An Accident Waiting to Happen: Carillion and Public Sourcing Incompetence

While the recent demise of Carillion is relatively easy to understand it raises a much more important issue about the pervasive failure of public sector sourcing in the UK in the last 30 years.

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In this short paper I explain why the government was unlikely to have been directly responsible for the company’s failure, but how its collapse highlights key weaknesses in the public sector’s current approach to insourcing and outsourcing.

Proximate Strategic Causes of the Carillion Collapse

It is not unusual for construction companies to go bust. The reason for this self-evident. The barriers to market entry in construction are relatively low and the switching costs for buyers between different companies on a project-to-project basis are also relatively low.

Given this the construction industry suffers from a high level of competition and market entry/exit. In such an environment companies have to bid on projects with high levels of contestation, and with buyers normally seeking the lowest prices possible. Given that construction projects have major uncertainties about ground conditions and supply chain predictability post-contractually, all potential suppliers operate in an environment of high risk. Uninformed clients exacerbate this uncertainty and risk because they often fail themselves to understand these post-contractual risks and/or (if they do) seek to pass them on to their suppliers.

The history of corporate strategy in project-based construction work is, therefore, one of rapid growth and often equally rapid demise. To overcome these risks sensible construction and project management companies seek to balance them by diversifying their businesses so that they have countercycle operational practices. This means they balance their high risk (and sometimes potentially very high reward)
project-based work with longer-term process-based work that provides continuous cash flow. This guarantees the overall business against any cataclysmic strategic failure if all (or a high proportion of) projects going wrong financially.

Following this approach, it would appear that Carillion had grown through a strategy of acquiring a balance of short-term, large scale, project-based work, as well as longer-term process-based outsourcing work from the public and private sectors. Unfortunately, this strategy now appears to have been unbalanced. Ironically, it now appears that while the balance of the process-based work, (much of it from the public sector outsourcing, PFI and public-private partnerships) was highly profitable, this was insufficient to mitigate the catastrophic cash flow problems created by a failure to deliver on a number of very large short-term projects.

It is clear, therefore, that the company’s strategy was unbalanced and this is not an unusual or novel story in the construction industry. Obviously, while there will be a great deal of media and political hype in the short-term about who did what to whom, and who was culpable for what, it would appear that the true cause of the companies demise was its unbalanced growth. This growth appears to have been overly focused on too many high risk projects that may have been won by excessively low-bidding, when the full gamut of post-contractual risks in construction could not be known pre-contractually.

It is clear therefore that, despite the media and political attempts to lay the blame for the company’s demise at the door of the government, the government is in no way directly responsible for its failure. Despite this conclusion, the Carillion debacle raises more important questions about a failure, not of government strategy to business, but of a government failure in public sector sourcing and outsourcing over the last thirty years. This is the real ‘accident’ that has been ‘waiting to happen’.

Carillion - The Accident Waiting to Happen in UK Public Sector Sourcing Practice

Over the last thirty years there has been a dominant paradigm amongst academics, major consultancies and the major professional bodies (like CIPS and ISM), as well as amongst professional buyers in both the public and private sector, about best practice in sourcing. This is the ‘fad’ of focusing on core competencies and then outsourcing non-core activities to suppliers, who can be managed more efficiently and effectively on the basis of ‘partnership’ relationships. This ‘fad’ in business management thinking has also provided the intellectual rationale behind the move away from insourcing in favour of outsourcing in both the private and public sectors, and also for all of the PFI and public-private partnerships in the UK.

For many years now the International Institute has been a lone voice arguing that this approach to sourcing is, at best, only fit for purpose under some circumstances, but, at worst, if applied unthinkingly to all sourcing decisions, a recipe for disaster. By analysing the circumstances of the Carillion collapse we can now see that our arguments about an ‘accident waiting to happen’ in public sector sourcing have now come home to roost with a vengeance!

This accident has happened because, as we have continually argued in recent years, the public sector in the UK has failed to develop a rigorous and robust approach to sourcing and procurement. Recent sourcing practice in outsourcing, PFI and public/private partnerships appear to ignore two of the most important factors that must be considered as part of a rigorous and robust methodology for making and managing insourcing/outourcing decisions. The two most common difficulties faced by buyers when they outsource existing internal resources and/or capabilities to suppliers are nearly always associated with an inability to avoid the post-contractual problems of adverse selection and moral hazard.

Adverse selection is the process by which buyers fail to understand their pre-contractual power situation and make inappropriate sourcing decisions and/or select sub-optimal suppliers.

Moral hazard is the situation by which buyers fail to create effective contractual safeguards pre-contractually, so that they experience extreme movements in their power and leverage positions overtime with suppliers, and eventually find themselves highly dependent on suppliers, with few and highly costly switching costs.

