The rise of the "public services industry"

A report for UNISON by Paul Gosling

Updated June 2011

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Executive summary

1. Introduction

- Governments of all three major political parties have engaged in a radical experiment in recent years – the "marketisation" of public services. The experiment began with Margaret Thatcher and has continued under all successive governments.

- That "marketisation" has created a multi-billion pound "industry", generating massive profits for a narrow group of giant companies.

- Previous public service "marketisations" have led now to a service crisis, in particular with the risk of the collapse of the residential care sector. This is a serious warning of what could happen to the NHS if it is opened to market forces and private sector engagement as has happened with social care.

2. The rise of the "public services industry"

- Private companies have in recent years played a major role in investing in public assets and infrastructure under the Private Finance Initiative (PFI) and Public Private Partnership (PPP) deals. They also provide IT, facilities management and back office functions. Increasingly, they are providing public services directly.

- A number of factors have led to the expansion of this market – including restrictions on public sector investment , the cap on NHS and other public service spending, an ageing population's increased demand for elderly people's services, outdated health and education infrastructure and the need to comply with stricter European environmental legislation.

- Key players in the "public services industry" have been banks, infrastructure funds, private equity houses, consultancy firms, multinational corporations, "third sector" enterprises, and a new breed of "multi-service" firms focused on winning government contracts.

- The Government's public sector white paper, due for publication in the summer of 2011, is expected to propose extending the range and scale of private sector provision of public services, to the point where businesses might potentially provide any public service.

- The Government's so-called "Right to Provide" will encourage staff to form mutuals or social enterprises to contract with their existing employer as independent businesses. In practice, this is likely to lead to joint ventures with private investors, who will take profits from the delivery of public services.

- Cutting public spending is portrayed as an unavoidable necessity to pay for the crisis in the public finances. That crisis was caused by banks, property developers and regulators, not by the public sector.

- One factor in that crisis was the speculation by investors in buying-up public sector assets. As these were re-sold and re-mortgaged they became over-priced. Eventually the devalued assets were worth less than the outstanding loans. Revenues also declined, causing borrowers to default. Many of those bad loans were made by Royal Bank of Scotland and Halifax's investment arm, now part of the Lloyds Group – banks that had to be bailed-out by the Government.

- The inflated valuations of former public sector assets therefore became a factor in the collapse of the public finances. Although not on the scale of the securitisation of dodgy mortgages, these misjudgements were symptomatic of a wider malaise in the banking and investment sectors, for which society as a whole is suffering.

3. Social care: the "marketisation" experiment that went badly wrong

- Social care is in turmoil through central government underfunding and the privatisation of services to companies.

- Private sector providers – including many operated by private equity houses focused on short-term financial returns – now dominate much of the social care 'market place'.

- The two largest providers of residential care services are Southern Cross and Four Seasons: Southern Cross is at serious risk of business failure and Four Seasons is also in severe financial difficulty.

- Southern Cross accommodates 31,000 residents and Four Seasons accommodates 17,500 residents. If these companies collapse, local authorities may have to make emergency arrangements to keep the homes operating and their residents protected. The councils have no funding for such emergency interventions.

- The Care Quality Commission, which regulates the sector for the Government, has found that care services provided by the public sector are consistently of higher quality than those provided by the public sector.

- There have been serious problems with the quality of services provided by some of Southern Cross's homes: one has been closed down and others prevented from receiving new residents because of service problems.

- Councils have responded to cuts in grant from central government by tightening the criteria for the elderly and disabled to receive support in their entitlement for residential care and other social care services.

- Part of the reason for the financial crisis of private sector providers of care services is because of the funding cuts introduced by local authorities, resulting from central government austerity measures.

- Thousands of vulnerable people dependent on care services are unsure of their future care arrangements.

4. The private equity “merry-go-round”

- Private equity investors have had a core role in transferring public sector assets into commercial activities.

- Public sector assets have been bought by private equity investors, amalgamated with other public sector assets and then resold at often vast profits.

- Finance has been obtained for short-term deals, leaving the operators vulnerable in the credit crunch and recession, unable to refinance.

- Downturns in demand, along with the Government’s austerity programme, have brought some privatised providers of key public services to the edge of collapse.

- Private equity tends to be a short-term holder of assets, seeking fast returns on investments. This encourages sometimes repeated transfers of ownership, undermining service continuity.

5. An expanding – and highly profitable – “industry”

- The market is dominated by a few highly profitable companies.

- Some of these operate across many different market segments.

- Leading companies operate internationally, learning from their initial experience in the UK.

6. The Icarus factor: companies that fell to earth

- While some companies have been very successful, others have been failures.

- Even some of the largest public sector contractors have gone bust.

- The reality is that the public sector must step in to protect key services.

- Public bodies then have to pick up the pieces and meet the additional costs.

7. Policy influence

- The “public services industry” has spent significant sums of money creating a **sympathetic environment** for increased privatisation. This has helped produce a climate where there is little opposition within the main political parties to its growing role.

- **Lobbying organisations** such as the CBI Public Services Strategy Board, the PPP Forum, the Business Services Association and the NHS Partners Network have developed close relations with government and the media.

- The industry also devotes considerable sums to **sponsoring research** that supports its role, through bodies such as the Serco Institute and the Aldridge Foundation, and by direct funding of "think tank" activities.

- Contractors have recruited many **former government ministers and senior civil servants** as directors and advisors.

- The "public services industry" plays a direct role in **government policymaking** through bodies such as Infrastructure UK and as policy advisors.

8. A very imperfect market

- Public service delivery markets are undergoing a process of **consolidation**, creating risks of market dominance and manipulation.

- While "marketisation" is promoted as a means of achieving lower costs and higher quality through competition, the reality is often that in sectors such as care home provision there is little or no actual competition – leaving public sector commissioners and service users **vulnerable to exploitation**.

- Although promoted as a means of avoiding capital expenditure, private investment in public infrastructure generates additional costs through higher ongoing **fees and charges** for services.

- **Transaction costs** generated by the complicated process of tendering, bidding, contracting and monitoring are substantial.

- Public services are generating **high levels of profits** for PPP/PFI consortia and private equity houses – often far beyond what might be regarded as "fair" returns on investment.

- Pressure to extract profits and pay dividends to shareholders can persuade contractors to prioritise cost-cutting at the expense of investment and **service quality**.

- Public service delivery contracts are **inflexible** and costly to alter, making it harder for services to respond to changing needs or revised policy priorities.

- Public bodies can be poor clients, which do not properly monitor contracts – undermining public service **accountability**.

- The claimed advantage for PFI and PPP of **risk transfer** is entirely notional – contractor failure must ultimately be bailed-out by the taxpayer, as major schemes cannot be allowed to fail.

- Reliance on **debt finance** by PFI, PPP and private equity investors heightened the exposure of key services and the Treasury to economic risk resulting from the collapse of the global financial markets and the subsequent increase in costs of finance.

- Some privatised public services have been subject to repeated **transfers of ownership**, leading to uncertainty for services users about the continuity of provision.

9. Conclusion

- Public services developed initially as a result of the inability of the market to provide essential services to vulnerable and poor citizens – the ultimate expression of market failure. Now the supply of public services through a private sector "public services industry" leaves service users dependent on profit-oriented businesses and vulnerable to new market failures and inflated charges.

- The increasing privatisation of public service delivery often fails to produce value for money for taxpayers or service users. It also increases the government's financial exposure and the risk of personal catastrophe for vulnerable service users.

- Reductions in public service regulation, such as the abolition of the Audit Commission, leaves taxpayers and services users even less protected from exploitation.

1. Introduction

The Coalition agenda

The Coalition Government will produce its eagerly awaited Public Service White Paper in summer 2011. It is widely reported that it will contain two important elements:

- One is that the private and voluntary sectors will be permitted (and probably encouraged) to bid to run any service that is currently in the public sector.

- The second is that there will be a "Right to Provide" – under which employees in any public service will be supported to bid to take over the running of their service as a public sector "mutual". However, it does need to be stressed that the term "mutual" has no clear and undisputed meaning. Judging by the first practical example of the initiative in practice – the conversion of the "My Civil Service Pension" service into a mutual – it seems that the preferred model involves employee participation, profit sharing and joint venture equity invested by a private equity house, or other external investor.

But while the white paper is intended to accelerate the trend towards public service privatisation, this is a journey that began many years ago. In parts of the old public sector, the privatisation destination has already been reached.

The example of social care

The privatisation of social care services is arguably the most extensive outsourcing of a public service yet undertaken in the UK. It has taken place for the most part under the public radar – yet the experience is one that has valuable lessons for politicians, government and the public.

The experience has been so bad that it is legitimate to describe the current state of social care services as in crisis. Some of the leading private sector providers of key care services are at risk of collapse. The public are increasingly forced to pay for services that were in the past free of charge – leaving many of our most vulnerable citizens without access to services that were considered as essential and fundamental to our understanding of the "welfare state".

In fact, "privatisation" now has a second meaning in the context of social care. It is not merely that the delivery of public services has become a responsibility of the private sector. The financing of previously public services has now in many cases also become a private responsibility, falling on those receiving the care and their families. Even worse, a government consultation has raised the possibility that almost all existing social care duties – including the assessment of care needs – may be removed from local authorities.

This is a far reaching and very disturbing extension of the concept of "privatisation".

Even using the more limited understanding of the term "privatisation" – the outsourcing of service delivery – social care has already gone through a massive service transfer in recent years. In the 1980s, 90% of local authority-commissioned care services were provided by the public sector. Today, the bulk of these care services are provided by the private sector.

The result of this transfer of responsibility should worry everyone who receives or pays for public services. The quality of care has to a large extent decreased, while the cost of care for service recipients has increased to a similarly large extent. Some service providers have gone bust, leaving vulnerable service users without continuity of care or provider. Other service providers – including the industry giants **Southern Cross** and **Four Seasons** – are clinging on by their finger nails.

This picture of service failure and the risk of lack of service continuity could be replicated in much of the public service landscape, if the Government's White Paper proposals are enacted.

There is a deep-seated irony attached to the recent history of this service externalisation. It is that the collapse of the banking sector has justified the argument that public service costs must be cut. Yet the privatisation of public services has played a (comparatively small, yet significant) role in the collapse of the banks.

Both **RBS** and **HBOS** loaned vast sums to companies that took over care homes. Yet the value of those care homes subsequently fell severely. In some cases, the banks have repossessed properties, taking heavy losses in the process. In other cases, the same banks had to write-off or write-down the value of the bonds they held in the care companies, or convert debt into equity – with the risk that they may never obtain a return on their loans (or even the return of their capital).

Eventually the Government had to step in to cover their losses, including those incurred by the banks for their role in the privatisation of public services. According to press reports, some of the social care companies that have hit financial difficulty have approached the Government for financial support to keep going. In so doing they are trying to recover the money lost because local authorities had their central government grant cut substantially.

The reality of public service "markets"

While the Government talks of its objectives of introducing competition to public service provision, it is important to contrast this with the reality of the public service "market place". One of the reasons why many of these services were provided by the public sector in the first place was that they are natural monopolies, into which it is difficult, sometimes impossible, to introduce, or maintain, competition.

Hospitals are an obvious example. A region may have only one local hospital and patients want to be treated locally. The concept of competition by providers on the ground may be impractical. It can be a similar picture with care homes: how many care homes can one small town or village accommodate? And even in larger towns, the dominance of individual care providers can invalidate the concept of competition. Where competition does exist, the motivation may be cost reduction, rather than service standard improvement.[1]

Yet the reality is that much of the motivation to open-up public services to the private sector is driven by external factors. One is that the UK has become an international leader in the provision of public service outsourcing. Companies such as **Serco** and **G4S** have become highly diversified, both in terms of the services that they operate and the countries in which they operate.

The Government is keen to assist UK companies experiment with public service delivery in Britain so that they apply the lessons in other countries, thereby generating export earnings.

According to the DeAnne Julius review of the "Public services industry" (PSI), completed in 2008 for the previous government, private sector providers of public services by then had a turnover of £79bn.[2] That figure is already out of date: the review of the sector by the industry body, the Business Services Association, reports that turnover has grown by 5.3% a year in the period 2007/8 to 2010/11.[3] That would put the value of the sector at the beginning of the 2011/12 year at over £97bn.

Despite the impact of the recession, the supply of public services by the private sector is now set to grow even more substantially. The Government's white paper – repeatedly delayed, but now due for publication in Summer 2011 – will (according to leaks) propose that all public services will be subject to possible privatisation.

The need for scrutiny

Yet there is little independent evidence about the value of privatisation. What we do know – and this is heavily documented by the National Audit Office and various House of Commons select committees – is that the use of the Private Finance Initiative has often led to a vast waste of money.

The key research project that that has informed the Government was led by DeAnne Julius – who stood down from her role as a director of public service industry giant **Serco** to take on the job.

Similarly, the firms advising government are open to accusations of conflicts of interest. Accountancy "Big Four" firms PwC and KPMG have in recent decades become consultants that advise public bodies, but they are now also generalist business service providers. Those services include KPMG supporting the move into GP commissioning for the NHS, through hands-on support services, having won two major contracts in this area of activity. PwC has won large contracts in the provision of welfare-to-work services. This is despite PwC having advised government on welfare-to-work policy.[4]

Other firms used by the Government as consultants have similarly turned into service providers – particularly **McKinsey**. It is especially worrying that McKinsey has become a leading provider of services, given that its advisors include Sir Michael Barber – who was arguably the most powerful prime ministerial advisor under Tony Blair on public sector reform. Other key advisors have moved into the private sector in positions that directly call upon their previous experience in the public sector.

Even the politicians themselves are subject to suggestions of conflicts of interest. Several senior ministers – including Alan Milburn, Pat Hewitt and David Blunkett – have gone on to take key roles with public service providers after they left ministerial office. Some permanent secretaries have done the same.

It is legitimate to ask whether sufficiently rigorous examination has been applied to the principle of public service externalisation and the financial and social costs associated with it.

2. The rise of the public services industry

The provision of services to the public sector has become a massive industry, particularly in the UK, which is described by government as *"a global leader in opening up public service markets to competition"*.[5]

The Labour governments of Tony Blair and Gordon Brown oversaw a revolution in the delivery of public services. While they increased funding for public services, they also allowed a free market to develop in much of the service delivery.

Some of this was inherited from the privatisation drive of Margaret Thatcher and John Major – in particular in the social care sector. But Blair and Brown took this even further, especially in the use of the Private Finance Initiative (PFI) and the related concept of Public Private Partnerships (PPPs).

With restraints on public borrowing imposed by government in response to pressure from the European Union and the markets, the Governments chose to use "back door", or "off-balance sheet" sources of finance. These arrangements have much the same effect as borrowing funds – the money still has to be repaid – but by treating the finance as delayed revenue spending for the acquisition of services (which includes the use of assets), the Government has been able to carry out an accounting fiddle that hid the costs from the public borrowing figures.

The resulting PFI and PPP contracts have stimulated a massive new industry of private sector contractors to finance schemes, build facilities, manage them and provide cleaning, catering and other services. But the costs associated with paying for the infrastructure are much higher than if Government simply borrowed the funds to directly pay for the infrastructure improvements.

Government IT, facilities management and back office functions are now far along the privatisation journey. The justification for transferring these functions is that they require significant investments that the public finances cannot afford.

Direct services to the public are also widely open to private sector provision. Social care is now a "market" dominated by private sector care providers – many of them owned by private equity firms. Leisure services and waste management are increasingly provided by the private, not the public, sector. Healthcare, school support and higher and further education all have a much increased private sector involvement. Recent reforms to the higher education sector, and the introduction of high tuition fees, is opening the door to a big expansion in private sector provision of higher education.

What is a public service?

The definition used by Oxford Economics in its survey of the public services market was: *"public service delivery and supporting services to public sector delivery organisations"*.

The European Union's services directive (2006/123/EC) refers to *"services of general interest"*, which include education, social protection, security, criminal justice and local government services such as refuse collection. Healthcare, social services and social housing are not included under these terms. The directive helps liberalise the cross border supply of services, creating a common internal market.

Estimates of the size of the public services industry vary according to which sectors are included in its definition. DeAnne Julius's 2008 review for government estimated total spend in 2006-7 at £79bn – representing between a quarter and a third of spending on public services. The Business Services Association has estimated subsequent growth in the sector at 5.3% per annum, which would put spending in 2010/11 at over **£100bn.**[6]

In addition to this, vast expenditure is committed to Private Finance Initiative and Public Private Partnership projects. While there is a capital build element to PFI and PPP schemes, a large proportion of the contract costs also involve the transfer of public service delivery into the hands of the private sector.

According to the PPP Forum annual review for 2010, "Over 800 PFI projects are now operational with a capital value of £64 billion".[7] The capital and revenue elements combined of PFI and PPP schemes are now substantially above £100bn. As well as being a very substantial liability, this also limits the capacity of current and future governments to alter spending priorities. Much of their future revenue spending is actually pre-determined by a previous administration – just as future governments' expenditure is committed by the current administration. This raises serious questions about the democratic legitimacy and accountability of these decisions.

Despite being critical of PFI in opposition the coalition government has committed to 61 new PFIs with a total capital value of £6.9 billion and Lord Sassoon, Commercial Secretary to the Treasury, has told the PFI industry that *"PPPs will continue to play an important role in Britain's future infrastructure"*.[8]

2.1 Growth drivers

A number of factors are leading to the expansion of the public services market. As the Julius review stated, *"the demand for public services in the UK is growing faster than the economy as a whole"*. These pressures are creating major business opportunities for private companies.

- The **financial crisis** caused by the banks and the developers, which led to banks being rescued by the Government and then led to a fiscal crisis. The Government responded by saying that many services must either be cut, closed, or privatised at lower cost.

- **Ideology** is driving the current government: it wants public services to be delivered by the private sector. This is evident with the so-called "free schools". The model appears to be that parents bid for money, get approval for a new school and then engage a private company to run the school on contract. The same ethos is evident with higher education, where the introduction of very high tuition fees is intended to drive competition against existing universities from new private sector institutions.

- **Restrictions on public investment** imposed by the European Union and, indirectly, by pressure from the markets mean that the Government has turned to private investors to finance improvement of public assets and infrastructure and for the significant investments needed for IT and communications services. The focus has been on finding "off-balance sheet" financing – a ruse that artificially reduces the official level of government borrowing. The result is that even more finance is actually committed by future governments, as the cost of finance is increased.

- There is a continuing **growth in the elderly population,** which is rising by over 1.5% per year.[9] Demographic factors appeared to make social care a very attractive sector for private equity firms. The number of beds in care homes is expected to increase despite falling public funding of social care – forcing more people to self-fund care.[10]

- The **capping of healthcare spending by the current Government**, combined with demographic pressures and the high rate of healthcare inflation, means that it is looking for private sector providers to take over healthcare and cut overheads**.** It will also create the opportunity for the expansion of the private healthcare sector, as more patients look to avoid longer waiting times as healthcare cuts bite. While Government spending on the NHS rose from £40bn in 1999 to over £127bn today,[11] the failure to match higher healthcare costs with continued funding increases at the same rate means, according to the Office for Budget Responsibility, that the NHS will have £1bn a year less to spend in real terms.[12] Private equity house **Bridgepoint** has reported that *"According to forecasts from the OECD, Britain will be spending almost £1 in every £8 of its GDP providing healthcare services by 2050, nearly 50% more than in 2005 … Such expenditure growth offers prospects for very high financial returns."*[13]

- Increasing **environmental concern** is creating new growth sectors. The last government sought £10bn in private sector investment to create a viable infrastructure to meet obligations imposed by the EU landfill directive. *"There are abundant opportunities in the UK for companies that provide waste management and treatment technologies and services. This is because the collection, management, recovery and disposal of waste is increasingly contracted out to private sector companies."* [14]

3. Social care: the "marketisation" experiment that went badly wrong

The crisis in social care

The social care sector is in turmoil. Specifically, the two largest providers of residential care homes – **Southern Cross** and **Four Seasons** – are both in desperately weak financial positions and it is unclear whether they will be able to continue trading.

