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# Carillion's collapse and the future of PFI

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## Introduction

An analysis of past corporate failures reveals that many of their causes are common across industries and countries (Hamilton and Micklethwait 2006). Carillion's rise to glory and spectacular downfall, reminiscent of Enron's, were attributable to reckless expansion, hubris and greed (House of Commons 2018). This article draws on data from published sources (ie Carillion's annual reports, press releases and parliamentary proceedings) to examine the causes and consequences of Carillion's collapse and the future of the Private Finance Initiative (PFI) policy.

Understanding the collapse of Carillion is important because:

- the collapse will cost taxpayers about £150m, as a large number of contracts between Carillion and the public sector need to be resolved and rescued
- it left a pension deficit of over £800m for workers, over £1bn of bank debts and over £2bn of trade debts (Ellison 2018; Carillion 2017), although stable dividends had been paid to shareholders and a generous executive compensation package for directors had been maintained, and
- the fact that risks transferred to the private sector can revert back to the public sector leads to the questioning of the notion of risk transfer and value for money in PFI contracts.

Prior to its collapse, Carillion, with 43,000 employees, was UK's second-largest construction and facilities management company, and had a large number of contracts providing essential public services across government departments, such as the NHS, defence, education, energy, and prisons. It collapsed following financial hits from PFI deals. Carillion has left behind a number of partly finished PFI contracts and created uncertainties about the provision of public services, thus forcing the government to intervene. Moreover, Carillion's collapse has called into question the role of accounting, pension and government regulators in promoting good corporate governance.

## Carillion's collapse: Causes and consequences

In July 2017, Carillion announced that its profits would suffer an unexpected fall of £845m and as a result there would not be any dividends for shareholders (Mor et al. 2018). Within two days of the announcement, Carillion's shares lost 70% of their value and its chief executive resigned. About £314m of the £845m losses were attributable to risky new market ventures in the Middle East (*Global Construction Review* 2018) while £375m losses were attributable to cost overruns in three public-private partnership (PPP) projects: the construction of a new £335m Royal Liverpool University, a new £350m Midland Metropolitan hospital, and a road project in Aberdeen, which were plagued by delays and escalating costs (Goodley 2018). In September 2017, Carillion's half-year financial statements showed that the company's operating profit before tax fell to minus £1.2b (Carillion 2017).

Although the second half of 2017 marked Carillion's demise, this was the culmination of poor strategic decisions over some years. Carillion's failure was not only attributable to failed PFIs. There were numerous red flags. Senior executives at Carillion followed the highly risky strategy of growing through external acquisitions (as opposed to internal organic growth), both to boost short-term earnings and to remove market competition for major contracts. It acquired Mowlem for £350m in 2006, Alfred McAlpine for £565m in 2008, Eaga for £298m in 2011 (House of Commons

2018), but in 2016 failed to merge with Balfour Beatty, whose directors were sceptical of Carillion's claims that the proposed merger would generate synergies to the tune of £175m a year (House of Commons 2018). The prices Carillion paid were substantially higher than the value of the net assets of Mowlem, Alfred McAlpine and Eaga, and as a result Carillion's debt ballooned from £242m to £1.3bn between 2009 and January 2018. Moreover, these companies had pension deficits, the responsibility for which fell onto Carillion following the acquisitions.

Although acquisitions offer the potential to rationalise activities and save costs, that may outweigh excessive prices paid, these synergies require senior management's time and resources, and can take years to come to fruition, if they do so at all. For example, Eaga made an accumulated profit of £31m prior to its acquisition by Carillion (Carillion Energy Services 2011) but in the five years following its acquisition it made accumulated losses of £260m (Carillion Energy Services 2016). Moreover, such acquisitions were motivated by the ambition, greed and hubris of executives who then spend insufficient effort on integrating activities to realise the potential synergistic benefits. While its acquisitions subsequently resulted in an impressive portfolio of activities, Carillion's risk exposure across a large number of unrelated sectors, locally and internationally, partly contributed to its collapse. In summary, the directors failed the challenge of understanding and managing a complex portfolio of diversified activities and interacting with diverse partners from the public and private sectors, nationally and internationally.