The reason why these two problems occur is normally because of an inability by buyers to understand what are the attributes of power that provide opportunities for buyers or sellers to have effective leverage over one another in business relationships. By failing to understand these attributes, which have been explained in detail by Andrew Cox in Sourcing Portfolio Analysis (2014), organisations make short-term
outourcing decisions that come back to haunt them post-contractually.

When making outsourcing (make/buy) decisions the first thing that must be understood by organisations is the current, and also the future, power position they are likely to be in with any potential supplier to whom they may decide to outsource any internal resources and/or capabilities (i.e. potential critical assets).

Figure 1 demonstrates the range of potential power positions that an outsourcing organisation might find its potential suppliers operating from:

<table>
<thead>
<tr>
<th>LEVERAGE (BUYER DOMINANCE)</th>
<th>STRATEGIC (INTERDEPENDENCE)</th>
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<tbody>
<tr>
<td>HIGH</td>
<td>HIGH</td>
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<tr>
<td>• Few buyers, many suppliers</td>
<td>• Few buyers, many suppliers</td>
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<tr>
<td>• Buyers have high share of market revenue</td>
<td>• Buyers have high share of market revenue</td>
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<td>• Buyers are not dependent on suppliers for revenue</td>
<td>• Buyers are not dependent on suppliers for revenue</td>
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<td>• Buyers' switching costs are high</td>
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<td>• Suppliers' switching costs are high</td>
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<tr>
<td>• Buyer's leverage position is high</td>
<td>• Buyer's leverage position is high</td>
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<td>• Buyer's share of supplier's business revenue is high</td>
<td>• Buyer's share of supplier's business revenue is high</td>
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<td>• Supplier's share of market is low</td>
<td>• Supplier's share of market is low</td>
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<tr>
<td>• Supplier's switching costs are low</td>
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<td>• Supplier's leverage position is low</td>
<td>• Supplier's leverage position is low</td>
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<tr>
<td>• Supplier's share of buyer's business revenue is low</td>
<td>• Supplier's share of buyer's business revenue is low</td>
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<tr>
<td>• Supplier's market power is low</td>
<td>• Supplier's market power is low</td>
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<tr>
<td>• Supplier's dependency on buyer is low</td>
<td>• Supplier's dependency on buyer is low</td>
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<tr>
<td>• Supplier is a generic commodity</td>
<td>• Supplier is a generic commodity</td>
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<tr>
<td>• Supplier is not unique</td>
<td>• Supplier is not unique</td>
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<tr>
<td>• Supplier has no critical assets</td>
<td>• Supplier has no critical assets</td>
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<tr>
<td>• Supplier is not a preferred supplier</td>
<td>• Supplier is not a preferred supplier</td>
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The Power Matrix shows that in an ideal world it would always be preferable for an outsourcing organisation to have their current internal resources and/or capabilities managed in the future by suppliers operating in the Leverage (Buyer Dominance) power position. This is because in this position the risk of post-contractual opportunism by suppliers is the lowest when compared with other possible power positions.

This is because there are normally many interchangeable suppliers in this power position, and the buyer has a large share either of the market for what is being outsourced and/or a very large share of any supplier’s business revenue. Supplier dependency on the buyer in this way normally ensures that they do not behave opportunistically post-contractually and will collaborate with the buyer on future required quality standards and pricing.

Conversely, the worst position for an organisation to outsource into is Dependency (Supplier Dominance). In this power position there are very few suppliers (and sometimes only one), who have no real dependency for revenue on the outsourcing organisation, but on whom the outsourcing organisation is solely dependent for their supply. In such circumstances an outsourcing organisation is often at the mercy of the supplier, who is normally able to operate as an opportunistic price and quality fixer.

In between these two extreme positions is the Alliance (Interdependence) power position, where there are only a few suppliers but any selected supplier is likely to be highly dependent on the outsourcing organisation for revenue, with relatively high switching costs for both parties in the future.

If this power position is clearly the most preferable for an organisation to outsource into after Leverage, then the Market (Independence) power position is rarely ideal. In this power position the buyer may have many suppliers to select from and switching costs may be low, but the sales volumes to the outsourcing organisation are normally not high relative to total revenue. Given this the incentives for long-term collaboration is normally low, and buyers can only expect basic market pricing and standard quality in the future.

As the Carillion case demonstrates many public sector buyers do not appear to understand the need to analyse the current power position of the potential suppliers to whom they may outsource potential critical assets.

More worrying for Strategic Outsourcing (make/buy) practice is not just the inability to analyse current power positions with potential suppliers, but the failure to also understand that business relationships between buyers and suppliers are dynamic.

This means that whichever suppliers are selected (and in whatever power position they may currently reside) they will always look for opportunities to move from less to more congenial power and leverage positions post-contractually.

As Figure 2 demonstrates for suppliers there is always an ideal power position of Dependency (Supplier Dominance) from which a supplier would prefer to operate if buyers cannot (or do not) put in place the post-contractual safeguards to stop opportunism by suppliers.
If this ideal power position cannot be achieved by a supplier they will, as demonstrated graphically in Figure 2, seek to find any routes that allow them to move into power positions that allow them to appropriate more value (in the form of higher revenue and higher returns) from the outsourcing buyer. The job of a buyer is always to ensure that these power shifts that improve the leverage of their suppliers do not occur post-contractually in the future.

