ADRg
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Carillion: Root Causes

1. Much has already been written about the demise of Carillion, the second largest UK construction firm after Balfour Beatty. Spawned in 1999 from Tarmac construction, Carillion had a debt funded acquisition spree in its core market and to provide outsourced services in the UK, Canada and the Middle East.

2. The Carillion liquidation was triggered on 15 January 2018 by the company being unable to service its debt and working capital. This was an effect, rather than a cause of the problems. Time will determine the root causes, with some good places to look being summarised below:

   a. **Mutuality of obligation** - We should firstly consider the moral dilemma whether some public and private sector organisations on both the client and supplier side have lost the concept of mutuality? We have a legal duty to ensure that for offer and acceptance to be concluded, the parties procuring and the parties offering to provide products and services under a project, properly appraise each other of the bargain that has been struck in the contract. The client therefore has a duty to provide sufficient data and access so that a suitably skilled supplier can reasonably determine a facts-based bid for the scope, risks and therefore overall bid price for the project. Whilst this does not eliminate some of the errors and omissions that occur, it would dramatically diminish the current level of nugatory effort expended on client and supplier disputes that result in mediation, adjudication, arbitration or litigation between clients, suppliers and third parties seeking to correct a bad deal that has been struck. Alternative Dispute Resolution (ADR) processes have proven very cost effective in bringing fast resolution of differences on such projects and contracts. Most of the people displaced from Carillion will find work other providers, but will suffer considerable financial & emotional turmoil.

   b. **Public sector and construction industry procurement practice**. It is not unknown for clients or their procurement advisors to inadvertently under estimate the budget required to deliver a public-sector project. Suppliers may similarly inadvertently under estimate the costs of delivering a bid for a project or fail to identify the contingency fund required to cover risks not foreseeable at the bid stage. This can lead to a financial "race to the bottom" on price and certainly discourages innovation and investment in smarter working. Replicate this flow down from the main bidder for the project to typically twenty major subcontractors and the scope for error can be magnified many fold. The client may, when the bids are received, convince itself that the lowest bidder can deliver the project, especially if it meets its budget constraints. Bid evaluation should always closely scrutinise bidder competence, experience and resilience, not simply price. Public procurement regulations can exacerbate tender evaluation and supplier selection. Especially when available projects are scarce, some suppliers will, however accurately they price for the project, include uneconomically low profit margins or even shave the bid to what they calculate will be a winning bid price and then worry post contract award about how to deliver the project. There have been issues during recent years of clients seeking to pass risks and costs to the supplier who

cannot control them, for example specification of some fit outs of buildings, but the materials and quality are to be chosen by the client. Risks are often flowed down to small subcontractors who are less able to accurately estimate or control them.

c. **Private Finance Initiatives** – designed to transfer delivery risk in major projects from the client to the supplier and to finance public sector projects directly through private finance rather than being counted against the Public Sector Borrowing Requirement (PSBR) which would add inflationary pressure. Tiny errors in calculation at the bid stage can be multiplied many fold by a PFI contract term of say 25 years. The funders owe a duty to their stakeholders to ensure they can recover their capital, leaving the constructors, who start with much lower margins, exposed to greater construction and operational risks that can easily be eroded by contingent risk, project scope creep and unforeseen project overruns. Retrospective analysis often leads to a negative view on the value for money of such projects.

d. **Cash flow and working capital requirements** can be high where a main contractor has to pay suppliers, subcontractors and its own labour for a protracted period before it receives payment from its client. Where there are project overruns due to effluxion of time and or scope of work creep this can lead to the client making stage payments later than planned. High debt ratios, pensions deficits and onerous contracts can all quickly pile on the pressure and the need to seek additional funding from the banks. Simply servicing debt can become a massive burden on the trading of a company seeking to work within its banking covenant tests and juggling operational income and expenditure.

e. **Onerous contracts** – Where it has been determined that revenue due to the supplier over the life of the contract is going to be lower than the forecast costs for the balance of the contract term, the supplier is required by good accounting practice to make a financial provision against its overall business trading for the affected time period. This can occur if the profits realised in the contract are going to be lower than forecast due to additional costs or if the profit recognition has been made earlier than its actual achievement stage of completion of the contract. The greater the number of contracts that this occurs in, the more dramatic the drag on the company finances. This can lead to sales teams being given "must win" tender targets that can exacerbate the problem of bid price cutting.

f. **Projects v outsourcing term contracts** – We should differentiate between "projects", which have a defined start, middle and end with handover of the project to the client, and "outsourced" contracts whereby the client hands over direct management of some or all of its services delivery to an outsourced services provider for a time bound period. It is illogical to suggest that major projects should be delivered via public sector resources due to a relatively short huge peak in demand for specialist skilled people and resources for which there would be no work subsequently on completion of the project. In outsourcing, whilst there may be an initial peak in demand, for example to business process re-engineer business deliverables or setting up a new "green field" operation, this is followed by a relatively long term steady state delivery. The supplier has to suffer the multiplier effect of any pricing errors in an outsourcing contract for its entire term. A massive benefit of outsourcing is that the client has to accurately and tangibly specify its business deliverables and then closely monitor the performance achieved by an outsource services specialist. Substantial savings are achievable by using shared services centres and pooling labour and

other resources for the benefit of all clients. Many outsourcers have demonstrated their willingness and flexibility to work with clients when, for example, they have to cope with budget reductions. By careful adjustment of response times for example, considerable savings can be achieved that have little detriment to actual service delivery.

g. **Governance and Management** – Governance and operational management of a large publicly traded company is a considerable challenge. Coping with multiple profit warnings resulting in a 90% reduction in the share price unnerves even the most stoic of investors. The Board and management teams may be incentivised on short term financial goals which can be to the detriment of the long term strategic objectives of the business. Operational delivery of a myriad of diverse project and service delivery contracts from school meals to prison support to construction requires very diverse management skills and approaches. When you add up all the above challenges with suppliers' global dominance aspirations to conduct business in jurisdictions with currency risks and business cultures that they may have scant knowledge of, the business objectives can prove to be insurmountable.

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