National Audit Office

Report
by the Comptroller
and Auditor General

UK Trade & Investment

Investigation into the UKTI specialist services contract with PA Consulting

HC 20 SESSION 2016-17 10 JUNE 2016

Summary

What this investigation is about

1 UK Trade & Investment (UKTI) re-let its contract for specialist services in May 2014. PA Consulting Services Limited (PA), the incumbent, won three of the five lots and Ernst & Young LLP the other two. The lots won by PA were designed to provide 'sector specialist services' – specialists in a number of industry sectors (such as nuclear, chemicals, food or healthcare) who work to attract overseas investors to the UK or to facilitate UK companies exporting to overseas markets. PA received £18.8 million in the first year of the contract (11 months to the end of March 2015) and the contract was due to last three years.[1]

2 UKTI let the specialist services contract through a competitive bidding process, and awarded it to PA on the basis of PA's quoted charges. UKTI and PA then agreed to incorporate activity from another contract, thus making a significant change to the specialist services contract. UKTI subsequently pursued with PA moving to a different charging model – which led to PA sharing, and UKTI reviewing, actual costs incurred under the contract, which would not have happened under the existing charging model.

3 In June 2015 the National Audit Office was notified by UKTI that it had concerns about the way PA had priced the contract and, in particular, whether it had represented its charges transparently and accurately. UKTI commissioned RSM UK Consulting LLP (RSM; at the time, Baker Tilly) to investigate the contract. RSM produced a draft report in September 2015, which contained the finding that PA had "consistently made incorrect and misleading representations relating to £3.9 million of the overheads charged".

4 This led UKTI to suspend payment of PA's invoices and to terminate the contract. The contract came to an end in January 2016.

1 All financial figures quoted in this report are exclusive of VAT.

5 PA disputed RSM's findings, stating that it had invoiced according to the agreed charging mechanism. The purpose of RSM's investigation was to inspect PA's financial records and consider the accuracy of PA's charges. RSM's report did not give full details of the representations that PA made about its charges to UKTI. We had also been told that UKTI's procurement of the contract fell short of good practice. We therefore decided to launch this investigation to ascertain:

- what representations PA had made to UKTI about its own costs and about what it would charge;
- whether and how UKTI had agreed those costs and charges during the procurement and management of the contract; and
- whether PA had represented its costs and charges transparently and accurately, and whether PA had overcharged UKTI in relation to the contract.

6 We have not sought to assess the value for money of the contract.

Key findings

7 Understanding exactly what happened in letting and negotiating this contract is difficult due to the lack of proper documentation, the disagreement between parties and, now, the absence of a number of people who were involved on either side. From our analysis of the evidence and facts that we have been able to piece together (set out in the main body of the report), we make the following summary observations.

UKTI's governance of the procurement

8 **UKTI's governance of the procurement was weak.**

- It is not clear that there was an agreed-upon commercial strategy.
- The procurement team had a poor understanding of the bid and requirement.
- There was no effective handover to the contract management team.
- There is no evidence that a number of key decisions were approved by any formal UKTI decision-making body.
- There is no evidence that UKTI received proper external advice.

9 UKTI did not maintain the minimum documentation necessary to support a procurement, leaving it exposed to not understanding what it had agreed to.

- Core documents, such as the business case, were not available to the contract management team.
- Key decisions and agreements with PA were not formally recorded.

Clarity of pricing

10 It is not clear how the contract was, or was meant to be, priced. As a result, UKTI was unable to understand the commercial deal it had struck, the allocation of risk between UKTI and PA, how changes would affect the economic balance of the contract or, therefore, the value for money of the contract.

- The contract states that UKTI wanted to buy trade and investment outcomes. UKTI agrees that PA performed well against those outcomes.
- The main service under the contract was the provision and management of individual specialists with trade and investment expertise. The contract is overly long and complex for a relatively simple requirement.
- UKTI's template for bidders was not clear about whether costs should be fixed or variable, or what should be entered in each line.
- PA's bid, answers to questions, and the resulting contract were self-contradictory about central elements of the pricing structure – such as whether prices were fixed or variable, and whether itemised costs included PA's profit or overheads.

Negotiation of a significant change immediately after the competition

11 UKTI and PA agreed to negotiate a significant change to the contract after the bids were submitted and before the contract was awarded.

- UKTI was procuring the contract under the 'restricted procedure', whereby the contract should be awarded on the basis of the bids provided by those invited to the competition. There should have been no further negotiation.
- UKTI and PA agreed to transfer resources from another contract, the Foreign Direct Investment Services contract, to the new contract. In substance, this acted to extend that part of the other contract beyond its allowed term. It also changed the terms under which PA was paid for the transferred specialists from a cost-plus basis to a banded day rate.
- UKTI decided to award the specialist services contract on 30 April 2014, on the basis of the bid provided by PA, despite having negotiated volume and price changes. PA sought assurances that the contract would be varied and UKTI issued a letter of comfort to this effect.

