

Public Administration and Constitutional Affairs Committee

Sourcing public services: lessons to be learned from the collapse of Carillion inquiry

Introduction

Private Finance Initiative (PFI) was introduced in the UK in the early 1990s on the basis that such reforms would improve the efficiency and effectiveness of public sector service delivery in areas such as hospitals, roads and prisons, with the private sector being considered best placed to manage these projects.

PFI requires a long-term arrangement where a public sector can purchase construction of public infrastructure, often with post-construction supply of services, from a private sector supplier. A long and detailed contract is entered into, often running for 30 years or more, in which the public sector makes annual payments based on the performance of the private sector supplier in delivering the contracted services. While PFI is the term often used in the UK, in other countries PFI-type infrastructure models may be referred to as, for example in Europe, Public Private Partnerships (PPPs).

Recently, Carillion, a major infrastructure and service provider to the UK Government, got into financial difficulties and was subsequently declared bankrupt. This raised a number of questions about governments' approach to public procurement in general and in particular with regards to PFI policy and the assessment of operational difficulties and deliverables. One of the main issues raised was "risk management" in PFIs and the transfer of risk from government to the private-sector partner. In this reply to the Inquiry I will focus on the risk management issues.

PFI Risk Management in the context of Carillion Inquiry:

Critics of PFI contracts often argue that PFI contracts are usually more expensive than traditional public-sector procurement and therefore do not represent value-for-money for tax payers. In response to this criticism, governments typically highlight that this is because the private sector accepts many of the risks that were previously the responsibility of the public sector and the "extra cost" is the price paid for the risk transferred from the public sector to the private sector. However, it can be very difficult to distinguish between risk and uncertainty and, in particular, how uncertainties are incorporated into risk. In the case of Carillion, it was also unclear what risks and uncertainties were transferred to the company as these overlapped and made it difficult to assess what risks were ultimately being left with the public sector (i.e. tax payer). Risks can be quantified but uncertainties are more subjective and difficult to value.

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There are fundamentally four main stages when PFI contracts in terms of value-for-money and risk need to be scrutinised and assessed. The first is at the time of signing the contract before the infrastructure is built; the second is after the infrastructure is built; the third is during the operational phase; and the fourth is the final stage of the project when the project terminates and the assets (and liabilities) are transferred back to the public sector. Usually large contractors will have a number of projects in different stages at any time.

My comments regarding the Carillion case will consider each of these stages in turn, together with “value-for- money” and “risk” issues.

Initial Contract Stage:

In the context of Carillion, it is contended that one of the contributing factors to the failure of the company relates to the lack of a competitive bidding market at the outset of PFI projects. While acknowledging that this may be a significant factor resulting in weaker companies winning PFI contracts, unless the risk management issues are clearly resolved between the private and the public-sector partners at the beginning of the project, the competitive bidding process for these projects will be unhelpful in enhancing value-for-money as each party will struggle to estimate the relevant costs and risks associated with the project.

In the Carillion case, given the size of the company, together with the number and value of PFI contracts it has been awarded, there were complexities involved in risk transfer. It appears that Carillion avoided disclosing the total risk that the company was exposed to given the complex structures of its PFI operations. Carillion also avoided risk by transferring risks through Special Purpose Vehicles (SPVs) that have independent financing arrangements to their subcontractors. This is supported by Demirag, Khadaroo, Stapleton and Stevenson (2011) who found that both debt and equity financiers of PFIs had little appetite for holding risks and they preferred to diffuse these to others through a complex web of subcontracting arrangements and insurance mechanisms.

The Carillion case therefore raises a number of issues, including:

- To what extent current accounting standards support the disclosure of risks where these are managed by SPVs and transferred to subcontractors or third parties?
- What are the current governance rules of SPVs and to whom are the SPVs accountable?
- Should SPVs prepare financial statements (individual and consolidated/group) and should these be audited as part of the main contractor’s company financial statements?
- Should the remit of “commercially sensitive information” be reconsidered in terms of PFI-risk disclosure by the main contracting companies in their annual accounts?

In 2017 the Government announced its intention to develop new corporate governance reporting requirements for large private companies to enhance transparency and accountability in these companies. Given recent events, SPVs should also be included in such reporting requirements.

In the case of Carillion, the public sector could be criticised for failing to provide sufficient resources to manage PFI risks effectively in their large infrastructure projects as, for example, it appears that public-sector departments (individually and/or collectively) were unable to assess the total risk that Carillion was exposed to. The management of risk between public-sector departments (e.g. health, housing, prisons and transport) could also be better coordinated and risk assessed and managed more effectively. In the longer term the public sector could invest in risk-management expertise under the Treasury to manage PFI risks more effectively and efficiently, thus increasing value-for-money for new PFI contracts.

After building the infrastructure:

Once the infrastructure is built, the construction risks are minimized and the value of the contracts changes based upon the discount factor used in estimating future cash flows. Re-financing of the projects can therefore provide opportunistic gains if these projects are sold to other interested parties. However, without properly understanding and allocating the risks at the contract stages, it is difficult to estimate the value of the contracts; thus it is unclear how the gains would be shared by the public sector if these were sold to other companies.

Given that the public sector, and in particular local authorities, is keen to complete unfinished projects following to collapse of Carillion, estimating the value of these unfinished projects can be complicated in the context of existing contracts.

Operational stage:

Risks can be identified and become more significant over time in PFI contracts as the perceptions of stakeholders may change during the operational phases. The role of contracts as formal documents and regulatory devices may be weakened and relationship issues may become more pronounced between the public and the private sector partners. In the Carillion case, attention has been chiefly drawn to risk management issues in the contracts, with behavioural, social and political considerations, such as broad societal benefits in the PFI operational process, have been largely ignored.

I will focus here on one area where research into the post-operational phase of PFI contracts is particularly relevant to how Carillion managed its overseas operations and may have contributed to its failure (see Ahmad, Connolly and Demirag, 2018). Good communication and collaboration between public and private sector partners is needed not only in the planning and procurement stages but also in the operational stages of

the PFIs – this could enable partners to gain continuous insight into each other's mission and issues, leading to trusting relationships. Ahmad, Connolly and Demirag's (2018) findings on how trust practices are used for achieving project objectives through managerial strategies could have had a significant impact on Carillion's project outcomes overseas. Carillion could have implemented management control strategies involving better collaboration, joint working and greater exchange of information (i.e. trust practices) with its overseas partners, together with the UK public sector without whom it is difficult to achieve the desired outcomes.

Final stage of project termination:

There are only a few projects at this stage and these are mainly located in Australia. To the best of my knowledge none of the UK projects has reached this stage. Based on the experiences of Australian projects, issues regarding termination risk of projects will need to be considered at the beginning of the project. However, due to uncertainties, as mentioned before, it is difficult to incorporate these uncertainties into contract risks at the beginning of the project as they will evolve over the life of the PFI project. In the case of Carillion, the company taking over the PFI projects from the company will need to carefully consider these risks and uncertainties and develop flexible and trustful approaches to managing contracts with their public-sector partners in order to deal with the uncertainties.

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References:

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