Despite fluctuating profits, Carillion's executives provided growing dividends to investors to avoid signalling bad news. For example, Carillion paid dividends of £77m in 2014, £80m in 2015 and £83m in 2016 (Carillion 2014, 2015, 2016). This dividend scheme, according to dividend signalling theory, was meant to attract investors and conceal bad news. The cash flow problems faced by Carillion did 'not prevent them shelling out dividends and handsome pay packets for those at the top' (Work and Pensions Committee 2018). For example, the chief executive (Mr Richard Howson) received an increase in his basic salary of 8% in 2015 and 9% in 2016 and 'a bonus of £245,000 (37% of his salary) despite meeting none of his financial performance targets', while the chairman (Mr Philip Green) received an increase in his fee of 10% in 2016 (House of Commons 2018: 33). In contrast, employees received only a modest pay rise of 2% in 2016.

The firm's operating margin in 2016 was 3.3% while its gross profit margin was below 10%, which provided very little margin of safety for covering interest payments. Weaknesses in Carillion were confirmed by its relative strength index (RSI) which went below thirty, implying an oversold position. The operating profit, which fell substantially between 2015 to 2016 owing to stiff competition, was absorbed by pension payments (and unfunded pension deficits to which the directors were reluctant to contribute), dividend payments, and interest payments. Moreover, the company was owed £400m from Middle East projects in Qatar, Dubai and Oman (*Global Construction Review* 2018).

Some investors and short-sellers spotted the problems with Carillion well in advance of its collapse. For example, in a letter to the Pension and Works Committee, the co-chief executives of Standard Life Investments stated that although in 2015 it had been a major shareholder of Carillion, holding a 10.8% equity stake, in 2016 it reduced its stake to 2.1% and had fully sold its equity by the end of 2017, 'due to concerns on a number of issues including strategy, financial management and corporate governance' (Standard Life Aberdeen 2018: 1). Short-sellers are generally risk-taking, but astute, investors who bet on falling share prices. At the start of 2017 about 25% of Carillion's stocks were owned by short sellers and this figure peaked at 32% (see, for example, shorttracker.co.uk, which shows the percentage of stocks sold by short sellers).

The firm's cash flow was dependent on long-term contracts and was volatile, even though it had dependable cash inflows from government contracts (House of Commons 2018). Carillion squeezed its suppliers by making them wait more than 120 days for payment and offering to pay them earlier under an Early Repayment Facility in return for a fee payable to partner banks. Through this Early Payment Facility, which the government introduced in 2011 to speed up payments to small businesses and contractors, suppliers could take their invoices to a number of partner banks (such as Royal Bank of Scotland, Lloyds and Santander) and be paid in advance in return for a fee, while the debt would be transferred so that Carillion then owed the money to the banks.

This ballooning of trade creditors increased the company's borrowings and risks. As regards receipts from customers, accounts receivables were growing faster than growth in turnover, which further stressed Carillion's cash flows. Despite these red flags, the external auditor (KPMG) did not qualify Carillion's audit reports and its internal auditors (Deloitte and EY) did not raise major concerns about the company's governance, risk management and internal controls. KPMG was Carillion's external auditor for 19 years, raising questions about whether such a long tenure had led to complacency and compromised KPMG's independence and objectivity. The Business, Energy and Industrial Strategy Committee and Work and Pensions Committee (House of Commons 2018: 4) assert that 'in failing to exercise professional scepticism towards Carillion's accounting judgements over the course of its tenure as Carillion's auditor, KPMG was complicit in them'. Therefore, these committees recommended that the government should make a case to the Competition and Markets Authority to consider breaking the Big Four audit firms into a number of smaller firms to promote trust in the audit profession and provide greater competition in the provision of professional services such as internal auditing, taxation, risk management, and business turnaround advising.

Prior to Carillion's collapse, PWC and EY refused to act as administrators amid concerns that they might not be paid for their services (*Financial Times* 2018). The government stepped in to pay for the costs of the Official Receiver when Carillion entered into liquidation on 15 January 2018, on the grounds that this move would protect the continued provision of public services in schools, hospitals and prisons (*Financial Times* 2018). This means that the government has committed to provide £150m of taxpayers' money to enable the continuation of the public services that Carillion had contracted to provide.

The burden of absorbing Carillion's pension deficit is going to be a major one for the Pension Protection Fund (Jones 2018). Although the directors were reluctant to contribute to Carillion's pension deficit, The Pensions Regulator is partly to blame for failing to use its power to enforce pension contributions (House of Commons 2018).

## Post Carillion's collapse: The future of the PFI policy

Mr Philip Green, Carillion's non-executive director from June 2011 until May 2014, when he became chairman, conceded that with hindsight he regretted a number of decisions that the Board had taken.