12 UKTI's handling of the procurement breached good practice and the principles of good procurement in several ways.

- The negotiations before contract award gave the impression of UKTI not wanting to reopen the competition to other bidders by awarding the official contract on one basis, while agreeing to act on another.
- These actions bring into question compliance with the public procurement regulations, and whether or not these changes were a **material** change to the bid and contract. PA sought assurances from UKTI that they were not considered a material change, suggesting that PA was concerned they may be viewed as such.
- UKTI was negotiating on key issues after bids were submitted, therefore restricting competitive tension and exposing it to a risk of significantly reduced value for money from the deal.

Renegotiation of the price

13 The negotiation on the contract outside of competition led to an increase in both PA's revenue and its profit from the contract.[2]

- After announcing PA as preferred bidder, UKTI agreed a new staff mix and volume of activity that increased PA's revenue on this contract from £14.1 million to £18.8 million in the first year. The change in staff mix significantly increased the proportion of PA employees with a corresponding decrease in the proportion of subcontractors, compared to PA's original bid. It is not clear that UKTI understood that the pricing model gave a 55% mark-up for overheads on PA's directly employed staff but not on the subcontractors, which increased PA's gross profit on the specialist contract by £1.4 million in the first year. PA told us there was a consequential decrease in its revenue and recovery of overhead on the Foreign Direct Investment contract, arising from the transfer of specialists between contracts.
- PA's new proposed rate card added £0.9 million of cost in the first year to the variable day rates. PA called this a 'subsidy' and its explanations of this, which have varied over time, imply this was to make up for its loss having underbid for the fixed-price elements of the contract. Our reading of the contract is that PA should have borne this cost. UKTI does not appear to have understood the implication that this 'subsidy' was a direct increase in PA's net profit.
- PA charged £0.34 million more than stated in the contract for the fixed-price elements in the first year. It is clear that the two parties were discussing revisions to the contract pricing but, due to the poor documentation, we do not know if UKTI had agreed to this increase.

2 All our financial analysis is based on the first 11 months of the contract from May 2014 to March 2015. The contract would extend for another two years, with an annual inflation adjustment for each year. The impacts described here would have carried forward to all three years of the contract, had UKTI not given notice to terminate the contract midway through 2015-16.

PA's transparency over its net profit

14 PA should have been more transparent in how it reported its forecast profit to UKTI.

- In response to a question from UKTI during the competition, PA's answer implied that its forecast profit on the contract was 6.2% based on the data provided in the bid. It later stated, on the rate card agreed with UKTI in the weeks after the contract was awarded, that its profit was 7.03%.
- UKTI did not define what it meant by profit, or how overheads should be treated.
- PA changed the way it calculated the profit between the amount stated in the contract, and the amount it stated in its cover emails to the three iterations of rate card used in the final contract negotiations. The introduction of the 'subsidy' acted to deflate the stated profit by £0.9 million.
- UKTI understood that PA had reduced its profit by £4 per specialist day, not increased it. UKTI thanked PA "for taking the hit on [its] profit".

PA's transparency over the inclusion of overheads in the day rates

15 PA's bid, rate card and explanations did not make clear the amount of corporate overheads built into its price.

- PA's use of total cost absorption to calculate its day rates is normal for professional service firms. Under this system, PA's total estimated costs of running its business (including all corporate overheads) are allocated across its total expected billable hours. This provides minimum hourly and daily rates so PA's partners can decide how much to charge their clients.
- In this contract, PA's use of total cost absorption for the day rates sat alongside the separate itemisation of overheads in the schedule of prices (the 'infrastructure' charge). PA said these items were fixed, implying they were not in the day rates.
- We can find no evidence in the bid, contract or negotiations that PA ever made clear that its rate card included at least £2.5 million of variable corporate overheads in the day rates of its directly employed specialists, in addition to the £1.3 million fixed infrastructure charge, which, PA has since stated, related to overheads for subcontractors.
- We found no evidence that UKTI realised that the costs underlying the agreed banded rates of PA's directly employed specialists included overheads. Internal UKTI emails show it believed that the day rates for all specialists were a pass-through of staff costs and a management fee (that is, it believed the stated staff costs were passed through PA either to the specialist or the tax authorities, only the management fee contributed towards PA's profit, and no overheads were included in the day rates).
- PA made a number of inaccurate and contradictory statements to UKTI about what costs were included in the day rates.

The impact on PA's profit of the separate charge for infrastructure

16 The separate charge for infrastructure is likely to represent an increase in PA's profit on the contract which was not clear to UKTI.

