than the private sector will. Analysts, bankers and lenders to Carillion did not see it coming, and I do not think Government would probably do that any better.

Government can monitor exposure to particular suppliers, and clearly if they had done that, going back to an earlier question, if we suddenly have a large amount of exposure and we are seeing a lot of very competitively priced contracts coming in, we could pick up those signals and at the margin say, "Should we be awarding the next contract?" So not declaring them bankrupt and saying we are not doing business with them, but certainly being sceptical on new business—not feeding them, as you say.

Q604 **Mr David Jones:** So building resilience into the contract.

Paul Davies: The third point is exactly that. What Government should do and has done very well is build resilience into the contract. Take PFI as an example, in the case of Jarvis and most other cases but Carillion. The structure of the PFI company and the due diligence meant that one of the questions we asked as lender was, "If the contractor goes under, can we replace them and deliver the contract?" In most cases the answer has to be yes before they will lend, and that is exactly what you are seeing.

You see headlines saying the Government are picking up the can for Carillion, but the bulk of the losses have been suffered by the private sector in replacing those contracts. So Government are very good at putting in replacement clauses, both in short-term outsourcing and PFI. A lot of the time it has not cost them a penny. I am not saying it is free, because you are clearly doing lots of administration and things round the side, but the general PFI contracts have stood up to the insolvency of the underlying contractor.

Q605 **Mr David Jones:** Is there any room for improvement in the way the

Government build resilience?

Paul Davies: I am not trying to understate the problems of Carillion and the headaches, but in the greater scheme of things for what was a massive insolvency of the UK's largest contractor, the Government have managed it pretty well.

Q606 **Chair:** You think it is a forlorn hope that Government could forecast or monitor companies more effectively to avoid getting into a Carillion situation.

Paul Davies: I did not say that. I am saying: would it do it any better than the private sector when you already have credit analysts and lenders and so on poring over companies to look at their freights? I would not recommend spending a large amount to set up a credit department in Government to review that, when you could just read an analyst's report and you could see some alarm signals. As we said earlier, when they start either doing profit warnings or not paying, that must feed into your decision-making process.

Q607 **Chair:** What would happen if, say, in September or October the Government had said, "There are some more contracts coming your way, but you do need to recapitalise your balance sheet and we will award you these contracts conditionally upon a rights issue and some asset sales", or something? Do you think that is getting too involved?

Paul Davies: It is quite involved, but in the private sector one might have those conversations. What you have just described is quite a different way of behaving, but it is not irrational behaviour. You would not do that publicly because, as Margaret said, if that was announced publicly it would be disastrous, but privately having those conversations? Quite possibly.

Margaret Stephens: I think a step short of that is speaking to your major suppliers and saying, "We are really concerned about your balance sheet", because sometimes that conversation can, at the level at which Government have these conversations, have a big influence on the behaviour of chief executives and chief financial officers.

Q608 **Kelvin Hopkins:** Going back a bit in history, Jarvis went bankrupt, effectively, 12 or 14 years ago now, and I asked a question to the Prime Minister in Prime Minister's Questions, "Would it not be sensible to buy up the shares, which were then at junk levels, take all these PFI schemes into the public sector and save a lot of public money?" I did not get an answer, I have to say.

Chair: What should he have said?

Margaret Stephens: I do not know if that would have been a value-for-money thing to do. In the case of Jarvis, as Paul has already said, the investors really bore those losses. They became involved, and they reorganised the contracts of minimal disruption to the public sector. It all seemed to be recovered from well at the time, but not for the individuals and Jarvis.

Q609 **Chair:** Why do the Government not write into PFI contracts that, if the PFI contract promoter goes bust, the ownership of the PFI contract reverts to the Government?

Paul Davies: If I were a banker I know I would say whoopee-woo. If I am going to be repaid the money, why do I need to do all the due diligence and cost reviews if Government are going to pick up the bag? It is a key question about incentives. If Government write into the contract that it goes wrong they will pick it up, then—

Q610 **Chair:** I am not saying that, but very often in these PFI contracts the SPVs themselves have been kept viable, because the Government or the hospital or service user have carried on paying the contract. Therefore, the SPV itself has remained solvent. But the value of the SPV contract, which is usually inflated as a result—usually the riskiest part is building the hospital—is now going to be swallowed up by one of the usual suspects further concentrating the market and running off with the profits of some of these PFI contracts that were probably more lucrative than they should have been.

Paul Davies: There are two points there. First, Government carried on paying mainly, they would be advised, because they carry on delivering the service, because the whole point is that they are incentivised to quickly find a replacement. If you are saying you could build into contracts the option for Government to say they would provide the replacement, I can see no reason why that could not, in theory, be something that could be written into a clause. Whether or not, come the time, Government thought they had the in-house capability to do that is a different question, but I cannot see why as an option Government could not build that in as long as you are letting them off the hook. If you let them off the hook you will get what you pay for.

Chair: Thank you very much indeed. Your evidence has been extremely useful. I am confident we will come up with some perhaps not particularly newsworthy recommendations, but very worthy recommendations, in this report we are going to produce. I am very grateful to you for coming today and for your written evidence.