- They failed to reduce the debt sooner through equity fundraising, which would have strengthened the company's balance sheet, prior to the collapse of its share price.
- They had wrongly decided 'to pay the dividend in March 2017'.

- They had failed 'to make a change in management sooner'.
- They had acquired Eaga, which 'was, in hindsight, a mistake and added materially to the debt position'.
- They had pulled out of contracts in the Middle East and Canada too late.
- They had bid 'for the four major contracts…which caused the company so much difficulty in 2017' (Green, 2018: 2).

Moreover, Mr Richard Howson, chief executive of Carillion from 2012 to July 2017, stated that, in year prior to its collapse, Carillion bidded aggressively on contracts because the company 'did not have any money to buy competitors' and had to grow 'organically' – it had to bid and win to survive (House of Commons Oral Evidence, 2018: 77)

In the aftermath of Carillion's collapse, in October 2018, the Conservative government's Chancellor of the Exchequer, Philip Hammond, announced the abolition of PFI for new infrastructure projects by stating that 'I have never signed off a PFI contract as Chancellor and I can confirm today that I never will' (BBC 2018). The rationale was that the PFI model, under which private companies take on most of the construction and facilities management risks of a project in exchange for a stream of payments from the government over the duration of the contract – 25 to 30 years – has provided poor value for money to taxpayers owing to inflexibilities, cost-escalation and complexities. In fact, it is worth noting that since the inception of PFI policy in 1992 by the UK's Conservative government, the sustainability and value for money benefits of using the controversial private finance policy to fund infrastructure projects has been under scrutiny. Nonetheless, the policy was significantly expanded under Tony Blair's and Gordon Brown's Labour governments.

PFI has been condemned for enabling private sector companies to rack up excess profits, providing poor value for money and burdening public sector organisations such as NHS trusts with crippling debt commitments. The UK's Office for Budget Responsibility has stated that PFI liabilities and commitments represent a source of significant fiscal risk to the government. Despite this change in political stance, there are still 700 active PFI projects that will cost taxpayers £199bn by the 2040s.

The value for money claims under PFI rest on private sector efficiency. In a typical PFI, the government seeks to transfer to the private sector a limited number of risks, such as: meeting required standards of service specified in the contract, construction of the facility within time and budget, the costs of providing facilities management services, and future costs associated with insuring and maintaining the PFI asset. The government claims that PFI enables the optimal sharing of risk between the public and private sectors and as a result provides better value for money than if the public sector were to retain all the risks.

It is worth noting that a PFI project could only obtain approval if it was cheaper than a 'public sector comparator' (PSC), which is a hypothetical cost of conventional public sector procurement. Public sector authorities were, however, told that conventional public procurement was not an option, ie PFI was the only way to go. Public bodies hired consultants to legitimise the PFI/PSC comparison, by valuing the costs of risk transfer, which were added to the PSC when calculating value for money for the PFI option. A number of studies have suggested that the PSC was cheaper than PFI before considering risk transfer, which involved making subjective estimates of expected probabilities and costs (eg Shaoul 2005).

Although in theory risks may be optimally allocated at a particular point in time, achieving optimal risk transfer over the life of a PFI contract is a complex and difficult process, primarily because

optimal risk transfer to the private sector is fraught with a number of uncertainties inherent in any project, external environment and PPP relationship. Therefore, risk management, which involves 'identifying, assessing and controlling risks that emerge during the course of the policy, programme or project lifecycle', should be a key component of the evaluation of PPP for value for money at the post-implementation stage (HM Treasury 2003: 79).

Although risks are shared with or transferred to private sector contractors, the public sector partner ultimately remains responsible for providing public services. While PFI companies are not too big to fail, the public services they provide are critical to an economy. Hence when PFI companies such as Carillion fail, taxpayers end up picking up the bill from poorly structured deals and private sector mistakes and inefficiencies. Governments may thus insulate corporations from the very risks they claim that they have transferred to the private sector. This may explain why the government continued to keep Carillion afloat by awarding PFI contracts even while Carillion was issuing a number of profit warnings.

PFI has been portrayed as a mechanism for privatising profit and socialising risk, despite austerity in the public sector (eg Shaoul 2005). Under PFI, payments for the costs of providing PFI services to the private sector are ring-fenced while the costs of providing core services, such as the provision of clinical services in hospitals and teaching services in schools, are not, leading to cuts in core activities when budgets are cut in times of austerity. This creates a perverse situation where the costs of infrastructure are left untouched while doctors, nurses and teachers could get a pay cut or be laid off.