What has gone wrong for Southern Cross and Four Seasons is a stark example of why the "marketisation" of social care has led to chaos, but it is also a warning of what might similarly happen as the NHS is increasingly opened to market forces.

Markets do not operate perfectly. They rely on the ability of entrepreneurs to predict future events and invest according to those predictions. Sometimes the assessments and predictions made by entrepreneurs are proven wildly misplaced. This is what led to the banking crash – and to the near collapse of Southern Cross and Four Seasons.

Both companies borrowed heavily to finance large-scale expansion and sector consolidation. Subsequently, government cuts to local authorities led to reductions in demand for residential care places and councils' reduced financial capacity to pay care home fees. At the same time, private payers had less ability to pay fees because the value of their homes – which are often sold to pay for residential care – fell substantially.

Across the social care sector, there is a consistent picture. Services that used to be provided by the public sector are now provided by commercial businesses. In the mid 1980s, 90% of social care commissioned by local government was supplied by councils' own staff. Now the proportion is nearly reversed. Today, the vast majority of care services funded by councils are provided by the "independent sector" – mostly the private sector, but some by charities. It is one of the most comprehensive public service privatizations ever conducted in the UK – possibly the largest of all.

There are several factors that sit at the heart of the severe problems that now afflict private sector social care providers – and, consequently, put at risk the vulnerable people who rely on care services.

- Some of the companies borrowed too heavily, with the financial performance of the companies too weak to repay borrowings on agreed terms.

- Demand for care services has not risen in line with expectations. One reason for this is the desire of more people for domiciliary support, rather than residential care.

- Local authorities have lost much of their grant funding from central government and have cut spending on social care services.

- In the case of Southern Cross, it separated the operation of care homes from ownership of the homes – committing itself to continued uplifts in rent, which became unaffordable when revenues fell.

- The collapse of the property sector meant that care home owners in many cases had borrowed more than what became the depressed value of their properties.

- The collapse of the banking sector meant that it became impossible for some providers to renew borrowing facilities on favourable/affordable terms.

These factors are typical of the problems facing many businesses. But they highlight the way in which public services become vulnerable and damaged as they transfer into the private sector.

It is inevitable in the private sector that while some businesses thrive, others fail. The problem for those dependent on public services is that when a provider fails it can lead to enormous distress, as well as the disruption of vital services. The closure of a care home in which perhaps fifty elderly people can no longer live cannot be compared to the closure of a café, the customers of which will simply use a neighbouring outlet.

Quality concerns

> *"Nine out of 10 (91%) people used good or excellent services provided by the private sector, compared with 98% from council-run services and 95% from the voluntary sector."*
>
> **The Care Quality Commission**[15]

Just as significant as a cause for concern is the quality of provision in the private sector. Independent reports have found that public sector care tends to be of higher quality than private sector care: presumably because the profit motive drives down costs more aggressively in the private sector. There is evidence that low wages drive a higher turnover of staff in privately run care facilities, undermining the personal connections that lie at the heart of quality care provision.

Specifically, independent inspection reports of some care homes operated by Southern Cross have criticized the quality of care.[16] A Southern Cross care home was closed because of poor operating standards, following criticisms by the regulator.

Case study: Southern Cross Griffin Care Centre, Luton

Care homes are regulated by the Care Quality Commission. The CQC took urgent action in January 2011 to close down Southern Cross's Griffin Care Centre in Luton *"to protect the safety and welfare of residents"* as the regulator *"judged people living in the home to be at risk"*.

Southern Cross closed the home: the CQC would otherwise have taken legal action to do so. The home's 57 residents were moved to other care homes, by arrangement with Luton Borough Council and NHS Luton. Failings regarding the management of medication that were previously identified by the CQC were found on subsequent visits not to have been resolved. During the visit that immediately preceded the CQC's action against the centre, inspectors found that medicines were being given together in breach of instructions on the labels and the

inspector had to intervene to prevent this happening. Homes closures are only required in extreme circumstances.

The Care Quality Commission[17]

The impact of personalisation

The personalisation agenda has accelerated the move away from public service provision, reducing the role of public service commissioners. Service users increasingly commission services themselves through direct payments or vouchers.

Personalisation is promoted as a means to provide greater choice and flexibility for individual services users. However, the grim reality behind personalisation is that its introduction is incompatible with the funding cuts being adopted across the country. What personalisation does achieve, in practice, is a lack of focus on the scale of those service cuts – which are too diffused to attract public, or media, attention.

The government recently announced new legislation will be introduced to tighten-up legal requirements for local authorities to promote and communicate Direct payments to carers. The consequence of this will be that service users through local authorities will commission less collectively and block contracting may not be guaranteed, making smaller and even some specialist providers more vulnerable to being sustainable.

Rather than diversify the market, personalisation and cuts combined appeared to have provided less choice in the range of personalised services locally.

The impact of the cuts

There are many disturbing examples of the cuts in care provision and support from local authorities.

- Some one in five **independent care providers** says that they don't believe they will survive the cuts in 2011 and will close due to reduction in fees offered by councils and the move towards councils contracting smaller numbers of providers.[18]

- **Councils have rationed the number of providers that they are willing to fund due to economies of scale.** The recent example in Aylesbury where funding of 40 organisations was reduced to six is not uncommon.[19]

- **Service users and providers (some care homes) are legally challenging** fee cuts and winning cases on the grounds that they have contravened the Disability Discrimination Act.[20]

- **Voluntary and community providers** receiving less funding making their provider status unsustainable. In adult care, some councils have ended contracts with voluntary providers of day centres, in part because of the personalisation agenda. A recent survey of care workers found that more than half had seen closures of services in their areas.[21]

- **Increased rationing of care packages** being offered by increasing cost prices or by raising the criteria threshold to access public fund.[22]

- **Meals on wheels services** being closed or privatised, increased prices and use of frozen meals which are delivered less frequently.[23]

- **Day care centres** are closing, including specialist centres. There is difficulty in making use of these services, because of the enforcement of direct payments rather than using a mixed personal budget of cash and local services.[24]

- **Community care transport** closure of services or rationing of service or difficulty of accessing services due to direct payments being provided rather than personal budget or fee to use the service introduced.[25]

- **Staff cuts in in-house frontline** roles and functions of care are being introduced. In particular the remaining 20% re-enablement social care teams are being merged or integrated with local health services often as social enterprise models.[26]

- **Some local areas cannot cope** with care demands due to lack of staff and the fact that personalisation has not delivered a care market place. In fact the opposite appears to be happening, with a decrease in diversity of providers.[27]

- **Some local authorities have stopped** transferring service users to contracted companies due to the high volume of complaints and the fact that companies were not properly staffed.[28]

- **Vacancies** are not being filled in vital care functions such as adult social workers and occupational therapists needed to assess the elderly and prevent long periods of bed blocking.[29]

- **Reduction in local agreement conditions** have led to care workers taking further cuts in pay and conditions by removing car allowances and unsociable/overnight pay etc. Some authorities are asking workers to stay on call at home without getting paid unless they get called out.[30]

- **Wages have gone down and turnover has gone up:** the average pay for care works is now £6.00 ph compared to £6.75 two years ago and the turnover rate of care workers in the private sector is now 25%.[31]

- **Financial targets for the reduction in workforce numbers in the public sector have led** councils to rush ahead to privatise remaining in-house services and staff without going through proper legal re-employment or TUPE transfer agreements.[32]

Turning care into a private responsibility

Not only is the private sector increasingly responsible for the delivery of social care services, but far too often payment for care is only available privately – from those who receive care, or their families.

A study by the Association of Directors of Adult Social Services in April 2011 found that only 18% of English councils (26, out of 148) now pay for social care for their citizens in "moderate" or "low" needs. A year before, 28% of councils paid for such needs. Those losing out include people who have difficulty because of illness or disability in bathing themselves, or preparing a meal.

In addition, some 19 authorities had made it more difficult to obtain free adult social care, by redefining the criteria for support. Some six councils will only provide support for people in "critical" need – such as those with life threatening conditions.[33]

Despite the state of crisis in which the social care sector is now in, things are likely to get even worse. The Department for Communities and Local Government has been consulting on local authorities' responsibilities in relation to social care: there has been speculation that this could leave vulnerable service users entirely dependent on the private sector, plus welfare benefits.[34] But there are doubts about whether local authorities have evaded their statutory responsibilities in the way they have already cut social care support, following a legal judgement recorded against Birmingham City Council.[35]

The funding review of social care, chaired by Andrew Dilnot, is expected to recommend private insurance top-ups, to go alongside reduced government funding. This could lead to less regulation of the sector, with lower pay rates for staff, more use of unqualified personnel and unregulated care workers. This would damage the residential care, nursing care and domiciliary care sectors. The quality of social care has already been damaged by reductions in the standards and frequency of inspection visits by regulators.[36]

3.2 Market trends

The social care sector has been transformed in recent years.

Residential care for the elderly

Residential care has mostly moved out of the public sector. In 1990, nearly 200,000 of the almost half a million beds in residential care homes were owned and run either by local authorities or the NHS. Now just 31,000 residential care beds are provided directly by local authorities and most of those that are left are expected to close in the near future.[37]

The public sector is set to withdraw further from directly providing care services, leaving an ever higher proportion of provision in the private sector. Yet falls in occupancy rates in the care home independent sector in recent years – to 89% in 2010, and to 87.5% in the nursing home sector – undermine the viability of even the very largest homes providers.[38] These use a business model that typically requires at least 90% occupancy to even break-even.

Laing & Buisson projects a 1.4% increase in publicly and privately funded older care home residents in the UK over the next five years, from 418,000 in 2010 to 424,000 in 2015, despite pressure on council finances from cuts in government grant. The number of older residents in private and voluntary homes is projected to grow by 4.4% from 382,000 in 2010 to 399,000 in 2015.[39] These trends threaten to cause substantial challenges to councils' ability to pay for social care – and other services.

Laing & Buisson predicts that local authorities will increasingly try to transfer care costs to the NHS – adding to other cost pressures facing the health service. There has been an average annual reduction in the number of residents paid for by local authorities of 3.1% over the last five years, in part because the NHS has taken over financial responsibility for more placements.[40]

The trend for people to live longer in their own homes and at an older age – avoiding or delaying the use of residential care homes – may have peaked. As older people live longer, there is a growing probability that towards the end of their lives they will not be able to care for themselves. The financial and social benefit of reducing the use of care homes may therefore just have been a short-term gain. In the year to April 2010 the number of older care home residents funded by councils and the NHS combined fell by just 0.5%.[41]

Local authorities have cut their payments to the operators of private sector nursing homes in real terms. Councils increased their payments to home operators by 0.8%, in a period in which care costs rose by 2.1%. Average fees in 2010/11 were £693 per week for nursing homes and £498 for residential homes. Care home owners have been squeezed, either operating at a profit, or passing on cost increases disproportionately to private payers.[42]

Further difficulties have been caused to care home owners by local authorities (and the elderly themselves) preferring support for people to live longer in their own homes, only moving to residential care when they are in advanced stage of infirmity. This has led to people in residential care needing higher levels of staffing support; blurred definitions between residential and (higher cost) nursing care; shorter stays in residential care (residents may live there for short stays in their dying days); faster turnover of residents; and lower levels of occupancy.[43]

Some 40% of residents in care homes are private payers, with 52% paid by councils and a growing proportion – now at 8% – of places paid for by the NHS. Residents in affluent areas, particularly the Southern home counties of England, are most likely to be private payers, with costs funded from the value of selling their own homes. About 28% of places shown as council funded actually make personal financial contributions to costs, through third party top-ups.[44]

The value of independent sector care provision has now reached £7.7bn a year.[45] This figure may now fall because of spending cuts imposed by central government, which could lead to reductions in the number of people supported by care services and cuts in operating margins. This could lead to increasing numbers of independent sector providers going out of business.

There will be an increase in demand for an additional 18,000 elderly people needing residential care, predicts BUPA. However, it also predicts that 81,000 existing residential care beds will be removed from the market as a result of funding cuts from central to local government, unless there is ring-fencing of grants. BUPA says there will be a shortfall of around 100,000 beds by 2021, creating a "bed-blocking" crisis in NHS hospitals.[46]

Care for adults with learning disabilities

The independent sector plays an even larger role in the care home sector for adults with learning disabilities, where it has an annual turnover of £2.7bn.[47]

Most day care for adults with learning disabilities is now provided by the independent sector. It has a market share of 57%, with annualized growth of 20%.[48]

The independent sector supplied 69% of the market for care homes for people with learning disabilities or mental illness and 47% of their non-residential care; and 37% of fostering services (figures as of 2007).[49]

Care for children

Residential care for children is in the process of moving from the public to the private sectors. More than half (54%) of children's residential care places are now provided by the private sector.[50] Charities operate more than 10% of care homes for children. Some of the largest operators of homes are owned by major private equity houses, including **Sovereign Capital** and **3i**.

- The private sector generates annual revenues of £587m from the children's homes it operates.[51]

- The value to the independent sector of fostering services has grown by 20% in two years and has now reached £548m.

- The independent sector generates revenue of nearly £1bn from running special schools and colleges.

- Policy development on the care of vulnerable children has encouraged children to move out of care homes into foster care. This has promoted a rush of aggressive private investors into the foster care sector: private equity firms now control 30% of the independent foster agency market. One of the largest agencies, the National Fostering Agency, is owned by Sovereign Capital.

Mental health hospitals

- The independent sector has become increasingly important as operators of mental health hospitals, now providing 27% of beds, at a value of £1.3bn a year.[52]

Social work

New attempts are being made to move adult social work into private practices – there are currently six pilots in England, modelled on the existing children's social care private practices – and these are giving rise to concern. These can become social enterprises, vulnerable to market forces and attempts to worsen pay and conditions such as fair deal in pensions. The result would be that adult social workers would be on worse pay and conditions in these sectors which would be likely to increase the turnover rate.

Demographic impact on demand

Demands for social care are increasing, despite cuts in central government funding to councils to pay for it. Sir Derek Wanless's review of social care for the King's Fund predicted a 54% increase over the next two decades in the number of older people with a high level of social care need.

People with disabilities – including many children born with profound disabilities – often live much longer now as a result of improvements to healthcare technologies. This has knock-on effects on the social care system. *"The number of people with learning disabilities is expected to rise by 20.6% between 2005 and 2041, from around 203,000 in 2005 to around 245,000 in 2041."*[53]

"The number of younger people with physical and sensory impairments will rise by 17.4% between 2005 and 2041, from 2,755,000 to 3,235,000."[54] *"The number of older people unable to perform at least one daily activity, such as eating, bathing or dressing is expected to be 2.4 million in 2041. The number of disabled older people is expected to rise by 108% to 4.95 million by 2041."*[55]

3.3 The care home providers

Southern Cross is the UK's largest care homes operator with over 750 homes across the country, in excess of 31,000 residents (at one point it catered for 37,000 residents) and 41,000 employees. By the company's own admission it is in serious financial difficulty. The business was bought in 2004 by the **Blackstone** private equity house, which floated it on the stock exchange a mere two years' later, generating a 400% return on its investment. Blackstone conducted a major restructuring of the company, including separating the operating company from the ownership of the property – the so-called op-co, prop-co division. This restructuring was central to the subsequent severe financial problems that continue to beset the company, along with a commitment to 2.5% annual rent increases to landlords – which include its rival Four Seasons and NHP, owned by the Qatar Investment Authority (which is also part owner of Four Seasons).[56] Southern Cross became unable to cover its rising fixed costs as income dropped. The first serious indications of financial difficulty emerged in 2008, when it warned that it was at risk of breaching its banking covenants. It has since reported a series of losses, and in 2010, following the publication of the Comprehensive Spending Review, the company warned than a previously predicted return to profitability had been undermined by a reduction in the financial capacity of local authorities to pay care home fees: 80% of residents have fees paid for by councils. But tight council finances were not the only reason for a disastrous reduction in bed occupancy rates. The company said another reason was what it described as "inadequate service delivery". Between March 2010 and the end of August, the value of Southern Cross shares fell from nearly £1.60 per share, to less than 20 pence. (It stood at a mere 6 pence at the time of this report's publication.) In 2007, shares had traded at £4.57 after the acquisition of a rival care homes provider. With a risk of collapse hanging over the company, it is unclear what will happen to the tens of thousands of residents. The company claims that local authorities would in these circumstances take over responsibility for the homes – presumably at substantial and unplanned cost to the councils. Southern Cross

remains, at the time of publication, a PLC, but negotiations with private equity firms to take the business private again have taken place. It remains likely that the company will collapse.[57]

"During the last several months, it has been a difficult trading environment for all care providers as commissioners such as Local Authorities grapple with the consequences of major budget cuts. Southern Cross has been particularly affected because of the type of lease arrangements which underpin our business model.

"On the 14th March we released a statement which said that our rent obligations had become unsustainable and we planned to seek concessions from our landlords. I believe it is in the interests of landlords to reach an equitable solution with us to help stabilise our business and create the conditions for new investment to come into our homes.

"Our plan is to seek to renegotiate the terms of our leases by July of this year. Whilst we cannot guarantee success, our banks are supportive of us and I am encouraged by the feedback from commissioners, residents, relatives and other stakeholders as they work with us to shape our future."

Statement by Jamie Buchan, Chief Executive of Southern Cross Healthcare, 15 March 2011

"Southern Cross is a low margin business and the progressive squeeze on its revenues over the last 12 months, while facing many upward pressures on its costs, means Southern Cross is now in a critical financial position and cannot afford to meet its future rent obligations in full…..

"Over the coming weeks the key stakeholders will need to agree on a comprehensive package to restructure Southern Cross' financial affairs so that a new, stable and sustainable corporate and business model can be developed and introduced to underpin the continued successful operation of Southern Cross' homes. In the view of the Directors there are reasonable grounds for believing that such an outcome can be secured and it is the responsibility of all stakeholders to work to that end."

Statement by Christopher Fisher, Chairman of Southern Cross Healthcare, 19 May 2011, when announcing interim results showing a pre-tax loss of £310.9m in the six months ending March 2011.