- Because PA's total cost absorption methodology is intended to allocate all budgeted overheads across the billable hours of its internal staff, and it included overheads in both its day rate and its separately itemised fixed-price 'infrastructure' charge, PA has charged more for its corporate overheads than it budgeted it would spend on these corporate activities.
- PA told us these separate fixed-price overheads related solely to the subcontractors, who represented an increase in PA's headcount of approximately 5%. It said the subcontractors do not have any allocation of PA overhead in their day rate and their engagement was not taken into account in the budgeting of corporate activities (such as IT, HR and finance).
- PA showed us that it overspent on its corporate activities and told us this was partly as a result of engaging the subcontractors. However, PA was not able to demonstrate how engaging the subcontractors would have increased its corporate overheads by the £1.3 million a year charged to UKTI. It is not clear to us why the itemised costs would not be, in the main, fixed costs of running PA's business.

The discovery of the problems

17 The problems with this contract only emerged due to the tenacity of the UKTI contract managers brought in after the contract had started.

- UKTI's new contract management team found it challenging to manage the contract because the contract and pricing structure were unnecessarily complex. They found it impossible to properly reconcile invoices with the contract because the documentation was poor and the agreement between UKTI and PA unclear.
- The team asked PA to move towards a 'cost-plus' approach to pricing the contract, which they believed would be more transparent and easier to manage. In analysing the cost-plus model that PA subsequently produced, they identified inconsistencies in PA's explanations of its costs which made them question the original basis of the contract's pricing.
- The team brought these concerns to the attention of UKTI management. The Managing Director for Investment led a series of 'challenge' sessions where he asked senior PA representatives to explain and justify the existing and proposed charges. PA's responses failed to allay UKTI's concerns. The Minister of State for Trade and Investment asked that Cabinet Office lead on a review of the contract.
- UKTI then gave notice to terminate the contract (not for breach) and transferred the specialists to its direct management.

Conclusion

18 It is clear that, on this contract, both UKTI and PA have fallen well below the standards expected in managing public money. UKTI should have been in control of the procurement and understood the pricing; PA should have been more transparent in its dealings with UKTI. UKTI's decision to negotiate a significant change to the contract after the bids were submitted and then award the contract on a basis it had already agreed to change was extraordinary. It raises the question of whether it followed the procurement regulations. It was unfair to other suppliers, and was commercially naïve. In moving to a different charging model, UKTI should have been able to rely on PA to be transparent regarding changes in its pricing and how it was disclosing its profit on the contract. PA's lack of transparency led UKTI to take false assurance that there was no impact on the value for money of the contract arising from the negotiations, when that was unlikely to be the case.

Timeline of key events

Date	Event
10 September 2013	UKTI issues invitation to tender for framework and call-off contracts.
21 October 2013	Tender deadline. Bids submitted by PA and four others.
21 November 2013	PA submits responses to UKTI's bid clarification questions.
10 December 2013	UKTI announces PA as preferred bidder.
Late 2013	UKTI and PA agree to transfer a number of specialists from another PA contract to the specialist contract, significantly increasing the volume of provision on the specialist contract.
1 March 2014	Framework contract commences.
Early April 2014	UKTI emails show that it does not understand what the specialists' day rates include.
25 April 2014	In response to a request from UKTI for details of specialists' direct remuneration, PA sends new rate card and states that the 'cost' shown is "what they are paid". The rate card includes the 'subsidy' for the first time.
29 April 2014	PA sends UKTI revised pricing schedules reflecting the increased volume of provision.
30 April 2014	UKTI sends signed call-off contract to PA. The contract does not reflect the increased volume of provision and UKTI issues a letter of comfort.
1 May 2014	Call-off contract commences.
Early May 2014	UKTI contract management team (two people) take up post.
16 May 2014	PA sends new rate card to UKTI, which UKTI accepts by email.
October 2014	UKTI and PA agree to move to a cost-plus pricing model from 2015-16.
13 February 2015	PA sends initial cost-plus model to UKTI.
25 March 2015	UKTI identifies issues in the cost-plus model which cause it to become concerned over PA's transparency and implications for the existing 2014-15 pricing mechanism.
30 April 2015	UKTI emails PA expressing "a number of serious concerns" arising from the data in the cost-plus model.
4 June 2015	UKTI and PA hold half-day 'challenge' session. PA agrees that the reference to "what they are paid" in the email of 25 April 2014 was erroneous and that the figures in the first cost-plus model were inaccurate.
1 July 2015	RSM commences an investigation into the contract on behalf of UKTI.
17 September 2015	RSM sends its draft report to UKTI.
14 October 2015	UKTI, Cabinet Office and RSM meet PA and share a partially redacted copy of RSM's draft report.
16 October 2015	UKTI writes to PA giving three months' notice that it is terminating the framework and call-off contracts with PA.
9 November 2015	PA meets Cabinet Office and submits a report challenging RSM's findings.
27 November 2015	Cabinet Office writes to PA stating that PA's report did not satisfy the "very serious concerns" of Cabinet Office and UKTI.
16 January 2016	UKTI's contract with PA terminates.
May 2016	UKTI and PA reach an amicable settlement.

Note

1 A more detailed timeline is given at Appendix Two.

Source: National Audit Office