In times of austerity, government departments may drive a hard bargain with the private sector. PFI contractors may also face pressures to drive down contract prices, underbid, and expose themselves to risks of insolvency, as the case of Carillion demonstrates.

Under PFI, the risks transferred to the private sector are reallocated among different private sector parties participating in the project, using a central consortium company which diffuses risks by subcontracting them to construction, facilities management and insurance companies. Carillion's case shows the public sector has limited recourse to the private sector partners, whose liability is limited. The use of high gearing in PFI contracts enables directors to maximise their own executive compensation while gambling the investments of equity of shareholders on risky projects. Carillion's collapse shows that the risks to debt financiers, workers, governments, and consumers of public services are real, and such risks revert back to the public sector when a PFI deal collapses.

In the case of Carillion, the government stepped in 'to support the official receiver to provide these public services until a suitable alternative is found, either through another contractor or through in-house provision' (House of Commons Hansard 2018). The government drew on the budgets of the relevant departments to pay Carillion's official receiver the wages of employees providing public services, to avoid disruption and further public backlash. In the longer term, some of Carillion's contracts may need to be taken in-house by the government or transferred to other contractors (House of Commons Hansard 2018).

The ineffectiveness of government in understanding and managing risks has partly undermined the value for money obtained from PFI contracts. The government aggressively transferred risks that it understood very little and focused on 'price while failing to appreciate differences in quality that contractors [might] be offering' (House of Commons PACAC 2018: 3). The government itself needs to reassess its risk exposure to the insolvency of large contractors, by examining how the portfolio of existing PFI contracts is spread across large private sector contractors, and whether the award

of new contracts would increase its risk exposure. While government and the opposition have demonised PFI in the light of Carillion's collapse, contracting with, and/or outsourcing to, the private sector in other ways will remain a feature of government. What matters most is the government's oversight and control of public services, and reforming systems and processes to protect the public's interest.

## Conclusion

Carillion's collapse points to systemic flaws that the government, regulators and the accountancy profession need to recognise and address. The collapse happened despite prior governance and accounting reforms in the legal and regulatory environments. Carillion's collapse points to the need to reconsider the powers of regulators and redress weaknesses and complacency in systems of governance. The aim should be to promote the corporate accountability of directors, not only to shareholders but also to stakeholders (eg employees, customers, suppliers, debt financiers and the government, among others). For example, whilst companies have an obligation to pay for a pension liability, the payment of dividends to shareholders and excessive remuneration to directors are optional. The Financial Reporting Council may need to adopt a more proactive role and be provided with the necessary powers to:

- call companies to account
- investigate allegations of malpractices from whistle-blowers or relevant stakeholders, and
- penalise companies for poor boardroom behaviour, thereby improving trust in financial reporting systems and processes.

PFI failures such as Carillion demand a reassessment of the sustainability of using private finance to fund public infrastructure projects. Carillion's case suggests that value for money benefits arising from sharing of risks with the private sector, leverage of expertise, and efficiency gains may be negated by poorly structured deals and excessive risk taking. It is worth noting that the abolition of PFI is unlikely to mark the end of private companies' involvement in infrastructure projects. Therefore, how should a new model be developed that would enable public and private sector partners to share the responsibilities involved in the designing, building, financing and operating of infrastructure projects in ways that are sustainable in the long term? Such a model would require the creation of appropriate support structures at the macro policy level, and the provision of joint equity, transparency, and sharing of risks to meet multiple expectations at the micro project level.

In the context of PFI decision-making processes, the supposed neutrality of calculation in demonstrating value for money through the application of rules and techniques for valuing risks may be a mere illusion that conceals the realities of under-bidding. The limits of the accounting techniques that are used to justify the PFI decision need to be acknowledged. In the current era of austerity, where PFI is widely perceived as the only option and conventional procurement is not perceived as a viable alternative, the incentive to manipulate figures to justify PFI will remain unless a real, sustainable, alternative procurement option becomes available to procuring authorities. The government may need to vet the value for money of PFI bids carefully by looking beyond estimated costs, as the cheapest bid or the largest contractor may not necessarily provide the best value for money.

The government may also need to revisit its role in, and the value for money of, existing PFI contracts, assess the financial strength and capability of its partners, and restructure the PFI model to improve how it serves the public interest. This would involve engaging with its private sector

partners to understand their business model, corporate culture, and strengths and weaknesses so that the risks to the continuity of public services are quickly detected, addressed and remedied.

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