Four Seasons is the UK's second largest care home provider and it has had financial problems on a similar scale to those of Southern Cross – again raising doubts about its viability and capacity to continue trading. Four Seasons owns and operates over 400 nursing and residential care homes and specialist care centres in the UK, Jersey and the Isle of Man. It accommodates over 17,500 people and employs over 21,000 staff. A specialist division, the **Huntercombe Group**, caters for people with mental health, addiction, brain injury, neurodisability, learning disabilities and children with special needs. Four Seasons was majority owned by the **Qatar Investment Authority** (initially via the **Three Delta** fund), which bought into the sector to

exploit what was predicted to be a highly profitable growth business. Instead, Four Seasons has repeatedly hit serious financial trouble and has had to renegotiate debt with bondholders when unable to make repayments. Four Seasons avoided business closure or change of ownership by renegotiating £600m of debt in August 2010, giving it another two years to arrange a longer-term debt restructuring. Government-owned **Royal Bank of Scotland** became the largest shareholder in Four Seasons as a result of excessive and unwise lending to the care homes operator, financing large scale property acquisitions. RBS took a 40% ownership stake, in exchange for writing-off £300m in debt. The restructuring was made possible by RBS agreeing to withdraw from the process of renegotiating the terms of the deal on the debt with other lenders and foregoing voting rights. At that time, RBS held large stakes in both Four Seasons and one of its main competitors, **The Priory**.[58]

BUPA provides nursing and residential care to more than 29,000 residents in over 430 care homes in the UK, Spain, Australia and New Zealand. It had to write down £249.2m on the value of its assets in 2010, though still achieved a trading surplus of £118m on a turnover of £7.5bn. The write-offs reflected reduced valuations on its businesses, **Health Dialog**, **Bupa Home Healthcare** and the **Bupa Cromwell Hospital** in London. The write-downs were the result of health reforms in both the UK and the US. BUPA has just completed the sale of its domiciliary care business **Guardian Homecare** to **City & County Healthcare** (owned by private equity house **Sovereign Capital**). Guardian Homecare employs around 400 people operating from five regional offices in south east England, Lancashire and Northern Ireland. BUPA described the business as "non-core". BUPA also recently sold its protection and risk insurance division to insurance consolidation operation **Resolution** for £165m. BUPA said the sale was part of a process of rationalisation to enable it to focus on healthcare businesses, including health insurance products. [59]

Barchester Healthcare is the fourth largest operator of residential care homes in the UK, running over 200 homes, accommodating over 10,000 residents and employing over 14,000 staff. It acquired **Westminster Healthcare** in 2004. It is privately owned by a consortium of well-known Irish entrepreneurs: John Magnier, JP McManus and Dermot Desmond. They took a dividend of £363.5m in 2008, but, according to the *Financial Times*: *"the owners had to pay back some of that money after an interest rate swap went against them and the company faces difficulty with a high debt load"*. It took a risk in separating the business operations from the ownership of the property, for which they had to borrow heavily and the business model appears to now be working against the company. There are rumours that the company could be sold to a private equity firm.[60] Magnier, McManus and Desmond are also joint owners of another residential care company, **Castlebeck**, which provides residential care for adults with learning disabilities. According to the BBC Panorama programme, there were widespread instances of physical abuse of residents at a Castlebeck home at Bristol. The company said: "We are deeply distressed by the completely unacceptable and appalling behaviour of a small number of our employees at one of our facilities."

The Priory runs rehabilitation clinics, specialising in acute mental health care, including the treatment of celebrities' addiction problems. It also operates more than 50 nursing care homes, including for people with dementia, and has about 6,000 employees. The Royal Bank of Scotland was left with a majority stake in the business, after calling in guarantees on non-serviceable loans. Despite the general problems in the sector, the Priory reportedly remains profitable. The Priory Group was established in 1980 when a US healthcare company bought

the Priory Hospital, Roehampton. Subsequently, the Group was enlarged by the acquisition of other hospitals, enabling it to specialise in the provision of acute mental health care services and rehabilitation. This was extended to the delivery of specialist education services with the purchase in 1993 of the **Jacques Hall Foundation**. In 2000 Priory was acquired by **Westminster Health Care Group**; in 2002, it was bought by its own management, with the support of **Doughty Hanson** private equity; in 2005, it was acquired by the **ABN AMRO bank**. When ABN AMRO was acquired by the **Royal Bank of Scotland** in 2007, it became wholly owned by RBS. In January 2011, RBS sold the business to **Advent International** for £925m. Advent is a private equity firm that specialises in healthcare investments.[61] [62]

The home care and day care market is worth about £4bn a year**.** Key players in home care provision are mostly small firms, while day care is provided by housing associations and small firms. Many councils now have no direct home care support service. According to the former Commission for Social Care Inspection (CSCI), *"since the 1990s, councils have steadily increased the proportion of home care purchased from independent sector providers, and the independent sector has grown exponentially. The percentage of home care hours delivered by the independent sector increased from 2% in 1992 to more than 73% in 2005."* CSCI described the sector as a *"cottage industry with many small, inexperienced providers delivering (on average) 500 hours/week of care"*, but notes that *"there are signs that the sector is beginning to consolidate, as a result of councils' decisions to purchase from fewer providers and the competitive tendering processes they use."*[63]

4. The private equity "merry-go-round"

Private equity firms are the wheeler-dealers of company investment. They look to buy companies cheaply; make their operations more "efficient"; perhaps merge with a rival to spread overheads and reduce competition; and then sell on as quickly as possible, for as much as possible.

This is not the approach of every private equity house, but it is the strategy of many. Some are seen as highly aggressive in the way they cut costs, sack staff, move headquarters to tax havens and use their financial clout. Many private equity firms see major profit opportunities from the long-term demographics of rising demand for health and social care services and through buying public assets cheaply and turning them into profit-generating businesses.

Sometimes, returns are phenomenal:

- **Blackstone** obtained a 400% return in two years on its acquisition and then stockmarket flotation of **Southern Cross**, which is now at risk of collapse.

- **Allianz Capital Partners** made a return of nearly 100% by acquiring **Four Seasons** in 2004 for £775 million, selling it four years later for £1.4bn. The business subsequently collapsed in value.

- The **3i** private equity fund bought a 38% stake in **Care Principles** for £1.5 million in 1997, bought the remaining equity from managers in 2005 and sold it on to another private equity firm in 2007 **Three Delta** (then part owned by **the Qatar Investment Authority**, a sovereign wealth fund**)**, for £270 million. 3i says that the deal achieved a return of 390% on its investment. But the company hit serious financial difficulties under Three Delta's ownership and was unable to repay the debt used for a leveraged buy-out. It was taken under the control of its main lender Barclays Capital in 2009.[64]

- **Bridgepoint Capital** specialises in the social and health care-related sectors. One of its portfolio companies was **Tunstall**, which helps elderly people continue to live at home. It was acquired by Bridgepoint in 2005 for £225 million, merged with another Bridgepoint investment, and sold on after three years for £514 million.[65]

- **Sovereign Capital** achieved a growth in value estimated to be in the region of 100% after buying specialist care homes provider **Tracscare** for £26 million in 2004, followed it by acquiring another four care businesses for an estimated £20 million and then selling the enlarged group for around £200 million. It is in the process of building-up its presence in the domiciliary care through its ownership of the fifth largest provider in the sector, **City & County Healthcare**, which is undertaking a programme of acquisitions of other businesses in the sector. The firm has also built a significant presence in the special needs schools sector, through its **SENAD** operation; in independent schooling, through Alpha Plus; and is strengthening its provision of higher education, through **BIMM**.[66]

- Private equity finance has been heavily involved in the buying and selling of the **waste management** operators. Their objective appears to have been short-term ownership to

cut costs, improve operating margins and then to merge with competitors to improve economies of scale and market presence. According to analysis by Public Services International Research Unit at the University of Greenwich, average private equity ownership of the waste management companies has been a mere 2.3 years. [67] Profits on the deals have been significant for the firms – investments of €3.5bn have yielded returns of €2.5bn, equating to average returns of 69% in less than two and a half years. Total returns are underestimates as they exclude holdings retained by **Terra Firma** in part of the **Waste Recycling Group**, which is estimated to be worth £900 million. If this potential profit is included, private equity firms would have achieved an approximately 100% return on capital.

There are several reasons for concern about the involvement of private equity firms in the ownership and operation of public services.

- Acquisitions are usually financed by highly leveraged borrowings. This makes the terms of a deal potentially unaffordable over the longer term, when interest rates rise, when borrowing terms have to be renewed, or when finance becomes less available.

- Private equity ownership can be very short-term.

- Private equity owners operate by maximising value, often to re-sell at the highest price in the shortest time. This can put pressure on staff costs and service standards.

- Taxpayers have had to bail-out banks – specifically RBS and Halifax (now part of Lloyds Group) – that loaned too much to private equity speculators against over-valued assets. Taxpayers have consequently been participants and losers in a process of unsustainable public service asset inflation.

- Private equity ownership is high risk and can lead to service vulnerability.

- Some private equity houses that have acquired public sector assets have been advised by former ministers and senior civil servants – suggesting serious potential conflicts of interest.

- Some key public services have been subject to repeated transfers of ownership between private equity houses, and sometimes involving flotation on the stock exchange and even, potentially, then being taken private again by private equity investors.

- Many of the key private equity investments have been made by sovereign wealth funds, representing investment funds of foreign governments. There is an argument that key public service infrastructure in the UK should not be owned by an overseas government.

THE PRIVATE EQUITY EFFECT

- Private equity buy-outs lead to rapid job cuts, redundancies and a weakening of the terms and conditions of employees after buyouts.

- A study by **Birmingham Business School** and the **University of Bologna** revealed that in comparison to a control group, job losses at UK private equity owned companies were 7% higher one year after takeover and rose to 23% higher after four years.
- The **World Economic Forum** examined 300,000 US PE-backed firms from 1980 and 2005 and found that employment in PE owned companies declined sharply in relation to the control group after buyout, and was 7% lower after two years. Five years after buy-out, employment levels were over 10% lower in PE owned companies than they would have been had they developed in the control group.
- The **Centre for Management Buy Out Research** and **Nottingham University Business School** found that buy-out firms had significantly lower annual wage growth than non-buy-out firms. The study also revealed that the larger the company, the greater the downward pressure on wages.[68]
- TUPE – the Transfer of Undertakings (Protection of Employment) Regulations 2006 – does not apply to takeovers that take place through a transfer of shares, including in private equity buyouts. This leaves the workforce vulnerable with reduced protections. Workers' rights to information and consultation is also undermined, as their interests are not taken into account or protected. The TUC wants to see TUPE extended to share transfers. This would ensure that workers in companies being taken over by private equity funds will be informed and consulted about the proposed takeover plans. It would also guarantee that their terms and conditions were maintained after the buyout and that any redundancies carried out solely because of the buyout would automatically be unfair.[69]

4. An expanding – and highly profitable – "industry"

Key sectors

Construction and "hard" facilities management
Key players: **Serco**, **Morrison**, **ISS**, **Rentokil Initial**, **Carillion**, **MITIE**, **Interserve**, **Mitie**, **Balfour Beatty**, **Integral**, **Laing**, **Amey**, **Caxton**, **Operon**, **GSL**, **Wates**, **Amec**, **Bovis**, **Costain**, **Skanska**
The increase in PPP/PFI DBFO (design, build, finance and operate) contracts has been one of the main factors creating growth in the sector, with particular demand in the education, health and police sectors.[70] The facilities management sector is divided into two: hard FM and soft FM. Many of the construction companies are involved in the provision of hard FM services such as building maintenances, engineering and landscaping.

Support services and "soft" facilities management
Key players: **Compass**, **Mitie**, **Spectrum**, **ISS**, **Rentokil Initial**, **Aramark**
Health has been a key growth area for the contract cleaning market in recent years.[71]

ICT, business process and corporate services
Key players: **Capita**, **BT**, **Serco**, **SBS**, **HBS**, **Vertex**, **Atos Origin**, **Liberata**, **IBM**, **Fujitsu**, **EDS**, **Steria**
The market for support or back office services is one of the most developed in the public sector, and is being further developed as part of the drive to make savings through "shared services" initiatives that allow government departments, local authorities and other public bodies to achieve economies of scale by pooling "back office" functions. According to the Business Services Association the outsourcing industry generates a combined turnover (in the public and private sectors) of about £14bn a year, employing about 340,000 people.

Schools
Key players: **Amey**, **Costain**, **Skanska**, **Bovis**, **Capita**, **Mott Macdonald**, **Balfour Beatty**
The "free schools" initiative of the Government is likely to see a big increase in the management of publicly funded schools by commercial businesses. While parents take the initiative in proposing new schools, there is a limit to the extent to which the parents themselves can run the schools.[72] Under one pilot model, the parents buy-in all management and administration services from the private sector. Yet this follows a troubled experience of private sector involvement in schools, not least because of weaknesses in the capacity of the public sector to efficiently tender and manage contracts with businesses. The Building Schools for the Future (BSF) programme was funded at £2bn to £3bn a year, but a review conducted by Sebastian James (head of **Dixons Retail Group**) for the Department of Education concluded that the scheme cost about 30% too much because of the way in which buildings were commissioned. The programme was abandoned by the coalition government, which has drastically cut back on school building and wants to restrict local determination of design.[73]

LEA outsourcing
Key players: **Serco**, **Capita**, **Tribal**, **Amey**, **Nord Anglia**, **Cambridge**
There is a growing sector of private sector managers of "failing" local education authorities and schools. The Bradford, Hackney, Haringey, Islington, Leeds, Southwark, Swindon, Walsall and Waltham Forest LEAs have all been outsourced. So too has the management of the London

comprehensive school Salisbury, which has been outsourced to the US company **Edison**. These same companies are likely to be the leading providers of management and administration services to the so-called "free schools".[74]

Tertiary education

Key players: **INTO (part of Espalier), Kaplan, IBT, INSEARCH, A4E, Capita, Centre for British Teachers (a charity), VT (part of Vosper Thorneycroft), BPP, Cambridge Education, Pearson.** Private sector involvement in higher education in the UK is *"the fastest growing privatisation in Europe"*.[75] The Government's introduction of high cost tuition fees of up to £9,000 a year was driven, to a large extent, by its wish to attract private sector suppliers into the market to compete with established universities. Some 83 "alternative providers" of degrees were approved by the Government, making students at their courses eligible for student loan support.[76] In the period 1995 to 2004, private sector investment in tertiary education grew by 85%, while public spending grew by a mere 6%. The private sector now pays for 30% of investment in UK higher education, compared to an average of 16% across the EU. The nature of private sector involvement in tertiary education ranges from operating feeder colleges for university entrance; running higher education colleges as private companies; providing language tuition to foreign students at higher and further education institutions; joint ventures to provide vocational training; the design, build, operating and financing of halls of residence; joint ventures for exploiting university research; and private sector financing of university research. UCU has expressed concerns that further education colleges may be tempted to convert into private companies, following comments by Ioan Morgan, principal of Warwickshire College, who said: *"Some colleges could opt-out and try to become private companies. Why not?"* There is already an established history of the private sector as leader of vocational training – the Government's now abandoned Train2Gain programme involved making all adult vocational training being subject to private sector competition. In addition, there are an increasing number of private sector organisations that are accredited providers of degrees and other qualifications. **Buckingham University** was established in 1976 as a private sector university and approved in 1983 by the Privy Council to issue degrees. The **College of Law** – like Buckingham University, private but not for profit – was given permission by the Privy Council in 2006 to award law degrees. In 2007, two colleges owned by **BPP** were approved by the Privy Council to award law and business degrees and postgraduate qualifications.[77] **BPP** says that it is better able to concentrate on education provision because it is not also a research institution – which appears to conflict with the Government's objective of increasing British research skills. There is likely to be a big increase in private sector provision of higher and further education in the coming years. **BPP** is owned by the **Apollo Group**, an international US-based provider of higher education, which is 20% owned by the **Carlyle** private equity house. It was taken private by **Apollo** in 2009, having previously been a PLC.[78]

The future of universities?

"We ... want to make it easier for new and alternative providers to enter the new system – and there are clear ways in which we are doing so", said higher education minister David Willetts.[79] In another speech, Willetts said: "It is healthy to have a vibrant private sector working alongside our more traditional universities"[80].

Waste management
Key players: **Veolia**, **Biffa**, **SITA**, **Shanks**, **FCC (Waste Recycling Group)**, **Cory, Enterprise, May Gurney and Greenstar.**
More than half of waste management responsibilities have been outsourced by local government to the private sector. The Government is seeking significant additional private sector investment – £10bn over the next decade according to UKInvest[81] – to create a viable infrastructure to divert biodegradable waste from landfill to meet the requirements of the EU landfill directive. Despite fears about the long-term safety and health effects from incineration, the waste to energy sector is growing quickly. The Government also wants to see private sector leadership of small scale power stations that provide heat and electricity to local areas.

Consultancy
Key players: **IBM**, **LogicaCMG**, **Accenture**, **PA**, **Capgemini**, **Mott MacDonald**, **PwC**, **Atos Origin**, **KPMG**, **Deloitte**, **Steria**, **Tribal**, **McKinsey**, **Booz Allen Hamilton**, **Grant Thornton**, **Ernst and Young**
Since 2001 the use of external consultants in government has grown substantially. Kable notes that while there are *"a number of initiatives"* aimed at reducing dependence on external consultants, *"progress in most of these areas appears to be slow"*. **PwC**, **KPMG**, **Ernst and Young**, and **Deloitte** have played a central role in advising on and auditing PFI and PPP projects.[82] Several of the consultants have been involved in direct provision of services, for example, **Accenture** has provided IT services to government departments (very unsuccessfully in the case of the National Insurance Recording System) and several have provided business process outsourcing (BPO) services. One of the most serious concerns about the way in which the consultancy sector works is the fact that some leading consultants both provide advice to clients, but are also potential delivery agents in outsourced programmes.

Primary healthcare commissioning
Key players: **KPMG, McKinsey, PwC, United Health**
The abolition of Primary Care Trusts is leading to GPs taking on the additional responsibility of commissioning secondary healthcare. Some consultancy firms are moving into this market to supply administrative support to GPs, along with information systems that provide guidance to GPs on their decisions. **KPMG** and **McKinse**y have moved into key roles in this developing market. The **KPMG** Partnership for Commissioning won one of the first contracts to support the development of the early waves of pathfinders across NHS London: its partners are the National Association of Primary Care (NAPC), Healthskills, Primary Care Commissioning (PCC), **United Health UK** and **Morgan Cole**.[83] **McKinsey** is reported to have been engaged by at least 25 consortia of GP commissioners, supporting them with meeting efficiency targets, budget holding administration and governance arrangements. **McKinsey** was previously involved in controversy in its role as advisor to NHS London, when it recommended reducing the time patients were permitted to spend with GPs as a means of saving costs. **PwC** has won a contract with the NHS central commissioning body to advise which GP consortia are ready to take on local commissioning.[84]

Secondary healthcare
Key players: **Circle, Alliance Medical**, **Netcare**, **Care UK, Clinicenta, Nuffield, Partnership Health Group, Ramsey, Spire.**

A big increase in healthcare spending by Tony Blair's government was accompanied by a move to increase the involvement of the private sector in healthcare delivery and commissioning. Government policies encouraged the use of the private sector as alternative suppliers of healthcare services. Independent Sector Treatment Centres took over some of the work streams for simple elective surgery from the NHS, charging significantly higher fees. The work and payment structure attracted to the UK some of the largest healthcare corporations from the United States, South Africa and Canada. It is reported that discussions are taking place to privatise the NHS Blood Service – with **Capita** and parcel delivery company **DHL** the most likely companies to be awarded contracts.

The future of healthcare?

Mark Britnell was the NHS Director General for Commissioning and System Management, until he left to become global head of health at KPMG – which is winning contracts to advise on healthcare commissioning systems. He told a conference organized by private equity house Apax Partners – a leading investor in companies seeking to win contracts from the NHS – that the Government's Health and Social Care Bill will lead to a recasting of the NHS. "In future, the NHS will be a state insurance provider, not a state deliver," said Britnell. NHS will offer "business opportunities post global healthcare reform", adding that: "The NHS will be shown no mercy and the best time to take advantage of this will be in the next couple of years." Britnell is also widely described as a member of David Cameron's 'inner cabinet' of advisors on NHS reform.

Housing

Key players: **Places for People**, **Home Group**, **Anchor**, **Sanctuary**, **London & Quadrant**, **AmicusHorizon**, **Circle Anglia**.

In 1981, 30% of all homes in the UK were council housing. That has probably fallen to significantly less than 10%, with a higher proportion of social housing now owned and managed by housing associations.[85] The decline of council housing has been driven by Margaret Thatcher's "right to buy" policy, which has been described as the "biggest privatisation of them all",[86] and the growth of housing associations, with councils under pressure to sell off their council homes to housing associations, under large-scale voluntary transfers (LSVTs). Councils have been given financial incentives to sell and have found their ability to finance new social housing strongly restricted, creating pressures on them to agree to housing associations providing the required additional housing stock. While some housing associations see themselves as part of the voluntary or third sector – with many, for example, belonging to the Social Enterprise Coalition – others see themselves as businesses, whose difference from a PLC is merely that they do not distribute profits to shareholders. These trends have also been accompanied by a "marketisation" of social housing rents – increasing rents to market levels. Spending on subsidies on the building of council homes has been cut from £5.6bn in 1980/81 (at 2002 prices) to £0.2bn in 2002. However, as rents have increased and subsidy on the building of homes has been cut, so more public spending has been diverted to the payment of housing benefits.[87] In total, over three million council homes (3,089,277) were sold by local authorities, either through right-to-buy or as transfers to housing

associations, between 1979 and the end of the 2006/7 financial year. **Connaught** was one of the largest private sector organisations involved in the social housing sector: its services included property management for public sector clients. The company went bust in late 2010, putting nearly 10,000 jobs in jeopardy. The FTSE250 company accumulated £220m in debts, after public spending cuts meant its business was no longer profitable. Its market value on the stock exchange had reached half a billion pounds, but it lost 90% of its value in the run-up to administration.[88]

Custodial services
Key players: **G4S**, **Serco**, **Sodexo, GEO, Reliance, Kalyx.**
The private sector operates 10 prisons, two young offender institutions and seven immigration removal centres on behalf of government departments. The growth in use of the private sector reflects, in part, the big increase in the prison population under the last government – rose by a third, from 60,000 in 1997 to 82,000 in March 2008.[89] The private sector now manages 11.6% of the current prison capacity in England.[90] The commercial value of the sector is likely to increase substantially in coming years, as the work of the Probation Service comes under greater competitive pressure. The electronic monitoring of tagged offenders created a £100 million a year sector, the main beneficiaries of which are Securicor and Serco (through its Premier division).

Leisure services
Key players: **DC Leisure Management**, **Esporta**, **Greenwich Leisure**.
Many local authorities have ceased running their own leisure centres – either outsourcing their operations, or selling them off. DC Leisure Management runs several council contracts. Esporta, at one point owned by the private equity firm Duke Street Capital, has bought underused council leisure centres in several parts of the country. An alternative model preferred by many councils is to support the creation of trusts to take over the leisure centres. As charities they have two advantages over council services: they do not have to charge VAT, so that the full service charge can be used as income, and they are exempt from council rates (which, ironically, a council must pay on its own operations). It has been estimated that over 40% of local authorities have externalised their leisure centres to trusts or social enterprises.[91] However, trusts must compete to win and retain contracts against private sector bidders. There are growing concerns that as the first round of leisure trust contracts come to an end, many of the trusts will fail to retain contracts. The move to trust operations could therefore become in effect an unintended privatisation in two stages.

Museums and libraries
Local authorities' management of museums and libraries are two of the latest services to come under the scrutiny of the private sector. Southampton City Council is one of a growing number of authorities that has put out to tender the management of its museums.[92] Wokingham council plans to outsource the management of its 11 libraries.[93]

Key players

> *"A number of firms are emerging who are specialists in the general art of government contracting, and pursue contracts across a wide diversity of sectors … Clearly such firms have no initial expertise and therefore no particular substantive value added to offer within a new field … What they possess rather is a specialist skill in winning and possibly managing government contracts from politicians and civil servants."*
>
> **Professor Colin Crouch, Warwick Business School** [94]

Multi-service companies

Public sector services are delivered to meet a need. Now many companies deliver public services as economic activities, often despite them having no prior expertise and as part of a commercial strategy to deliver public services on contract across a wide a spectrum of activities as possible. This has meant there has been a significant growth in multi-purpose outsourcing supply companies:

- A leading example of the approach to generalist public service delivery has been **Capita**, which began as a small division of the public sector accountancy institution CIPFA. After Capita was spun off, it expanded quickly and diversified beyond its initial purpose of carrying out data processing contracts for public sector clients. It now describes itself as *"the UK's leading outsourcing company"* and carries out a wide variety of IT, human resource management, income collection and treasury management services. Capita also administers the congestion charge in London and has diversified into other markets, such as support for the turnaround of failing schools.

- The trend towards multi-faceted but public service-based contracting is clearest with **Serco**. It has contracts with a large number of central government departments, with local authorities and for facilities management under PPP/PFI contracts. Serco cleans streets, collects waste, operates IT systems, manages schools and hospitals, runs prisons and tells councils how to improve their schools. It is now a fast growing £4.3bn multinational business – whose revenues grew by 9% and profits 21% in 2010 – with interests in many countries and a vast range of public services. [95]

The Julius review noted that *"many companies span a range of PSI markets"*, citing the development of **BT** "who have grown from communications into IT services"; **VT Group** *"whose business has shifted from warship construction to providing mainstream PSI services"*; **Capgemini** *"who provide consulting, outsourcing and technology services"* and **Amey** *"who started in construction, but now provide a wide range of integrated support services"*. The contract cleaning market is increasingly dominated by "integrated facilities management" and multi-service providers such as **ISS**, **MITIE**, **Rentokil Initial**, **OCS**, and **Mowlem Pall Mall**.[96] Many housing associations increasingly have wider ambitions – including as players in the PFI and facilities management markets. For example **Sanctuary Housing** manages over 70,000 homes as well as having a number of subsidiaries including **Sanctuary Care** and **Sanctuary Home Care**, which run residential homes. **Sanctuary Management Services** provides facilities management services for PFI and other public service contracts, including for the NHS and higher education. But in some instances, housing associations have made substantial losses from their involvement in PFI projects, which have had to be underwritten by other housing association activities.[97]

Multinational conglomerates

Consolidation does not only happen across the public services: it also happens within public services across national markets. The Julius review noted that *"the UK is open to international firms in this area and provides a more transparent and predictable operating environment than many other countries"*.[98] Kable notes that *"several of the most significant actors are subsidiaries of companies hosted elsewhere in Europe"*, citing **Skanska** and **Capio** from Sweden and **Sodexo** and **Veolia** from France. Spanish company **Ferrovial** owns the major contractor **Amey** and the **British Airports Authority**. The waste industry is becoming heavily consolidated across Europe. PSIRU reported: *"In 18 months from the start of 2006 there have been 16 major mergers and acquisitions in waste management companies in Europe, with a total price of over €12.5bn. The companies which have changed hands have a total turnover of €6.6bn Euros, employing 39,000 workers."*[99] **Veolia** and **FCC** were major acquirers and both have gained a strong presence in the UK market.

Banks

Key players: **Barclays, RBS, Lloyds Group, Deutsche Bank, Macquarie**.

Banks play a variety of key roles in the marketisation of public assets. They provide finance, including by putting together infrastructure funds, may provide short-term and longer-term funding for acquisitions, acting as intermediaries in raising capital, for example in the issuing of bonds and advising clients and contractors in PPP and other contracts involving the public sector. Loans by **RBS** and **HBOS** to acquire over-priced public assets played a subsidiary role in their downfall and the bail-out of **RBS** and the **Lloyds Group** (which took over **HBOS**) by the taxpayer.

Infrastructure funds

Key players: **Innisfree, Macquarie, Barclays, Babcock and Brown, Morgan Stanley, Henderson, Goldman Sachs, 3i**.

Infrastructure funds have been formed by banks, with the backing of insurers, pension funds, hedge funds and private equity houses. By owning essential infrastructure, these funds provide investors with long-term strong returns that match the liabilities of, in particular, pension funds, especially in the context of challenging demographics. Public sector pension funds have been leading investors in infrastructure funds and, indirectly, in the privatisation of public services. Infrastructure funds own a range of privatised and other infrastructure, including hospitals, schools, airports, sea ports, energy generating and distributing companies, water companies, telecoms networks and toll roads. **Innisfree** has become the second biggest owner of UK schools and hospitals (after the state), with responsibility for 100,000 pupils and 13,000 hospital beds.[100] Some of the infrastructure funds are dedicated operations (such as **Innisfree**), others are banks with much wider involvement in private sector ownership of public assets and, increasingly, some (such as **3i**) are private equity firms. In addition, there are some groups, notably **Ferrovial**, which specialise in the ownership of infrastructure assets, whose shareholders include investment funds.

Case study: Innisfree

Andrew Gilligan *in The Daily Telegraph* highlighted the role of **Innisfree** in the PFI market. Gilligan revealed key facts about the company and its publicity shy chief executive, David Metter.

• David Metter is believed to have generated a personal wealth of £60m from his company's investment in PFI and PPP schemes.

• Metter personally owns nearly 75% of Innisfree.

• Innisfree employs just 14 staff – yet owns or co-owns 28 NHS hospitals, 269 schools, the Whitehall HQ of the Ministry of Defence, a Scottish motorway and a Welsh jail.

• Bromley's NHS hospital cost Innisfree £118m to build, but taxpayers will pay £1.2bn to Innisfree.

• Innisfree's return on investment at Bromley is 71%.

• Innisfree will receive £1.4m a year until 2035 as the 80% owner of a PFI school in Clacton – which is now closed.

• Innisfree has a 50% stake in the Defence Animal Centre, where the cost per night per dog kennel is higher than that for a five star hotel.

• Innisfree borrows in preference to investing its own money: of the £4.8bn of UK hospitals that it owns, only £376m of the investment came from its own funds.

• In 2009/10, Innisfree generated a 53% profit on its turnover. This compares to the typical 6% profit for FTSE 250 companies.[101]

Small firms
The Government wants 25% of public contracts to go to SMEs.[102] Yet the promise to help small firms gain more public contracts is in sharp contrast with the reality of contracting practices – which is to aggregate contracts, encourage contractor mergers, reduce competition between contractors and reward the very largest PLCs. The small firms' representative body, the Federation of Small Businesses, complains that contracts are usually too big for "micro businesses" (employing less than ten people) to bid.[103] We will have to wait and see whether "Contract Finder" achieves its objective.

Third sector businesses
Key players: **Barnado's**, **Turning Point**, **Mind**, **Greenwich Leisure**, major housing associations
Across the sphere of public services, there has been a growing trend for not-for-profit organisations to take on public service provision, led by a strong commitment by Tony Blair. The argument is that community-based organisations are closer to their client group and can be more responsive to service users' demands. However, social enterprises – not-for-profit businesses, with social objectives – are subject to the same market disciplines as any other business. Consequently, **Ealing Community Transport** was effectively forced to dispose of its recycling business to **May Gurney PLC** to avoid the whole group becoming insolvent. In other ways, too, market disciplines and business logic force social enterprises, including charities, to act like PLCs when they compete against PLCs. The lobby group the Association of Chief Executives in Voluntary Organisations (ACEVO) has been particularly vocal in promoting the idea that big voluntary organisations should be allowed to compete for large public contracts. One risk of this approach is that, just as in the private sector, some contracts lose money and some businesses go broke. This has caused some housing associations to make losses on PFI contracts in which they have been involved as contractors. Those losses will usually be met from income from other activities. Another risk is that commercial activities are in effect

subsidised by the unpaid labour of volunteers. Charities and social enterprises are most commonly involved in contracting in those areas of activity in which they have traditionally been involved – such as social care and support for the homeless. Social enterprises have large numbers of contracts for the management of leisure services – led by the largest, Greenwich Leisure. One particularly disturbing trend is that the traditional voluntary sector – the small, local voluntary groups that had a strong connection with their locality and membership – have become marginalised, with the big national voluntary organisations taking an increasingly prominent position as public sector contractors. These big national organisations have themselves merged and consolidated, in many senses acting in a similar way to PLCs.

> *"The strength of the VCS lies in its flexibility, responsiveness and accountability. These attributes can be found in small local VCS groups across the country. Large nationals have their strengths too, but they are different … Treating the big national charities as synonymous with the VCS would be a massive misunderstanding of the sector, with serious and negative results. It is no good abandoning the 'monolithic state services', as Alan Milburn once described traditional social services, only to replace them with provision from large, centralised charities … Yet there is now a serious risk that, driven by the demand for cost savings and contract 'aggregation', local authorities will drop the small local organisations that serve them so well and enable the big charities to get bigger."*
>
> **Kevin Curley, National Association for Voluntary and Community Action**[104].

Public service co-operatives?

Under the Cabinet Office's Right to Provide initiative, staff have the right to put forward their own proposals to run services as co-operatives or social enterprises. Eventually, says Cabinet Office minister Francis Maude, one million "public servants" – one in six public servants – could operate in this way. This proposal carries several serious risks for service users and staff.

- The initiative is not backed by an advisory service to assist staff take over the operations of their employers. They are therefore unlikely to have the skills needed to run services for the benefit of users, or in ways that are likely to be financially sustainable.
- The initiative is not backed by adequate working capital. Staff may have to provide their own funds, including by waiving pay initially, to enable the "business" to cope with fluctuations in demands and costs.
- Many of these public service co-ops and social enterprises are likely to quickly go out of business, creating a threat to the continuity of services.
- Providers that go out of business may simply be taken over by large private sector operators, so that the "right to provide" is merely a process of transition to full privatisation.

- It is unclear how the right to provide complies with European procurement law and could be challenged by large private sector providers, which would be in a strong position to compete in open tenders and win contracts – perhaps through loss leading initial contract periods. [105]

It is also important to note that in the first large scale externalisation under the so-called "mutualisation" option, the details appear to show that staff will potentially hold a minority equity stake. It is more accurate to conclude that there will be a "co-partnership" between staff, with a minority equity stake, and external investors, who may be private equity firms. Those investors will inject commercial management skills to create a financial return.[106]

6. The Icarus factor – companies that fell to earth

Capitalism works on the basis that some businesses succeed, others fail. The successful ones generate substantial returns for their investors, while people pick themselves up from their feet after the collapse of a failed business.

There has always been difficulty with this characteristic of the capitalist system – ranging from the notorious South Sea Bubble in 1720, up to the banking crash of recent years that led to government rescues and takeovers of some of the world's largest banks.

Public services run by businesses have experienced more than their share of commercial failures. There are particular problems with this as people reliant on public services will, typically, comprise many of the most vulnerable and dependent citizens in society.

The claimed major advantage of transfer of risk is entirely notional. Contractor failure must ultimately be bailed out by the public sector client: major schemes cannot be allowed to fail. **Metronet**, **Jarvis** and **Dundee** are notorious examples. (See below.) Just as some banks were "too big to fail", so some public service contracts are "too big, or too important, to fail". Rescues, when they happen, tend to lead to unplanned and high costs for the public sector – wiping-out the notional cost saving from the initial privatisation.

The fallacy of the risk transfer argument is also illustrated by the way that contractors use specially constructed joint venture companies to isolate the main operational businesses from the specific risk associated with the PPP or PFI contract. In this way, the failure of that joint venture does not damage the viability of the main company, which may even continue to return strong profits in a period in which a PPP contract goes disastrously wrong.

Change in ownership structures can seriously affect PPP and other privatisation contracts. Even before the collapse of **Metronet**, there had been serious problems facing two of the owners of the Tube Lines consortium – which runs the third of the London Underground upgrade contracts. **Jarvis** and **Amey** both hit serious financial difficulties which led them to the brink of collapse. **Amey** was bought by the giant Spanish company **Ferrovial** (which also owns the **British Airport Authority**) – while retaining its stake in Tube Lines. **Jarvis** had to dispose of its **Tube Lines**' stake as part of its rescue strategy.

There is now a long history of public service contractor problems.

- **Connaught** was one of the largest private sector organisations involved in the social housing sector: its services included property management for public sector clients. The company went bust in late 2010, putting nearly 10,000 jobs in jeopardy. The FTSE250 company accumulated £220m in debts, after public spending cuts meant its business was no longer profitable. Its market value on the stock exchange had reached half a billion pounds, but it lost 90% of its value in the run-up to administration. Connaught Partnerships won a major £125m contract for waste and recycling services, street cleaning and council house repairs with Norwich council, but was unable to fulfil it when it went bust – causing major problems for Norwich. Councillors at Norwich City Council subsequently reported that they feared that Connaught had bid at unrealistic

and unsustainably low prices for parts of the work – but felt unable to reject the bid, as it was the cheapest.[107] [108]

- **Mouchel** is one of the largest public sector contractors, specialising in maintenance and infrastructure consultancy. It entered a period of intense commercial crisis in early 2011, which involved a series of profit warnings, a loss of £1.53m for the 2010 trading period and abortive negotiations with **Costain** seeking a possible takeover rescue. Rival **Interserve** had previously discussed with Mouchel taking over the business, but abandoned the approach after conducting due diligence.[109] It is unclear, at time of publication, what is to happen to Mouchel – and to the public bodies dependent on contracts with the company.

- **Ballast PLC** was a subsidiary of **Ballast Nedam** and won contracts with public sector clients. It was prime contractor on a £120 million PFI project with the London Borough of Tower Hamlets for the refurbishment of schools. Facilities management was to be undertaken by another subsidiary of Ballast PLC, **Wiltshier**. The contract was awarded in 2003 and was to have run until 2007, but Ballast PLC ceased trading in 2003 after recording a series of multi-million pound losses. Wiltshier also closed. Ballast Nedam paid compensation of £8.2 million for withdrawing from the contract, but Tower Hamlets was left with the necessity, cost and delays involved in beginning a new tendering process. Schools suffered severe disruption as a result of the strategic decisions of two very large groups to withdraw from an unprofitable market. Ballast Nedam was later named by the Office of Fair Trading as one of the construction companies against which it issued "Statements of Objection". (See p54)

- **Carter & Carter** was founded in 1992 by Philip Carter, who was awarded the prize of "entrepreneur of the year" in 2007. The company ran a variety of training and education courses, boasting that it was "the largest provider of learning solutions in the UK". It grew through a series of acquisitions, including **Assa** for £24 million, **Fern Group** for £14 million and **Quantica**, **NTP** and **IMS** for a combined £23 million. In 2005, the company's turnover was £51 million, with a declared profit of £4.3 million, following a loss of £1.9 million in 2002. In 2006, Carter & Carter signed a memorandum of understanding with Castle College in Nottingham, to provide training in partnership with the college. But the following year, Philip Carter died in a helicopter accident. In March 2008 it went into administration, with debts of £130 million and allegations of false accounting. The company had 25,000 students on its courses and 2,500 employees. Its services were safeguarded by much of its operation being transferred to Newcastle College – using public money to rescue the failed private venture.[110]

- **Candover Investments**, and its associate business **Candover Partners**, became a leading private equity firm. Its directors included Lord Jay, a former Permanent Under-Secretary at the Foreign Office, Head of the Diplomatic Service and British Ambassador to France; its chairman was Gerry Grimstone, a former assistant secretary at the Treasury. Two senior Candover people – Grimstone and Martin Read – led a major efficiency review for the Treasury,[111] and Read was subsequently recruited to advise the Conservative Party on "public sector productivity" and is now a member of Francis Maude's Efficiency and Reform Group at the Cabinet Office.[112] However, the firm was taken over by **Arle Capital Partners** after it suffered poor returns on investment.

- **Terra Firma**, originally the private equity arm of **Nomura** bank, became one of the world's most successful private equity houses, buying-up various public service contractors. It played a central role in the process of privatisation of waste management contracting, owning stakes in **Waste Management Contractors** and the water company **Hyder** – which won public sector outsourcing contracts. Mike Clasper moved directly from Terra Firma to the role of executive chairman of HM Revenue & Customs. William Hague was a member of its advisory political council, before he became Foreign Secretary. However, Terra Firma was severely damaged by a massive and unwise acquisition of **EMI** and a resulting, unsuccessful, courtroom conflict with **Citigroup**.

- **Jarvis** was an important public services contractor, until it went into administration in 2010. The company was involved in a range of service contracts, including schools construction and railway maintenance: it was also part owner of the **Tube Lines** contractor, which holds one of the massive PPP contracts for the upgrading of the London Underground. Prior to administration, charges had been made regarding Jarvis's alleged partial blame for the 2002 Potters Bar train accident in which seven passengers died and more than 70 were injured. Stephen Norris, a former Conservative government minister of transport, had been chairman of Jarvis. Jarvis was on the verge of bankruptcy in 2004, after it accepted liability – jointly with Network Rail (as the successor body of **Railtrack**). Jarvis was already in serious difficulty because of compliance problems on some PFI contracts, having to pay compensation for delays to building projects and having booked profits on PFI contracts too early, with the effect of boosting profits. Jarvis emerged with a debt of £230 million, but annual profits of less than 10% that figure. At the time of crisis in 2004, Jarvis held 10% of all PFI construction contracts, with a total investment value of about £3.5bn and was still winning PFI bids when apparently on the verge of bankruptcy.[113] Several thousand staff lost their jobs as a result of the problems at Jarvis: it had 2,000 staff when it went into administration, but 4,500 a couple of years earlier.

Case study: Metronet

Metronet was a consortium of Bombardier, Balfour Beatty, WS Atkins, Thames Water and EDF, who were each shareholders. It won two of the three 30 year PPP contracts to upgrade the London Underground network. The capital value of the projects was about £12bn. But as a PPP, the contract did not fix price and was subject to price reviews at seven and a half year intervals: 95% of the debt was guaranteed by TfL.

Metronet (completely legally) awarded all its work through a tied supply chain to its own shareholders. According to TfL, Metronet failed to manage those supply chain contracts – presumably because the shareholders had a dominant relationship over Metronet. This, in turn, contributed to major cost over-runs. Because Metronet failed to properly manage those contracts and control costs, it was unable to recover the excess costs from TfL. This led to Metronet going into administration and TfL taking direct responsibility for the infrastructure upgrades – at considerable additional cost compared with the original budgets.

Metronet created two specially constructed companies for the Tube upgrade contracts. The liability of the five shareholders was limited to their shareholdings of £35 million each, but

there was a total of £1bn at risk from the contractual dispute. It became cheaper for the shareholders to walk away than to fix the problem. The consortium partners' share prices were unaffected and they continued to win other PPP and infrastructure contracts – Balfour Beatty and Atkins have been named preferred bidder for a £2bn contract to widen the M25 contract.

TfL says it will be "some time" before the cost of Metronet's collapse will be known, but the transport union RMT estimates the extra costs to TfL will be about £500 million.[114]

Question marks also hang over the continuation and terms of the second major London Underground PPP contract with **Tube Lines**. Charges for the second seven and a half year period of the Tube Lines' contract could rise to between £5.1bn and £5.5bn, compared to the £3.1bn that Transport for London had projected for the renewed contract – though this is less than the £7.2bn that Tube Lines itself wants to charge. Under the complex PPP agreement, charges are referred to an external arbiter – the rail regulator – who has come up with initial projections of £5.1bn to £5.5bn. This means that Transport for London may have to find about £2bn that it has not budgeted for, to meet the escalating costs of the contract.

The London Tube PPP has a cost structure that is outside the control of TfL and under which the risks of contract inflation as well as contract failure are largely held by the public sector client. [115]

Case study: Dundee Student Villages

A new university hall of residence was constructed for Dundee University, structured as a joint venture, Dundee Student Villages, between the university and a private operator, Sanctuary Management Services. The halls failed to attract sufficient students to allow the company to break-even, which recorded losses in sequential years of £400,000 and £1.3 million.

The university has had to provide funding to the company from its revenues, leading to moves to make staff redundant.[116] Sanctuary Management Services is a wholly-owned subsidiary of Sanctuary Housing, a charitable housing association which operates residential housing under PFI contracts for a variety of public bodies.

Case study: Sedgemoor care homes

Sedgemoor ran 45 care homes for sexually abused and autistic children. It was bought by ECI Partners, a private equity firm, for £13 million in 2000. Sedgemoor leased its homes and when occupancy levels fell could not afford to pay staff or rent, the company collapsed in 2007. Some of the care homes were sold, leaving many vulnerable children potentially homeless. Local authorities had to intervene to find homes for many of the children. The Adolescent and Children's Trust (Tact), the UK's largest fostering and adoption charity commented: *"Private equity firms are more interested in maximising profits for shareholders and operating for short-term gain rather than providing long-term care for the most vulnerable."*[117]

*For more disaster stories in the care home sector – **Southern Cross, Four Seasons** and **Care Principles** – see Section 3 above*

7. Policy influence

The "public services industry" has spent significant sums of money creating a sympathetic environment for increased privatisation. These companies have helped form a climate where there is little opposition within the main political parties to the privatisation of public services.

7.1 Lobbying organisations

Lobbying organisations such as the CBI Public Services Strategy Board, the PPP Forum, the Business Services Association and the NHS Partners Network have developed close relations with government and the media.

The CBI Public Services Strategy Board
The CBI has a Public Services Strategy Board, chaired by **Interserve** chief executive, Adrian Ringrose, with representatives from **A4e, Amey, Babcock, Balfour Beatty, BT, Capita, Carillion, Circle (Healthcare), Enterprise, Fujitsu, G4S, May Gurney, Mitie, Pinnacle, Serco, Vertex** and **Working Links.** The Board *"leads our campaign to improve the quality and efficiency of the UK's public services. Its aim is to show how business can help government build more innovative, efficient and effective public services, as part of a credible plan to reduce the public spending deficit and boost the growth of the UK economy."* The CBI also runs a Public Services Forum, chaired by **Carillion** chief executive John McDonough, which *"brings business leaders together with decision makers and influencers from Westminster, Whitehall and across the public sector to discuss public services reform"*. Forum events have involved speeches from senior cabinet ministers. The Board publishes reports arguing its members' case – recent publications have covered probation services, the police, the immigration service, social housing and shared services in local government. The reports consistently argue for greater contracting-out of public services. CBI's director of public services is regularly quoted in the UK media lobbying for greater private sector contracting.

The PPP Forum
The **PPP Forum** is the *"private sector industry body for the PPP/PFI industry"*. The PPP Forum's work is *"sponsored by 111 organisations that play a leading private sector role within the PPP industry"* from the *"corporate"* sector (including **McAlpine**, **Amey**, **Balfour Beatty**, **Carillion**, **Interserve**, **ISS**, **Laing**, **Kier, Siemens** and **Skanska)**; *"financial"* sector (including **3i**, **Barclays**, **HSBC**, **Innisfree**, **Lloyds**, **RBS** and **UBS**) and *"professional"* sector (including **Allen & Overy, Clifford Chance**, **Deloitte**, **DLA Piper**, **Ernst & Young**, **Grant Thornton**, **KPMG**, **Pinsent Masons** and **PwC**). Its objectives are to "demonstrate the success the private sector is achieving in delivering modern public services infrastructure. Engage with government departments and related organisations to develop infrastructure procurement policy and contracts. Take part in public debate and present an informed and business based perspective on infrastructure procurement and the surrounding issues." It is committed to publicly putting forward the case for PPPs and PFI, challenging what it regards as "negative" media coverage, including by contributing to newspapers and magazines, publishing a resourced website and providing case studies. It holds annual dinners attended by cabinet ministers and permanent secretaries, and an annual four-day skiing event in Chamonix for senior people in the PPP/PFI sector. The PPP Forum is used as a stakeholder consultee by the Treasury in discussing PPP policy development – confusing its role as a lobbying group with that of a representative industrial organisation.

The Business Services Association
The Business Services Association *"represents companies providing business and outsourced services in the private and public sectors"*. Full and associate members include **Amey**, **Serco**, **KPMG**, **Pinsent Masons**, **Deloitte**, **Barclays**, **3i**, **Sodexo**, **Rentokil Initial**, **Interserve**, **Compass** and **Babcock**. It promotes *"the industry and the positive contribution it makes to the economy – driving innovation, training, efficiency, raising professional standards and improving productivity"*. The BSA has a communications and public affairs objective of *"working to shape public policy and political debate in those areas that directly affect the industry"*. It produces *"a range of publications"* that are *"aimed at building awareness and understanding of the industry amongst the Government, MPs, officials, European Commission, opinion formers and other stakeholders"*.

The NHS Partners Network
The NHS Partners Network operates under the umbrella of the NHS Confederation, representing commercial and not-for-profit providers of outsourced services to the NHS. Members include **Bupa, Alliance Medical, Barchester Healthcare, Care UK, Circle, the General Health Group**, **Pfitzer** and **UnitedHealth**. *"The Network works to raise the profile of independent NHS healthcare providers and to build greater understanding of and support for the role they play in the NHS",* it says. The NHSPN has worked closely with the CBI. The Network meets on a regular basis with ministers, advisors and civil servants in the Department of Health. [118]

The English Community Care Association
The ECCA is *"*the leading representative body for independent care providers*"*, with a membership including *"organisations of varying types and sizes, amongst them single care homes, small local groups, national providers and not-for-profit voluntary organisations and associations."* Its objectives are "*to ensure that care services are commissioned fairly, efficiently and on a properly funded basis, to meet the true costs of providing appropriate care*"; its activities include *"leading the national policy agenda"* and *"lobbying for the independent care home sector"*. Providers represented on its board include **Anchor Trust**, **Craegmoor**, **Barchester**, **MHA Care Group**, **Southern Cross** and **Care UK**. A similar role is undertaken in Scotland by *Scottish Care*.

7.2 Research sponsorship

The Serco Institute
"The Institute is **Serco**'s research facility," it says. "Our aim is to foster the development of sustainable public service markets through an outward-facing programme of research and communication." It publishes reports *"intended to enhance understanding, in governments and the wider community, of the role that competition and contracting can play in improving public services"*. The Serco Institute has sponsored work by the **Institute for Public Policy Research**.

2020 Public Services Trust
The Trust has published recent reports examining the improvement of public sector outcomes through payment by result. The Trust's chair is Lord Geoffrey Filkin, a minister in the last government, Lord Michael Bichard, a former permanent secretary, and Sir Merrick Cockerill,

the leader of the Royal Borough of Kensington and Chelsea. Its partners include **Amey, A4e, Accenture, Cap Gemini, Ernst & Young, KPMG, Microsoft** and **Partnerships UK**.

The Aldridge Foundation
The Aldridge Foundation was established by founder and former chairman of **Capita**, Rod Aldridge through a £2 million share transfer from Capita. As well as sponsoring school academies and youth volunteer schemes it will *"seek practical solutions to removing the barriers to public service reform, promoting effective partnerships between the public, private and third sectors"*.

The PwC Public Sector Research Centre
PwC's "Public Sector Research Centre" publishes several reports a year and also sponsors work by think-tanks and others. Recent publications include *The Smarter State*, *Fiscal policy and spending* and *Cities and local government.* The Centre has sponsored reports by other think-tanks, including **Demos**, the **Social Market Foundation** and the **New Local Government Network**.

KPMG
KPMG published a report, *Achieving the potential*, arguing for greater use of public sector service charges and "co-payments". KPMG's inquiry was led by former home and education secretary Charles Clarke, who was paid for this work by KPMG. KPMG partner **Paul Kirby**, who co-authored an influential report on public service marketisation in 2010,[119] was seconded to George Osborne's office while the Conservatives were in opposition and has now been appointed Head of Policy Development at 10 Downing Street where he is reported to be driving the development of the "Open Public Services" white paper.[120]

Reform
Reform describes itself as "an independent, charitable, non-party think tank whose mission is to set out a better way to deliver public services and economic prosperity". Since its launch in 2002 it has maintained a strong focus on public service marketisation through a series of reports on health, education and other sectors. It also supports offshoot organisations such as **Doctors for Reform** and **Educators for Reform** which aim to bring together professionals favouring market-based solutions. The latest annual income reported to the Charities Commission was £980,000. Reform's advisory board includes **Christopher Gent** of **GlaxoSmithkline** and **Tim Parker** of outsourcing specialist **Compass Group** and its advisory council includes **Adrian Bull** of **Carillion Health**. Its programme at the 2010 Conservative Party Conference included a panel discussion between public health minister **Anne Milton** and the CEO of **General Healthcare Group**.

Policy Exchange
Policy Exchange played a key role in refreshing and rebranding the Conservatives' policy agenda, in its own words "using centre right means to progressive ends", including "reinventing government" to "encourage enterprise and competition". Recent publications include *Higher Education in an Age of Austerity: Shared Services, Outsourcing and Entrepreneurship* (2010) which argued that university managers had "failed to recognise the savings and service improvements that could be obtained through engagement with commercial partners and the use of shared services"[121] and *Special Educational Needs: Reforming provision in English schools* which called for SEN schools to be handed over to

private providers.[122] Director Neil O'Brien has urged the Coalition government to "shake off its aversion to allowing for-profit companies to run schools".[123] Policy Exchange runs a "Business Forum" for private sector partners and encourages "corporate partnership on events and reports". Its 2010 Conservative Party Conference programme included an event on waste infrastructure sponsored by (and featuring a speaker from) **Sita UK**, and an event on "school autonomy" sponsored by (and featuring a speaker from) **Pearson**, an education firm hoping to benefit from the Conservatives' "free schools" programme.[124]

The Centre for Policy Studies
One of the original "Thatcherite" think-tanks, the **Centre for Policy Studies** remains an important influence on Conservative Party policy development. Its board includes **John Nash**, founder of **Sovereign Capital** and former chair of **Care UK** who helped to fund **Andrew Lansley**'s private office prior to the 2010 General Election.[125] In its own words the Centre has been "a consistent advocate for greater choice and diversity of provision, opening up state monopolies to new providers", having published the famous pamphlet in which Nicholas Ridley argued for an "enabling council" in 1988.

2020health
2020health claims to be "an independent, grassroots, health and technology policy think tank" but is funded by pharmaceutical companies such as **Pfizer** and **Lilly**.[126] It is chaired by **Tom Sackville**, a former Conservative health minister who is now Chief Executive of the International Federation of Health Plans (a network of private health insurers), and its own Chief Executive **Julia Manning** stood as a Conservative Parliamentary Candidate in 2005 and was included on Cameron's "A-list" of potential candidates in 2010. A report published in 2010 advocated the end of NHS funding for "minor" treatments.[127] 2020health is a significant presence at Conservative Party conferences and hosted a key policy lecture from Andrew Lansley before the election.[128]

The Centre for Social Justice
The Centre for Social Justice is a think-tank established by work and pensions secretary and former Conservative Party leader Ian Duncan-Smith. Although it describes itself as "independent", it is closely associated with leading figures within the Conservative Party. Its report on looked-after children, *Couldn't care less*, was produced by a working group led by Ryan Robson, a former Conservative councillor at the London Borough of Wandsworth and founder and managing director of **Sovereign Capital**. Sovereign Capital made about £100 million from its involvement in the buying, reselling and consolidation of social care businesses, including **Tracscare.** It owns the **National Fostering Agency,** independent schools groups **WCLS** and **Alpha Plus**, **DC Leisure,** a leading operator in the market for managing council leisure centres and NHS service providers **C.H.O.I.C.E., TRACS, Alkare, Cascade** and **Parallel.** Robson is also a member of the Centre's board of directors. David Blunkett is chair of its advisory board: other members include Labour MP Frank Field and foreign secretary William Hague. Its report on outcome-based government was supported by Oliver Wyman, a management consultancy.

TaxPayers' Alliance
The TaxPayers' Alliance describes itself as "Britain's independent grassroots campaign for lower taxes". It is closely associated with the Adam Smith Institute, which was influential with the government of Margaret Thatcher. TPA favours lower taxes, smaller government and a stronger role for the private sector in place of the state. Its chairman is former Conservative

councillor Andrew Allum: a partner in consulting firm **LEK**, where he is involved in its public sector practice. Allum and the other founders of TPA are also associated with the Freedom Association. It is unclear how the TPA is funded: there are a significant number of people who are employed by, seconded to, or volunteer at the organisation.

The Social Market Foundation

The **Social Market Foundation** (total expenditure, 2008: £875,000) has been an influential think-tank for several years. *"Critical to our success is the close partnership we enjoy with organisations in the private and third sectors"*, it says. Its board includes the newspaper columnist Mary Ann Sieghart (the chair), Labour peer Lord Lipsey and former Conservative MEP Graham Mather. Advisors include business minister Vince Cable, former home secretary David Blunkett and former health secretary (and current chair of the House of Commons health select committee) Stephen Dorrell. The Foundation has a business forum, which acts as an "engagement between business and the Westminster world". Current members include BP, KPMG and Merck. Previous sponsors of Foundation work have included **Accenture**, **Barclays**, **Boots**, **BUPA**, **Capio**, **Deloitte**, **Fujitsu**, **KPMG**, **PwC, Pfizer** and **Standard Life Healthcare**.

The New Local Government Network

The **New Local Government Network** has been influential in encouraging the Government to adopt reforms in the management and operations of councils, including through the use of more private contractors. Its "partners" include **the CBI, the Business Services Association, Eversheds, O2, Atkins, Balfour Beatty, BDO, PA Consulting** and **Mouche**l. Board members include Nick Sharman, director of local government Services at **A4e.** Dan Corry, the former head of the NLGN (and a former senior staffer at IPPR), went on to become head of then prime minister Gordon Brown's policy unit.

The Institute for Public Policy Research

The **Institute for Public Policy Research** (total expenditure, 2009: £3.2 million) has been a key location for research and policy development around public service reform since its Commission on Public Private Partnerships in 1999-2001 (sponsored by **KPMG**, **BT**, **Serco**, **Nomura** and **Norwich Union**). IPPR was very influential with the former Labour government. Its former heads included Patricia Hewitt, who went on to become health secretary, and Matthew Taylor, who became head of policy for Tony Blair. IPPR's influence was so great that its then chairman of trustees, Chris Powell, was quoted as saying that it had two departments: its research and development in its own offices and the "applied department" within government.

7.3 Incorporation into government policymaking

The Public Services Industry Review

In December 2007, the Government's Department of Business, Enterprise and Regulatory Reform's agreed to requests from the **CBI** to establish a review of the "public services industry", under the leadership of Dr DeAnne Julius. Dr Julius was, until December 2007 – when appointed by the Government to conduct the review – a senior non-executive director of **Serco**. The Review's Advisory Panel comprised representatives of the **CBI**, **Partnerships UK**, **Cap Gemini**, **Working Links**, **Logica CMG**, **Spire Healthcare**, **ACEVO**, the **Social Enterprise Coalition**, **Babcock**, **KPMG**, **Serco**, and Birmingham University's Centre for Public Service Partnerships. Trade union representatives were invited at a later date after protests from the TUC. In July the

final report of the Review concluded that *"there is a clear case for action to ensure conditions for growth of the public services industry continue"*.

NHS Co-operation and Competition Panel
The NHS Co-operation and Competition Panel has been established by the Department of Health to oversee competition between NHS bodies and the independent sector. Its chair is Lord Carter of Coles, a Labour peer who founded **Westminster Health Care** – a leading provider of nursing and specialist healthcare. The NHS Partners Network, in a statement on behalf of the independent sector, said it welcomed his appointment as *"he has substantial commercial experience in the sector"*.[129]

Gershon Efficiency Review
Sir Peter Gershon conducted a series of cost-cutting efficiency reviews for the Government, which provided for the reduction of 84,000 civil service jobs. His 2004 review proposed reforms that included using "change agents" to increase the potential for civil service outsourcing. After completing the reviews, Sir Peter returned to the private sector where he went on to become executive chairman of **Vertex** – one of the largest suppliers of business outsourcing services to the public sector. His 2004 efficiency review received staff seconded from a variety of public sector contractors, including **Deloitte, PA Consulting,** HEDRA (now part of **Mouchel**)**, Hewlett Packard** and **IBM.**[130]

Infrastructure UK
Infrastructure UK was formed in 2009 to improve the Government's focus on infrastructure renewal. It took over responsibilities from Partnerships UK and its initial chief executive was James Stewart, who moved over from the same role at PUK, before moving on to **KPMG** to head its global infrastructure practice. The chairman of Infrastructure UK is Terry Hill, who works for construction advisory firm **Arup** as leader of its global transport market.

Partnerships UK
The main body charged with the promotion of PPPs and the PFI, Partnerships UK (PUK) was a quasi-government agency. It is in the process of being closed and some of its operations transferred to Infrastructure UK. PUK was originally the Treasury PFI Task Force, but was reconstituted as a private company, in which the Treasury and the Scottish Government hold shareholdings, along with many of the main industry players. Its role was to roll-out PFI and PPP projects. Commercial shareholders included **Uberior Infrastructure Investments** (an investment vehicle of Bank of Scotland Corporate), **Prudential**, **Abbey**, **Sun Life**, **Barclays**, **RBS**, **Serco**, **Global Solutions** and **British Land**. Gordon Horsfield, a former executive with **PwC**, is a former chairman of PUK. James Stewart was chief executive of PUK from 2000 to 2009, when he moved over to take a similar role at Infrastructure UK. He was previously an investment banker with Newcourt and, before that, at Société Générale. He was recently appointed by KPMG to head its global infrastructure practice.

Partnerships for Schools
Partnerships for Schools (PfS) was the non-departmental public body set up by the Department for Children, Schools and Families to deliver the Building Schools for the Future programme. Partnerships UK was a 50% partner in PfS, sitting alongside DCSF and other non-executive directors on the Board of PfS. PUK also assists the programme by seconding staff to PfS. Building Schools for the Future LLP invests in the Local Education Partnerships that are set-up

to deliver new and upgraded schools in the Building Schools for the Future programme, working with the local authority and their private sector partner .

Local Partnerships
Local Partnerships (formerly known as 4ps) is the agency established to provide expertise to local government, which is jointly owned by the Treasury and the Local Government Association. Its role is to support their involvement in PFI, PPP and complex procurement deals. It can assist councils obtain funding and accelerate progress with schemes.

7.4 Influence: contractors and their government connections

As well as influencing government policy and the broader culture of debate, contractors appoint directors and advisors who have clout. Many of the largest companies have big hitters on their boards, who have political experience, knowledge and contacts.

- Health Secretary **Andrew Lansley** received a £21,000 donation for his private office from John Nash, former chair and major shareholder of health and social care firm **Care UK**, and a founder of **Sovereign Capital**, a private equity firm with interests in the healthcare sector, while in opposition.[131] Nash was subsequently appointed by **George Osborne** to a panel of "experts" overseeing the Treasury's public sector spending cuts.[132]

- Foreign secretary **William Hague** was an advisor to private equity firm **Terra Firma** – major investors in public service privatisations – before he re-entered government.

- Justice secretary and former Chancellor of the Exchequer **Kenneth Clarke** was an adviser to private equity investment house **Centaurus Capital** before he re-entered government. Centaurus is the largest investor in **Atos Origin**, a leading contractor to the public sector for IT and consulting services.

- International development secretary **Andrew Mitchell**, while in opposition, was paid at least £35,000 a year as senior strategic adviser to **Accenture**, a leading provider of consultancy and business processing services to the public sector.

- Culture minister Ed Vaizey was a director of **Edexcel**, a qualifications assessment company.

- **David Willetts** received advice on "Early Years Entitlement" from **PwC** to the value of £4,662.

- Former Foreign Secretary **Sir Malcolm Rifkind** was chairman of **Alliance Medical** – which has large contracts with the NHS, and is involved with **Care UK** in supporting its private hospitals group – until 2006, when it was bought by the Dubai International Capital private equity fund from the Bridgepoint private equity firm. He is an advisor to **LEK Consulting** – which has close connections to the **Taxpayers Alliance**.

- Former environment secretary **John Gummer** (Lord Deben) is chairman of water services company **Veolia**.

- **Alan Milburn** obtained several directorships after he left government, where he was health secretary from 1998 to 2003. He subsequently became a director of **Covidien**, which describes itself as *"a $10bn global healthcare products leader"*; a member of **Lloydspharmacy**'s Healthcare Advisory Panel; an advisor to the European advisory panel of leading private equity firm **Bridgepoint,** which specialises in healthcare investments; and a non-executive director of Diaverum AB, a provider of renal dialysis services, engaged to help develop its quality services agenda. While an MP, Milburn declared his income from senior appointments as over £30,000 a year from Bridgepoint; over £25,000 from Lloydspharmacy; and over £20,000 as an advisor to **Pepsico**.

- **Charles Clarke** became a director and adviser to several companies after leaving government, during which time he was education secretary from 2002 to 2004 and Home Secetary from 2004 to 2006. He is a non-executive director of the **LJ Group**, which supplies teaching materials and equipment to schools and training services, including through the Government Building Schools for the Future programme, which Clarke initiated as education and skills secretary in 2004. Clarke has acted as consultant to **KPMG** on public sector reform, for whom he wrote a booklet promoting the use of co-payments – service user contributions – to the NHS and other public services. He advised **Charles Street Securities** investment bankers/private equity fund managers; and has been a consultant to **Beachcroft** LLP, a legal firm that specialises in advising PFI/PPP deals.

- **Patricia Hewitt** was health secretary from 2005 to 2007. She is senior adviser to **Cinven**, a private equity-backed private hospitals and healthcare group. She is also special consultant to **AllianceBoots**, which is owned by private equity firm **KKR**, and a director of **BT Group**, which is providing business outsourcing, IT and telecoms services to a range of public bodies. Hewitt established the telecoms and media regulator Ofcom in an earlier job as secretary of state for trade and industry and was in charge of the National Programme for IT – in which BT won one of the largest contracts – while secretary of state for health.

- **David Blunkett** was home secretary from 2001 to 2004, education secretary from 1997 to 2001 and work and pensions secretary in 2005. He is now an advisor on business development to **A4e** Ltd, for which he is entitled to be paid between £25,000 and £30,000 a year, but on which entitlement he has not yet drawn.[133] A4e describes itself as a *"market leader in global public service reform"* and has also recruited **Jonty Olliff-Cooper**, former adviser in the Conservative Party Policy Unit, as its Director of Policy and Strategy. David Cameron has appointed A4e CEO **Emma Harrison** as his "family champion".[134] Blunkett is also an advisor to US fund **Secure Trading**.

- **Alistair Darling, Liam Byrne** and **Angela Eagle** received unpaid advice and support from **PwC** in their then role as Treasury shadow ministers, during the passage of the Finance Bill in 2010.

- **Lord Warner** was a health minister from 2003 to 2007, with specific responsibility for much of that time for the radical reform of the NHS – overseeing the introduction of more private sector involvement. Since he stepped down from that role he has taken on a directorship with **UK HealthGateway** and is chairman of the Government Sector Advisory Panel for **Xansa plc** – a leading provider of business outsource services to public bodies and holder of the £1bn NHS's shared business service centre contract, providing accounting and finance services to the NHS. Lord Warner is also an advisor to **Byotrol** (a provider of micro biological health treatments), **Apax Partners Worldwide** (a private equity firm, with strong connections to the Government – founder Adrian Beercroft was appointed to George Osborne's panel of "experts" overseeing public sector spending cuts in 2010[135] – and which has invested heavily in health providers seeking contracts with the NHS), **Deloitte** (an accountancy and consultancy firm, with large incomes from government agencies) and **DLA Piper** (a legal firm, which, like Deloitte, specialises in advising on private contracting to the public sector). Lord Warner remains influential within the NHS as chair of the NHS London Provider Agency.

- **Hilary Armstrong** was secretary of state for local government from 1997 to 2001, and minister for the Cabinet Office from 2006 to 2007. She is now chair of waste company **SITA**'s advisory committee.

- **Nick Raynsford** was a local government and housing minister from 1997 to 2005. He is now a non-executive director of **Hometrack,** a lettings service and was non-executive chairman of local authority recruitment agency **Rockpools** PLC.

- **Sir Ian McCartney** was a trade minister from 1997 to 1999 and again from 2006 to 2007. His department, Trade and Industry, had responsibility for energy policy. After leaving office he became a senior adviser to the US **Fluor Corporation**, an energy contractor that is believed to have ambitions to win nuclear clean-up contracts in the UK. He was paid £113,000 a year for his advice.

- **Stephen Byers** held a variety of ministerial posts, including as trade and industry secretary from 1998 to 2001. He went on to become non-executive chairman of water treatment company **ACWA** and **Ritz Climate Offset Company**.

- **James Stewart** was chief executive of Partnerships UK from 2000 to 2009, when he moved over to take a similar role at Infrastructure UK. He was recently appointed by **KPMG** to head its global infrastructure practice.

- **Michael Barber** was head of the Prime Minister's Delivery Unit, where he oversaw public sector reforms in health, education, transport, policing, the criminal justice system and asylum/immigration. He is now an expert partner in consulting firm **McKinsey**'s Global Public Sector Practice.

- **Phil Wheatley** has served as Director General of the National Offender Management Service and Director General of HM Prison Service. He was hired by **G4S**, a company that manages prisons for the Government, at the end of 2010. His appointment was criticised by the Prison Officers Association as giving his employers an unfair advantage when tendering for contracts.

- **Mark Britnell** was the director general of commissioning and systems management for the Department of Health. He left to join **KPMG**, where he is head of its global health service practice. He is also a member of **David Cameron**'s inner cabinet of NHS advisors.

- **Gary Belfield** replaced Britnell as the Department of Health's interim director general of commissioning and systems management – until he left also to join **KPMG**. He is now its associate partner, leading the practice engaged in seeking and winning contracts to advise GPs on healthcare commissioning.

- **Baroness Sally Morgan** was a close aide to Tony Blair when he was Prime Minister and she was director of government relations in Downing Street and subsequently was made a minister and a member of the House of Lords. She is chair of Ofsted. Morgan is also a director of the largest care home operator in the UK, **Southern Cross**, which has expanded substantially as a result of government reforms to the structure and funding of social care. She is a member of the advisory panel of **Lloyds Pharmacy**, which could benefit substantially from the marketisation of the NHS. Morgan is also a director of **Carphone Warehouse**. She is an advisor to Ark, a charity that runs a chain of academy schools.

- **Sir Peter Gershon** was brought in by The Treasury in 1998 to reduce government expenditure and improve efficiency – he conducted a series of reviews in the period to 2004. He became a civil servant in 2000 as founding chief executive of the Office of Government Commerce. He remains close to government, as a non-executive director of the Treasury and an advisor to the Government's Defence Academy. After completing his efficiency review, Sir Peter became executive chairman of **Vertex**, one of the largest suppliers of business outsourcing services to the UK public sector. He remains non-executive chairman of the **General Healthcare Group**, the largest private healthcare group in the UK – owned by the private equity group **Apax Partners** and the South African healthcare company **Netcare**, which has supply contracts with the NHS. He is also non-executive chairman of Symbian, a software licensing company, and of Premier Farnell, a distributor of electrical equipment. In 2010 Peter Gershon was recruited to the **Conservative Party's Public Sector Productivity Advisory Board** which advised the party that it would be able to make billions of additional "savings" to government expenditure through an accelerated outsourcing drive,[136] and after the election was appointed to the **Cabinet Office Efficiency and Reform Group**.[137]

- **Serco**'s directors included **DeAnne Julius** until she embarked on her review of the sector for the Government. She is also a former independent member of the Bank of England's monetary policy committee.

- **Sir Gerry Loughran** was head of the Northern Ireland civil service from 2000 to 2002. After retiring he took on a number of private sector directorships. He is non-executive chairman of **Phoenix Natural Gas**, which is owned by the **Terra Firma** private equity firm. While a senior civil servant, Loughran chaired the Strategy 2010 project,[138] to sell and leaseback the civil service property portfolio. After leaving the civil service, Loughran became a director and chairman of **Partenaire**, where he led the company's

(unsuccessful) bid to win the £2bn Workplace 2010 contract that was to have resulted from Strategy 2010. (The project was abandoned after property prices collapsed.)

- **Lord Wilson** of Dinton was, as Sir Richard Wilson, head of the Home Civil Service and secretary to the Cabinet – as such he had the overall responsibility for seeing that the Prime Minister's policies on public sector reform were carried out. He became a director of **Xansa** (now part of the Steria group), one of the main providers of business process outsourcing services to the public sector and is now a director of **BSkyB**.

- Lord Wilson's successor as head of the Home Civil Service was Sir Andrew Turnbull, now **Lord Turnbull**. Lord Turnbull's current directorships include **British Land** (active in the PFI/PPP market), **Prudential** (also active in the market) and **Frontier Economics** (which advises private sector clients on public sector reform). Turnbull is also chairman of **Brevan Howard Global**, an investment management company.

- **Sir Steve Robson** was one of the most controversial senior civil servants of recent years, who oversaw the privatisation of British Rail on behalf of Sir John Major. Robson went on to become second permanent secretary at HM Treasury until he retired in 2001. During his earlier career, he was seconded to **3i** while remaining a civil servant. He oversaw the Government's policy on PPPs while serving the current Government at the Treasury. Since retiring, Sir Steve has been a director at **Partnerships UK**, **JP Morgan Cazenove** (a global bank), **Xstrata** (a mining group) and the **Royal Bank of Scotland** (one of the leading investors in PPPs, and during the period in which it collapsed). He remains a non-executive director at the accountancy and consultancy firm **KPMG** (a leading adviser to PPP and PFI schemes).

- **Sir Peter Middleton** was Treasury permanent secretary from 1983 to 1991. He went on to become chairman of **Barclays Bank** and his various other City positions included being a director of **Three Delta**, which used funding from the **Qatar Investment Authority** to invest in care home businesses **Four Seasons** and **NHI.**

- **Simon Stevens** was Tony Blair's health advisor within 10 Downing Street and, with Alan Milburn, was the key architect of the NHS reform programme. He is now an executive vice president of **UnitedHealth** in the US, which has attempted to win large health care contracts in the UK.

- Following his period as chief inspector of schools, **Chris Woodhead** set-up the **Cognita** group of independent schools, using funds supplied by a private equity firm, **Englefield Capital**.

8. A very imperfect market

8.1 Market power

> *"Competition does not always work well even in private sector markets, and there are additional complexities for public services. For example there are difficulties associated with … scarcity, or lack of diversity, in supply, caused by monopoly, high market concentration among suppliers or geographical remoteness."*
>
> **The Audit Commission**[139]

Consolidation is the name of the game in the "public services industry". Big players in the public service contracting market are making themselves even larger through a steady stream of acquisitions. Smaller companies are also becoming bigger, through a process of mergers and acquisitions. Consolidation is happening wholesale – within market sectors, across market sectors and even across countries. In short, the public services industry is being controlled by ever fewer businesses, whose influence is ever greater.

In many cases, the consolidation has earned the new owners of public services massive returns – sometimes doubling the stake invested by private equity firms. But in other instances, cross-sectoral consolidation has actually opened up a company to service diversification risks that were not anticipated. When losses are incurred, perhaps because of a lack of sector experience, the result can be the withdrawal of a public service and extra costs for the public sector client.

It is evident that the process of market consolidation has the effect both of offering higher returns to service operators because of economies of scale, but also the potential to increase profits because of reduced competition. Given that the Government has said that the attractions of bringing in private sector contractors include increasing the diversity of public service supply and offering consumers more choice in public service supply arrangements, sector consolidation may be against the public interest in many circumstances.

The public sector "market" is not an easy one for potential contractors to enter. As the Federation of Small Businesses has observed, it is one that mostly excludes small firms.[140] In fact, it also typically excludes all but the largest PLCs and multinationals. It has high transaction costs for contractors (as well as for the public sector client), requiring enormous investment just to bid for contracts. This acts as a barrier to market entry and creates economies of scale that favour large providers. These barriers to entry are reinforced by the tendency for "incumbency advantages" to accrue to those providers that establish themselves in the market.

> *"If the incumbent is in a privileged position when it comes to the re-tendering of a particular contract, this may discourage participation of firms with low chances of winning, and may weaken competition overall. Where repeated selection of the same firm increases incumbency advantages … a buyer … may find itself with a rather restricted choice of suppliers in the long term. To the extent that sector bidders anticipate such an outcome, they have an incentive to reduce their price when a new*

requirement is first put out to tender in the expectation of little competition and higher profits in the future."

Office of Fair Trading[141]

CONCENTRATION IN THE PUBLIC SERVICES INDUSTRY

There has been significant consolidation of the **facilities management** sector in recent years. Carillion has acquired Mowlem, while Kier, Vinci, Jarvis, Rentokil Initial and AWG have all been restructured. Industry analysts anticipate that *"recent trends towards consolidation among existing companies will continue over the next few years, with acquisition activity remaining high. FM contracts in general are becoming larger and operated over longer terms … and FM companies need to be sufficiently large and offer a sufficiently diverse range of services in order to be able to compete for these large scale projects."*[142] The growth of "bundled" service delivery and "total facilities management" has resulted in higher contract values and *"has also led to reduced market potential for smaller FM contractors and has encouraged the current high levels of acquisitions in the market"*.

As **social care** services have increasingly been taken over by the private sector, providers have been amalgamating into ever large businesses. Many care businesses operated just single care homes, or two or three homes. As regulatory pressures have increased, it has become increasingly difficult for these small businesses to comply with them. These often underperforming or undercapitalised businesses had their prospects improved by new management, extra finance, or by merger. Private equity houses have played the key role in this consolidation, which is continuing.

The contracting-out of **waste management** services has been accompanied by extensive reorganisation of the private sector interests owning the waste management operators. In 2004 the Office of Fair Trading warned that *"increasing vertical integration amongst suppliers … might limit the number of competitors that can be sustained in the long term because of potentially significant scale economies in waste disposal."*[143] The Office of Government Commerce (OGC) has registered *"concern that competition is limited, with too few players dominating"* – eight to nine suppliers control at least 78 per cent of the market, and in most regions even fewer are able to bid effectively for contracts. The OGC believes that the trend to consolidation *"looks set to continue – which is likely to further reduce the number of suppliers competing for major contracts"*.[144]

The private **healthcare** sector has seen significant consolidation of ownership in the last five years. As a result *The Economist* has warned that the government's aim of creating *"a vigorous external market in hospital care … may be thwarted if the private sector becomes too concentrated"*.[145] Some experts have also warned against undue market power accruing to joint ventures formed between Foundation Trusts and private healthcare companies, which could leave healthcare commissioning constrained by *"the lack of competition these behemoths provide in some parts of the country"*.[146]

The **leisure management** industry is consolidating to a significant extent within the UK – with DC Leisure Management (owned by the private equity house Sovereign Capital) now a leading

operator of services for councils across the country. Greenwich Leisure has taken over the management of leisure centres for eleven other London boroughs, another two councils outside London and facilities for the London Development Agency and community groups.[147]

Housing associations have gone through a comprehensive programme of restructuring in recent years, to bring down the costs of administration and achieve economies of scale. Some housing associations today are the product of mergers of as many as five mid-tier associations. This has included mergers between long-standing housing associations that serviced specific localities, with associations based in other areas and regions and with what had been dedicated LSVT associations created to takeover particular councils' housing stock. In doing so, they been accused of losing touch with their founding ethos, their membership, their geographical focus and of paying senior managers at private sector rather than community sector rates.[148]

This process of consolidation may be further exacerbated as the public sector seeks to minimize the fragmentation and duplicated transaction costs resulting from contracting out by re-integrating and re-bundling services in larger, longer-term contracts. However, this struggle for cost-cutting contradicts the demands from the National Audit Office and the House of Commons Public Accounts Committee to strengthen the contract management function within the public sector, to protect the public purse and ensure that contract terms are property fulfilled.[149]

> *"The tendency in recent years has been towards aggregation of different services to increase the scale of individual commissions … medium to large service providers are in the strongest position to respond, and hence market consolidation is likely to continue across the market".*
>
> **Kable**[150]

The buying and selling of public infrastructure assets and the service concessions – which most notably characterises private equity involvement in public services – mean that public bodies can have no certainty about which organisations they are working with or their long-term objectives.

8.2 Weak public sector commissioning

Weak procurement capability and a sometimes naive attitude amongst public sector commissioning staff has allowed private sector contractors to get away with excessive profits on occasion.

A study by the Office of Fair Trading concluded that "Government commissioners and procurers of public services could do more to leverage competition as a means of achieving long-term value for money." [151]

There are particular problems with the public sector's use of consultants – even after the current Government pledged to cut down their use. The National Audit Office concluded that "government is not getting value for money from its use of consultants

because it often lacks the information, skills and strategies to manage them effectively".[152]

The NAO study found that 17 central government departments spent over £1bn in the 2009/10 year on consultants and interim managers. The NAO added: "The quality of departments' management information on consultants and interims is poor. Few departments can provide information on their spending by type of consultancy, the number of interims employed, or interims' roles and length of contracts. Departments do not always follow best practice when buying and managing consultancy and interims. The price that departments pay is often based simply on time spent on a project, rather then being fixed in advance or related to the achievement of specific objectives. Most departments do not assess the performance of consultants, or whether the work done was of benefit."

The House of Commons Public Accounts Committee was more direct in its criticisms of the way consultants were used. "Despite spending over £1 billion a year on consultants and interim staff, central government departments are largely in the dark about whether this represents value for money," said Margaret Hodge, the PAC chair. She added: "Departments do not control and manage their spending on consultants." The committee pointed out that the Department of Transport, in particular, was very dependent on external consultants.[153]

The public sector has repeatedly failed to invest sufficiently in its client function, to enable it to properly manage and monitor contracts. The Audit Commission review of business process partnerships reported that *"the level of resource is low relative to comparable data on the cost of managing external contracts"*. ESSU reports that *"lack of client and contract management resources"* is universal and *"when the financial analysis of bids and the public sector comparator are close, cost reductions are made to widen the gap in favour of outsourcing. Client and contract management are usually first in line for cuts."*[154]

Public sector clients have in some instances shown themselves to be terribly naïve. The NAO criticised the failure of many public bodies to employ full-time contract managers, which the NAO describes as *"risking false economy"*. In Northern Ireland, local education authorities lost £4.2 million by selling land below market value. Not only did they not properly market test the value of land, but in one instance no attempt was made to check the size of a plot of land measured only by tenderer – which was actually half an acre larger than quoted for. As a result, the public sector lost a third of a million pounds. In another case, land sold for £750,000 was resold for £950,000 just four months later.

Even where the public sector client ties down a contractor to what seems to be a fair price, the risk exposure remains substantial for the client. As we have seen, a key public service contract cannot be allowed to fail and, ultimately, the public sector client must pay the price of re-establishing a service arrangement where the private sector fails to continue supplying the service. The threat to sack a bad contractor can appear to be a hollow one, when the effect of doing so is at least as financially damaging to the client as it is to the contractor.

> *"Councils generally lack sufficient people with the procurement, risk or contract management skills to make effective use of market mechanisms; information about local public service markets that would enable them to use or develop those markets; and information about delivery costs, management costs or service performance to determine the best service delivery option and the best way to secure that option."*
>
> **The Audit Commission** [155]

8.3 Investment costs

While a common justification for privatising public services is that they require significant investments that the public finances cannot afford, the reality is that because their control and ownership is in the private sector there are major on-costs and large fees and charges that the public purse must pay for. Savings in capital expenditure are at the expense of increased revenue spending.

Analysis of the first 12 PFI hospitals showed a much higher cost incurred by the public sector because of the use of private sector funding. The cost of this, just on those 12 hospitals, is an extra £60 million a year. This equates to 20% to 25% of those NHS trusts' annual income. The study concluded: *"If this experience is generalized across the entire PFI programme ... then the extra costs of private finance for the signed PFI capital programme in hospitals worth £8.67bn is about £480 million every year."*[156] This would be enough to pay the capital costs for three extra large hospitals a year. If these costs are extrapolated across PFI procurement on all government departments (but excluding PPPs) – whose PFI programme in 2007 had a capital value of £53bn[157] – this suggests the Government is paying as much as £2.7bn annually to finance the capital costs of the PFI programme, rather than using direct procurement.

Independent Sector Treatment Centres were promoted as a means of delivering new capacity to the NHS, but *"to encourage entry into the market and to cover the cost of new buildings and refurbishments"* private companies were paid over the odds for relatively straightforward procedures.[158] First wave ISTCs were paid 11.2% more than NHS trusts, which works out at 30% more once the greater simplicity of their procedures is taken into account.[159] In addition, ISTCs are paid at guaranteed activity levels, resulting in what the Healthcare Commission and Audit Commission reported as *"widespread frustration among NHS organisations that ISTCs were paid for activity that was not performed"*.[160]

In order to pay for PFI and PPP contracts – including the higher cost of borrowing to invest and the profits to pay contractors and consultants – the public sector is faced with an affordability problem. Quite simply, when spending increases to procure and manage assets, other expenditure must be cut back.

The impact of this extra cost of private finance is particularly severe on NHS acute trusts, which must increasingly compete for work under the Payment by Results system. They are hindered in this by the effect of the cost of borrowing under PFI schemes. Capital costs in the 2005/6 year for 4.3% higher for NHS trusts with major PFI projects than that allowed under the Payment By Results tariff structure.[161] In fact, while the cost of capital for the NHS is 3.5%,

according to analysis conducted by accountants PwC found the average rate of return for the private sector in a PFI contract is 7%. (However, as the Cuthberts have argued – see below – this dramatically understates the real rate of return over the full PFI contract period.) As such, even using figures that are more supportive to private contractors, PFI hospitals must cope with a doubling in finance costs.[162] (A study is currently being conducted into how foundation trusts burdened by high legacy costs for mega PFI projects can compete in a market-based NHS.[163]

This affordability "crunch" has had a serious impact on trusts' finances. While less than a quarter of all NHS trusts were in deficit in 2005/6, half of those trusts with major PFI projects were in deficit – some very substantially. This is clearly not a coincidence. Yet, acute trusts have taken serious steps to address this affordability gap – by cutting back on the size of the hospitals. As has been repeatedly reported, in the health sector the issue of affordability has been partially resolved by reductions in the number of beds in new replacement hospitals, compared to their predecessors. While there are new hospitals, the benefits have been seriously mitigated by the fact that fewer patients can be treated at any one time.

The use of PFI has often been justified by spurious claims by departments of it being "best value for money". But PFI has actually been used as an accounting device to convert capital costs that would traditionally have been covered by borrowing into future revenue costs that create a financial burden for future governments. The overall cost is higher, but this artificially massages the public sector borrowing figures.

The reality was disclosed by the House of Commons Public Accounts Committee. "Local authorities and health trusts used PFI because there was no realistic alternative, not because it represented best value for money," said the PAC chair, Margaret Hodge in February 2011. "The use of PFI and its alternatives should now be robustly evaluated."

The committee also expressed concern that public sector staff engaged in PFI contracting had not extracted the best terms from contractors, in particular by failing to convert private sector investors' economies of scale into savings to be retained by public sector clients. "As with previous reports, we found no clear and explicit justification and evaluation for the use of PFI in terms of its value for money."[164]

Dependence on PFI financing meant that the public sector was especially vulnerable during the "credit crunch" that led into the global recession. As funding for major infrastructure projects dried up – exacerbated by the sudden inability to obtain bond guarantees, because the traditional guarantors had also stood behind mortgage securities – so the Government had to pay much higher rates of interest and arrangement fees to obtain PFI funding. The higher costs were such that "the Treasury should not presume that continuing the use of private finance at current rates will be value for money," said the NAO.[165]

When the House of Commons Public Accounts Committee looked at this it concluded that the taxpayer had been required to pay an extra £1bn to cover the higher financing costs on PFI brought about by the credit crunch. "During the credit crisis, in 2009, at the very time that the taxpayer was providing unprecedented support to the banking system, the banks were

increasing the cost of financing PFI projects by up to a third, and transferring risks back to the public sector.," said the PAC chair Margaret Hodge.[166]

These concerns were echoed by a subsequent National Audit Office enquiry into PFI schemes, which concluded that public bodies should be more sceptical and challenging of the assumptions behind the use of PFI financing.

"The case for using private finance in public procurement needs to be challenged more, given the spending watchdog's previous analysis that the cost of debt finance has increased since the credit crisis by 20 per cent to 33 per cent," said the NAO. "Also, under the national accounting rules, privately financed projects will often still be off balance-sheet which may continue to act as an incentive to use PFI. The NAO concludes that, in the current climate, the use of private finance may not be as suitable for as many projects as it has been in the past.

"There has not been a systematic value for money evaluation of operational PFI projects by departments. There is, therefore, insufficient data to demonstrate whether the use of private finance has led to better or worse value for money than other forms of procurement. The NAO calls on the Treasury and departments to identify alternative methods for delivering infrastructure and related facilities services, building on the lessons learnt from PFI, to maximise value for money for government."

Amyas Morse, head of the National Audit Office, explained: "The public sector should make better use of the hard won lessons from the extensive and substantial PFI programme. This means acting as a more demanding and intelligent customer, by harnessing government buying power through concerted tactics and tougher negotiation."

"One for the price of two"

Jim Cuthbert, a former chief statistician with the Scottish Office, and his wife Margaret, a leading academic economist, have produced a series of analytical papers criticising the cost of PFI. The Cuthberts argue that official assessments of returns on PFI projects have used a misleading statistical analysis to artificially underestimate the real level of profit achieved on PFI projects.

The standard measure of profit achieved is the Internal Rate of Return – the return achieved on equity, though in practice, this includes share-based equity and subordinate debt. The Internal Rate of Return quoted by the Treasury and other public bodies is argued to be reasonable, typically at 15% to 20%. But, point out the Cuthberts, this ignores the reality that PFI/PPP schemes are heavily financed through debt. This high level of debt causes a long delay before shareholders take dividends on their shares. Consequently, the Internal Rate of Return will "rapidly snowball" towards the latter period of the contract.

The real Internal Rate of Return can be understood by an actual example of a hospital in England. The capital cost is nearly £70 million. Finance of over £60 million is borrowed from banks, at an interest rate just over 6%. The PFI consortium invested almost £10 million as subordinated debt, earning 15%, while the equity stake is a mere £1,000. The banks' senior debt is paid off rapidly, leaving only the subordinate debt outstanding, which earns the consortium members a very large annual return. Without the need to pay off the senior debt towards the end of the contract period, the equity return accumulates at a much higher rate in the last years.

The effect is that a £1,000 equity stake generates dividends over the period of the contract of over £50 million. Taken with an eventual £40 million return on the subordinate debt, the consortium members will generate profits of £90 million on equity of £1,000, plus subordinate debt of £10 million.

A hospital costing £70 million has generated profits for the contracting consortium of £90 million, on top of the actual costs of the project. This, say the Cuthberts, means *"the taxpayer has got 'one for the price of two' through using PFI"*.[167]

8.4 Transaction costs

Contracting-out services generates additional "transaction costs" such as writing contracts, legal and technical advice, monitoring performance and controlling the behaviour of contractors. These costs may outweigh any savings achieved through outsourcing in circumstances *"when asset specificity is high, contractors have incentives to behave opportunistically, the number of potential external suppliers is small, and future product requirements are uncertain*".[168]

The Office of Fair Trading observed: *"Evaluating bids is costly, in particular where the buyer's needs are complex and requirements cannot be specified in a simple way""*[169] A related point was made by the Audit Commission, which noted that *"at least some"* of the apparent savings claimed for Compulsory Competitive Tendering *"were offset by the costs associated with managing competitive processes."*[170]

Ironically, the public sector even has to incur costs to ensure that a market exists, even going to the point of subsidising some potential contractors. The Office of Fair Trading observed: *"The public sector may [need to] help firms to overcome entry barriers.*"[171] It added: *"Incumbency advantages … may have to be neutralised … by paying new entrants to invest in getting up to speed with requirements."*[172] Transaction costs for the public sector also arise from the legal obligations required of public bodies (including European Union legislation) to ensure that contracting is not corrupt or discriminatory.

Initial reports of cost-savings under **Compulsory Competitive Tendering** have been found to be *"biased upwards"* as a result of a disproportionate focus on some services, despite evidence that *"CCT appears to lead to additional spending in street cleaning and some aspects of catering"* – as a result such research may *"disguise the fact that, in some councils, competition has imposed extra financial burdens on local taxpayers."*[173]

The Audit Commission review of **Strategic Service Delivery Partnerships** warned that *"contracts will be complicated and procurement costs for all but one of these councils are just over £1 million"*. ESSU cites Southampton and Somerset approaching £3 million. Some projects did not deliver *"the core value for money benefits"* and that *"the contractor had overestimated the scope for savings"*. Partly this was a result of flawed approach to comparing costs based which *"does not include the costs associated with procuring and managing the SSP"*. They recommend that *"councils should expect to invest at least 3% of the contract value to resource client-side management"* contract management could be 2% to 7% – *"increased complexity in contractual arrangements requires higher contract management costs"*.

> *"Local authorities have traditionally failed to identify all the transaction costs involved in procurement, usually by counting the cost of consultants but under-estimating or excluding their own staffing costs and on-costs. The latter represents an opportunity cost and must be fully accounted for."*
>
> **European Services Strategy Unit**[174]

8.5 Excess profits

Private sector ownership and operation of public services is reaping profits which are often far beyond those that might be regarded as a "fair" return on initiative and investment.

Private Finance Initiative

The total capital value of PFI and PPP schemes to date completed or signed is more than £100bn. The largest sector commitments are for transport schemes and hospitals and other health projects. As contractors typically operate on a 10% to 20% margin,[175] this represents at least £10bn in profits alone for the construction companies. In addition professional fees – for legal services and accountancy/consultancy advice – generate substantial earnings for the firms.

Exceptional profits can also be achieved when firms "exit" a contract, selling on their equity stakes. **Balfour Beatty** obtained exceptional profits of £5 million in 2003 from the disposal of its interests in some early stage PFI contracts. To avert administration, **Jarvis** sold its stake in Tube Lines for £147 million, a massive return on its collateral stake of £51 million.

A comparable process of super-profit generation has taken place through the refinancing of PFI projects. Start-up PFI schemes are funded typically mostly by loans, rather than equity. This minimises the losses for investors, whose debt is ranked as a preferential debt (unlike equity). But the interest rate on a loan for a start-up PFI scheme will be quite high. As the scheme beds down, the associated risk falls markedly – with the result that the interest on the loan becomes

much lower. PFI contractors have been able to refinance projects taking advantage of lower interest rates on mature schemes. In the case of **Serco** – one of the partners in the Octagon Healthcare special purpose vehicle that won the Norfolk and Norwich hospital PFI scheme – it obtained a windfall profit of £4.1 million from its refinancing. As much as 80% of contractors' profits in the early PFI projects came from refinancing. Several requests to share the benefits between contractor and client of the re-financings were rejected. There is now a requirement in PFI contracts that any refinancing windfalls must be split 50/50 between contractor and client.

Companies that set-up PFI projects usually operate through Special Purpose Vehicles jointly owned by the contractors. These "SPVs" isolate contractors from potential losses, yet can generate very high rates of return on investments. It was the use of SPVs by Enron to manipulate profits for the benefits of executives and hide losses that led to the most notorious business scandal of recent years. *"The [hospital] SPVs' only activities and income relate to their contracts with the [hospital] trusts. They are shell companies without employees and simply channel payments received from the trusts to its subcontractors, typically their sister companies."*[176] As this analysis noted, the SPV structure allows for the possibility of "transfer pricing" – diverting profits between related companies, in order to declare income in the company (or jurisdiction) that is most tax beneficial. It also creates tied relationships between the subcontractors that own the SPV and the lead contractor that limit choice and "contestability" in the awarding of service subcontracts to fulfil the main contract. In the case of Metronet, the contractor merely awarded contracts to its contractors – who owned the SPV – without any real attempt at monitoring contract performance. This meant that poor performance by subcontractors was not challenged by the lead contractor. Transport for London found the structure destroyed performance accountability.[177]

Consortium members have other ways to increase profits further. The National Audit Office found that changes to PFI contracts and exceptional work were not always charged on a reasonable basis. Despite the massive profits achieved by the companies involved in PFI, ongoing charges can be both high and petty. The NAO found that £180 million a year is paid out to PFI contractors for contractual amendments. It reported major variations in charges for what was often routine maintenance work, which had failed to be specified in the original contract.[178] While one school had to pay £320 to fit a new electric socket, elsewhere the charge was £30.81. At one hospital it cost £486.54 to fit an extra lock: at another it was £15.09. One hospital was charged nearly £50 for a new key – elsewhere it was £4. In many cases there has been no competitive tendering for variations and additional work carried out because of weaknesses in the initial contract terms. Contractors often seeking significantly higher fees as part of periodic reviews. The London Borough of Haringey faced demands of £2 million for backdated "variations" on secondary school facilities management contracts, plus a more than 50% increase in cleaning contract charges.

In the construction sector evidence has come to light of extensive collusion among businesses aimed at holding up prices and saving on bid costs. Clients – which included local authorities – were left with what the OFT termed *"a false impression of the level of competition and this may result in it paying inflated prices"*. The OFT also alleged that successful bidders in some instances made compensation payments to other companies that agreed not to compete aggressively for contracts. The allegations of bid rigging involved a range of construction projects, including hospitals, schools, universities and housing. The OFT has not published its

Statement of Objections – the formal allegations – against the companies, so it is not known which allegations relate to which companies. Statement of Objections were issued against 112 businesses including some of the largest companies in the sector, including **Balfour Beatty**, **Carillion**, **JH Hallam**, **Kier Group**, **Ballast Nedam**, the **Caddick Group**, the **Hall Group**, **Henry Boot**, **Interserve** and **Willmott Dixon**.

Tax avoidance

Prem Sikka, Professor of Accountancy at Essex University, has analysed the impact of PFI on UK tax revenues. His conclusion is that the use of offshore company registrations and other tax avoidance structures have denied the UK Exchequer large amounts of tax income. *"Numerous practices are used to avoid taxes, including setting up complex structures in offshore tax havens which peddle secrecy, low or no corporate taxes,"* he concluded.[179]

However, even where UK investors invest in offshore and other non-UK registered funds, they might still expect to pay UK income tax on their dividends. But, Sikka found, a number of the shareholders that invest in the offshore-registered PFI infrastructure investment companies are also registered offshore. In this way, they avoid paying UK income tax as well, except where individual shareholders bring that income back into the UK. If they spend the money outside of the UK, these offshore-based shareholders in offshore-based companies can completely avoid UK tax – even though the activities that generated this tax were earned within the UK and – in the case of PFI and PPP contracts – paid for by UK taxpayers.

Companies registering offshore are also not liable to UK stamp duty or capital gains tax. PFI and PPP companies that use offshore residencies include **3i Infrastructure Ltd** (Jersey), **Allianz PFI Assets** (Jersey) Ltd, **Hermes** (based in Guernsey and a large investor in PFI/PPP projects) and **Coutts Bank** (whose Jersey division is used for trust-based shareholdings in PFI/PPP schemes).

Professor Sikka found that some companies involved heavily and profitably in PFI schemes did not pay any UK corporation tax, through their use of tax efficient structures. What is more, some shareholders also did not pay any tax on their dividend payments through the use of offshore shareholdings.

Understanding the accounts and finances of some PFI and PPP contracting companies is extremely difficult because of their use of a web of cross-shareholdings, special purpose vehicles and multiple companies. In the case of **Innisfree**, for example, Companies House shows 38 companies that use the Innisfree name and that appear to be possibly inter-related. Other companies associated with the group do not use the Innisfree name. In addition, the Innisfree group has close relationships with construction companies Skanska, John Laing, Mowlem and WS Atkins to build infrastructure that Innisfree finances, owns and is involved in managing. Innisfree also has interests in sector-specific PFI and PPP management companies, including NewSchools Ltd and Health Care Projects Ltd.

The PPP marketplace is muddled by the extent of cross-holdings, disposals and use of offshore investment companies. In 2005, **John Laing** disposed of half its interest in four PFI assets to **Allianz**. But while Allianz is a German insurance and finance group, the division that bought the assets was Allianz PFI Assets (Jersey) Ltd. Despite the partial sale, the assets (two police stations and two police firearm training colleges) were to remain under the management of a Laing company, Laing Capital Management.[180]

8.6 Quality

Part of the rationale for the "marketisation" of public services is to cut costs. Once privatised, the providers of services are motivated by the twin desires to operate the contract in accordance with the specific terms of the contract and their need to extract profits, to pay dividends to shareholders. These pressures can mean that contractors prioritise cost-cutting at the expense of service quality and conditions of employment.

In particular – and especially where contracts are awarded for short-term periods – there can be under-investment in public services, with little incentive to properly resource a service where it may become the responsibility of a rival in the foreseeable future. (This has been an acute problem with railway franchise contracts.) Obviously these pressures are at their most severe towards the end of a contract period if the contract is not to be renewed, when perhaps relations with the client and reputation are no longer priority concerns. These factors can mean that assets decline in quality, that IT and other infrastructure is not invested in and that staff are not adequately trained. It can also mean that staff are allowed to leave towards the end of a contract period – at the expense of service users, with inexperienced or too few staff to service the needs of clients.

Economic analysis suggests that *"market forces"* may not be *"sufficient to ensure that agents fulfil the objectives of principals" (ie contractors) and that this is particularly likely where "information on the quality of service actually delivered remains asymmetrical"*. Furthermore, *"it may be argued that the incentive to 'shirk' on quality is greater for private than public agents. Once a contract price has been agreed, a private firm can boost its profits by reducing service quality"*.[181]

Investment in the staff who deliver public services is a key dimension of this. The last Government recognised that terms and conditions offered by contractors *"must be sufficient to recruit and motivate high quality staff to work on the contract and designed to prevent the emergence of a 'two-tier' workforce, dividing transferees and new joiners working beside each other on the same contracts"*.[182] However, the Coalition government abolished the Two Tier Code that was intended to prevent the creation of a two tier workforce of staff transferred to contractors under TUPE, who kept their public sector pay and conditions and those taken on later who worked on contractor's inferior terms and conditions. The government is also reviewing the arrangement which allows public sector workers to keep their pensions when they are transferred to other sectors. The overall effect of these changes will be a race to the bottom, with contracts going to those who pay the least to their staff.

A two tier workforces with poor employment standards impacts on service quality, and means that the public sector is ceasing to accept its responsibilities for paying decent wages or providing good quality pensions – which, in turn, means that it will have to pay more in means-tested benefits in later years.

Research has also shown that private equity firms that own portfolio companies for a short period of time do not prioritise staff retention and that companies in which private equity is involved have a faster turnover of staff. Where private equity houses take over companies that are contracted to provide public services, TUPE no longer applies – allowing private equity firms to cut wage rates and pension entitlement and increase working hours. There is evidence that

much of the reward for private equity investors comes at the expense of workers' pay and conditions. This mirrors criticisms of the way private equity works in taking over private sector companies. The high level of debt taken on by private equity firms often leads to cuts in jobs, as they seek to repay loans and achieve very high targets for returns. This, in turn, affects the quality of service provided, especially to vulnerable people, such as care of the elderly and vulnerable children.

Private sector run public social care services have been demonstrated to be of poorer quality on average than those provided by the public and voluntary sectors.

> *"In the past, services run by the third sector (voluntary, community, charity or nonprofit organisations) had the highest proportion (80%) of services rated good and excellent. However, by 2010, services run by councils had the same proportion of good and excellent services (91%) as third sector organisations. Privately run services had a smaller proportion of good and excellent ratings (81%) compared with other ownership types in April 2010…… Similar findings are reported in an international review of research, which found a trend towards higher quality in not-for-profit nursing homes when compared with services run for profit."*
>
> **The Care Quality Commission**[183]

QUALITY IN QUESTION

Compulsory Tendering of **local government services** raised concerns that it *"engendered short-term, low-trust relationships between principals and agents. Having won the work, contractors had good reason to minimize their efforts consistent with compliance"*.[184]

The private provision of **school catering services** has resulted in understaffing, poor pay and conditions, little training, and underinvestment, making it harder to raise nutritional standards, tackle child obesity and improve public health.[185]

The widespread contracting out of **hospital cleaning services** has resulted in staff reductions, poor terms and conditions, and under-investment in training and equipment, resulting in a fall in hospital cleanliness that has been linked with the rise in Hospital Acquired Infections.[186]

The Audit Commission found that for large scale **strategic service delivery partnerships,** *"variables like service quality are hard to measure and there have been occasions when performance targets have been met on paper, but the council has had concerns about the quality of service delivery that cannot be evidenced through their performance management processes"*.[187]

The market for **ICT services** is one of the most developed in the public sector – it is also one of the most troubled. There is now a long history of contracts that have gone wrong- ranging from the EDS and Andersen contracts with the Inland Revenue, to the large number of revenue services contracts in local authorities that failed. ESSU report identified 105 public sector ICT contracts with £9bn cost overruns averaging 30.5%, a third of contracts suffering delays and 30% of contracts terminated.

Evidence from the National Audit Office, the Prison Service Pay Review Body, and the Prison Inspectorate suggests that cost-savings achieved by **private prisons** are largely the result of employees working longer hours, with few holidays, for lower pay and inferior pensions and other benefits.[188]

Wage rates in the **social care** sector have always been poor – even when in public sector ownership. But there is evidence of pressure to cut wage rates, working hours and staff numbers even further. (See Excelcare case study.) There is also evidence of companies bringing in workers from other countries who may be more willing to work on the UK minimum wage. The Care UK annual report for 2007 said that to avoid recruitment from within the NHS it has recruited staff from 13 countries, with "62% of employed healthcare professionals being recruited from overseas.

The shift towards a largely outsourced **home care** services has left us with a sector that is *"struggling already to provide services of sufficiently high quality"* and failing to *"recruit, train and develop care workers … to meet new demands and ways of working."*[189]

There are also worries that **voluntary sector providers** are failing to maintain conditions of employment previously provided by the public sector – a situation unlikely to change as their costs come under pressure from private sector competition in which costs are rigorously controlled. Research evidence indicates that third sector organisations are responding to the need to compete for service delivery contracts by reducing staff, cutting terms and conditions, and that smaller organisations are finding it increasingly hard to survive.[190]

Case study: Exelcare care homes

Excelcare took over ten care homes from Essex County Council in 2005. It runs these as part of a chain of 39 care homes, with 1,800 beds, in England and Wales. After taking over the Essex care homes, the operations were divided between ten separate legal companies.

A year later, Excelcare announced that it was facing financial difficulties and cut the terms and conditions of the workforce: wages were reduced by up to 40% for senior carers, with some experienced staff having to take the minimum wage, while working hours were increased from 10 to 12 hour shifts. Some staff had to obtain state benefits to compensate for pay cuts. New starters were put on reduced terms and conditions, creating a two-tier workforce. This led to an exodus of staff who refused to accept the working conditions.

But according to accounts filed at Companies House, the homes would have been operating profitably were it not for unspecified administrative expenses placed onto the balance sheet, which on average worked out at £470,000 per home. This gave rise to allegations that losses were artificially generated to justify cuts in pay and conditions for staff.[191]

Barnet care homes

The Fremantle Trust decided in April 2007 to dismiss and re-engage care workers who had previously been employed by the London Borough of Barnet. Their new terms and conditions were much inferior, with staff losing up to 35 per cent of income and cuts to their sick pay and holiday entitlement, even though staff had been transferred to Fremantle under the Transfer of Undertakings (Protection of Employment) Regulations five years before. Staff had been assured

their terms of employment would be upheld when the not-for-profit Fremantle Trust took control of Barnet Council's care homes.[192]

8.7 Inflexibility

The privatisation of large numbers of direct service organisations undermines the ability of public bodies to provide services on a flexible basis, responding to changing demands.

A serious problem with **business outsourcing** contracts is that they can prevent clients acting flexibly to changing environments. The Audit Commission warned: *"Councils and their contractors will be unable to predict how the political and financial environment will change over the duration of the SSP [strategic service-delivery partnership], and in some circumstances SSPs may reduce the flexibility of the council in responding to these changes."* [193] It found that contracts may be obstacles to councils changing as service demands change. Public sector clients found an absence of partnership ethos where there were no financial incentives rewarding this built into the contracts. The National Audit Office has also warned that outsourcing corporate services to shared service providers *"can tie purchasers of shared services to providers that are prepared to work around purchasers' inefficient processes"* and *"entrench"* inefficiencies.[194]

Schools locked into contracts with private catering providers or PFI consortia have faced prohibitive costs when trying to improve the nutritional standards of **school dinners**. It was reported that a number of schools in Merton may have to be exempted from new standards because of the costs of renegotiating contracts with Scolarest (a division of Compass), while schools in Islington faced penalty payments if they opted out of catering contracts agreed by Cambridge Education Associates who run education in the borough.[195]

The Local Government Association has warned that efficiency targets will be harder to meet with "between 20-30 per cent" of **local authority** non-schools spending *"tied up in external contracts with the private and voluntary sector"* as *"often contracts cannot be renegotiated over short time periods (for example waste collection contracts often run for seven years)"*. The result is to place an even greater burden on services that have not been contracted out.

"Once you have set up partnerships or outsourced service provision to make savings these contracts are then fixed with probably indexation included which makes it difficult if not impossible to extract further savings in the short term."

local authority, quoted by the Local Government Association[196]

"Those that have already sold their housing stock, transferred their leisure services to a trust and have outsourced their major process driven work (eg waste) will find it impossible to find such savings from the relatively small number of retained services."

local authority, quoted by the Local Government Association[197]

Case study: Balmoral School, Belfast

Belfast's **Balmoral School** was built under the PFI and provided to the local education authority on a 25 year contract. But unexpected falls in student numbers meant that it closed just six years after it opened.

The result is that public bodies will have to pay £9.26 million for the empty buildings over the remainder of the contract period. At least four other PFI schools have similarly had to close, despite the ongoing financial commitments.

8.8 Accountability

The weakness of public sector agencies in relation to private contractors is a recurrent concern. The sheer size and scale of some contracts means that the public sector is, in practice, weak and dependent on its private sector contractors. Far from the client controlling the contracting environment, all the power lies in the hands of the private provider. In these circumstances, contractors can insist on favourable contract conditions and the absence of any alternative suppliers means the public sector client must comply.

Service providers can dominate the contracting arrangements – particularly where the scale of the required investment means there is weak competition for contracts. Building Schools for the Future was reshaped to fit the requirements of the market, rather than the clients. Where the financial requirement is huge – as with the Tube PPPs – the entire market for potential lenders is drawn into the contracting as co-financiers, meaning that all their demands must be met. There is then, in effect, no competition between potential providers, nor potential investors.

Accountability through contracting often fails to work. Ultimately, the client can only "sack or accept" the failures of a private sector client that continually underperforms. Ironically, this is particularly true with very large contracts – such as that for the NHS patient records contracts.

> *"Where customers of private firms are normally able to seek out alternative suppliers if any particular firm cannot deliver, this option does not normally exist in the case of public services. Any failure of procurement that jeopardizes the ability of the public sector to provide services to the public is highly visible, and may have significant detrimental effects. As a result, avoiding failures is a high priority for the public sector. This may lead to an overly strong incentive to limit participation in public tenders to large and reputable firms, or to stick with incumbent suppliers."* **Office of Fair Trading**[198]

An NAO study found serious problems with the retendering of the facilities services components of PFI contracts. In nearly half of the early PFI contracts examined, value for money had not been achieved, or could not be shown to have been achieved, when the facilities services elements of contracts came up for retendering. Facilities services constitute a large part of the ongoing value of a PFI contract. It is usual for contractors to be given the opportunity to tender for continuing to supply of these services, with the bid compared with

market costs either through benchmarking or market testing (competitive tendering). The NAO found that where value for money had been achieved, it had involved public officials negotiating down the price proposed by the contractor. In other cases, above inflation increases in service costs had been agreed without adequate competitive pressure on contractors. A legal opinion obtained by the NAO found that original contracts had not been sufficiently well drafted to ensure that public bodies were able to competitively test prices for the renewal of facilities services.

Contractors will often insist on confidentiality clauses, restricting the supply of information to the media and the public on contract details. This can mean that it is impossible for the public to determine whether costs are paid are reasonable and whether a contract offers good value for money.

Case Study: South West One

Southwest One is a shared service partnership, entered into with IBM by Somerset County Council, Taunton Deane Borough Council and Avon and Somerset Police. It has taken over the jobs of 1,400 staff, under a contract worth £585 million to IBM. It includes a framework agreement, through which another 33 public bodies may join Southwest One.

While the councils claim that £200 million in efficiency savings will be achieved, they and IBM have refused to provide evidence for the claim – arguing that commercial confidentiality requirements prevent this. The scale of the claimed savings are so large that UNISON believes they are not credible.

Analysis conducted for UNISON found six shortcomings in the procurement process: there was no consultation with service clients, such as schools; there was no proper scrutiny of the contract proposals; it is unclear how or whether service transformation will be achieved, because of secrecy provisions; the governance structure for Southwest One is also a secret, undermining public service accountability; the contract arrangements have undermined staff relations; and there was not full consideration at an early stage of alternative options. UNISON has called for an Audit Commission review of the contract before its operations are extended further.[199]

8.9 Service disruption

The outsourcing of IT support services has opened-up the Government to additional security risks. With more organisations involved in the management of data, the risk of data loss is multiplied. The crisis over the loss of an HM Revenue & Customs disk containing information on all tax credits claimants was caused when the disk was despatched by a private sector mail agency. PA Consulting have been blamed by the Home Office for losing information on all prisoners, after a member of staff mislaid a memory stick. And EDS has been accused by the Ministry of Justice of allowing a hard drive to go missing, which contained personal data, including addresses, of prison staff.

The Audit Commission found that of its sample three **strategic service delivery partnerships** were terminated *"because anticipated benefits had not materialized and there was little confidence that they would"*. It judged that *"many councils erroneously considered a high*

proportion of risks as being transferred to the contractor. These councils either transferred too many risks, or considered that risks had been transferred when they had not." [200]

Even contracting services to not-for-profit social enterprises is no guarantee that a public body will not end up being supplied by the private sector, or of ensuring continuity of supply arrangements. Ealing Community Transport, a social enterprise, sold its waste management operations to leading private sector contractor Gurney May. In doing so, local authorities that had contracted with the not-for-profit sector found that service delivery had been transferred to one of the leading businesses in the sector.

8.10 Economic risk

> *"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."*
>
> **John Maynard Keynes**

Reliance on private finance makes a government very vulnerable to market conditions. There has been a substantial use of debt rather than equity for private equity acquisitions and for the financing of PFI and PPP contracts. This has several implications.

One of the most serious is that as the cost of borrowing rises and when loan finance becomes scarce – as happened in 2007 and 2008 – the business model may no longer be sustainable and the business may no longer be viable. Lenders have in the last year had less money available for making loans because of the tightening of the inter-bank lending market. This, in turn, made it more difficult and more expensive to borrow for PFI and PPP projects.

By gearing financing to borrowing rather than equity, commercial partners have less commitment to the company, while the shareholders have preferential call on the assets of the business in the event of liquidation. This creates incentives to structure a company fulfilling public service contracts as a "special purpose vehicle", with a small equity commitment, and to abandon it if the losses become severe. This is exactly what happened in the case of Metronet (see case study).

The nature of the financing can also seriously affect the nature of charges made to customers. While shareholders' returns vary according to the performance of the company, lenders have an agreed rate of return that must be maintained whatever the performance of the company. When privatised, water companies were largely financed by equity, with shareholders content to expect long-term returns. Subsequently, much of the sector has been bought by private equity firms that demand high, short-term, returns, with purchases financed by loans that have become more expensive as the credit crunch has impacted. This suggests that water charges are likely to rise in the medium term, while private equity firms' short-term returns have been achieved by economies of scale from industry consolidation – undermining the whole principle

that the then government set-out when it privatised the industry through a diversified ownership structure.[201]

Government finances are therefore put at further risk when the economy performs badly and when money becomes more expensive to borrow. If the trend towards further consolidation of the industry continues and one of the largest commercial providers collapses because of the cost of borrowing, the Government could face demands to bail out companies providing services that it had sought to distance itself from.

9. Conclusions

There is a reason why the public sector was created, evolved and provided services. Before the welfare state was created, essential services that were required by the public were actually only available to those who could afford them, or those who benefited from charities. This is why state education, the National Health Service and the welfare state were created. The recent direction of public services is taking society gradually back towards that old situation – as can particularly be seen by developments in social care and the NHS.

The widespread privatisation of public services is now a reality. The impact of this can be observed widely. The supply of public services through the “public services industry” makes service users dependent on the private sector and vulnerable to market changes. This means, for example, that the ownership of the services can change rapidly – as has happened in the residential care sector. It can mean that services are withdrawn – as has happened for vulnerable children in residential care. The cost of paid-for services can increase when the way the service is financed changes.

Ironically, the increased “marketisation” or privatisation of services has coincided with a commitment to reduce the burden of regulation imposed by public service regulators, including through the abolition of the Audit Commission. Serious questions have also been raised about the capacity and competence of the Care Quality Commission to properly regulate its extended brief of residential care and healthcare.[202]

As a result in the decline of regulatory oversight, private companies taking over the running of public services can expect less close inspection and evaluation of their competence than was the case with the public bodies that used to run the services. Altogether there is a worrying trend towards a reduction in the regulation of the public services industry – just when it needs to increase. Any reduction in regulation runs completely contrary to the experience of the financial services sector, which is that light touch regulation allowed banks to bring the financial system to the edge of ruin.

With the allegations, too, of collusion between suppliers – as with the Office of Fair Trading’s investigation into the construction industry – there are fears that public bodies are not getting good value for money from contracting with the private sector. The privatisation of large numbers of direct service organisations undermines the ability of public bodies to provide services on a flexible basis, responding to changing demands, and to compare prices to ensure tendered prices represent good value.

The reality is that all too often the marketisation of public services fails to produce value for money for either the public sector, or for the citizens who depend on the services. Meanwhile, far from saving the Government money, private finance increases the costs and exposes it to massive new risks of service failures, which the Government will have to step in and resolve. The marketisation of public services represents a failure of policy that increases the Government’s financial exposure and presents a potential personal catastrophe for vulnerable service users.

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