For effective Strategic Outsourcing (make/buy) decision-making it is always essential therefore for buyers to ask a number of key questions. It also appears that this competence has been absent from most public sector decision-making in relation to Carillion (and one suspects other public sector sourcing decisions over the last thirty years). The key questions, and their apparent absence in the Carillion case, are identified below:

1. What is the relative criticality to our business of the internal resources and/or capabilities post-contractually that we are planning to outsource?
2. What are the current power positions of all of the potential suppliers to whom we might outsource these internal resources and/or capabilities?
3. Will any of these resources and/or capabilities allow any of the potential suppliers to transform the future power position to their advantage and to our disadvantage post-contractually in the future?
4. If there are risks of post-contractual moral hazard with any supplier with whom we might engage, are there any contractual safeguards we can put in place to avert the shift in power favouring the supplier post-contractually?
5. If these contractual safeguards can be put in place to which suppliers should we outsource given their current and future potential power and leverage positions?
6. If these contractual safeguards cannot be put in place is it safe to outsource, or are we taking unacceptable risks that would lead us to retain insourcing rather than outsourcing for the time being?

Unfortunately, the Carillion case appears to show that buyers in the public sector do not always ask these questions in a rigorous or systematic way. If they had public sector managers would have realised that they were at risk of adverse selection by continually allowing on to their bid lists a company that had an unbalanced strategy, with a tendency to bid low on high risk projects that they were continuously failing to deliver on.

If they had asked these questions they would also have realised that this strategy was creating negative financial reports in the City and amongst informed financial commentators, who had identified the lack of tangible assets on the company’s balance sheet, leading to hedge funds betting heavily against the current share price. The lack of awareness of these issues and due diligence in selecting appropriate bid lists demonstrates that the key questions above were not being addressed, and nor were effective contractual safeguards against non-performance being put in place.

Therefore, because public sector buyers in general do not appear to have a rigorous and robust make/buy methodology, or the positioning tools to enable them to understand properly where they are located within the Power Matrix, and how to make appropriate relationship management choices given their position within it, they will continue to experience similar problems of adverse selection and moral hazard when they undertake strategic outsourcing.

There is a final pitfall that outsourcing companies experience called inappropriate relationship management post-contractually that the Carillion case also showcases. This pitfall arises because the outsourcing organisation does not fully understand how to effectively manage relationships with the outsourced provider post-contractually. Figure 3 demonstrates the sourcing choices available to buyers when they source from suppliers.

As the matrix demonstrates there are basically four ways in which buyers can interact with suppliers of outsourced goods and services.

When a company manages reactively it bids work on a short-term basis and can either do this at the first-tier (Supplier Selection) or in the supply chain (Supply Chain Sourcing). When sourcing in this manner the outsourcing company normally operates at arm’s-length and does not engage in extensive close working relationships with suppliers.

On the other hand, when a buyer sources proactively at the first-tier (Supplier Development) or in the supply chain (Supply Chain Management) the outsourcing company is supposed to make extensive long-term dedicated investments in the relationship. The supplier is supposed to do the same.
In recent years it is clear that many outsourcing organisations only really undertake a fairly limited and short-term view of outsourcing and then operate at arm’s-length with their suppliers when they should be working on the basis of long-term collaboration. Related to this is the second problem that arises when outsourcing organisations do enter into long-term outsourcing relationships. Often the suppliers understand how this can create switching costs and lock-in but the buyer does not.

All too often we have found that outsourcing relationships are poorly managed by the buying organisation, with the creation of significant post-contractual switching costs favouring the supplier. Often this is a function of complacency by the buyer or outsourcing organisation once a long-term relationship has been established. Unfortunately the ability of farsighted suppliers to offer loss leaders to hard pressed outsourcing organisations, who then find themselves unable to manage outsourced relationships effectively post-contractually, is legion.

The recent apparent failures of government oversight in the Carillion case by the Cabinet Office Crown Office Representative and the designated public sector strategic partnership managers are classic examples of a failure of post-contractual relationship management and post-contractual moral hazard. It would appear that these managers failed to provide adequate early warning of the financial and operational issues that would develop for the public sector, such as the predictable problems of high switching costs and the potential for supplier dominance in negotiations as the government searches for alternative suppliers.

**Developing Competence in Strategic Sourcing and Post-Contractual Relationship Management**

It is clear, therefore, that before any organisation undertakes outsourcing it must understand whether or not any activity it is contemplating outsourcing is of strategic importance to its business strategically and/or operationally. In order to understand this it must have a methodology to understand the critical assets in the supply chains within which it operates. Clearly, organisations must not give away resources to suppliers that are the basis by which they achieve their strategic and key operational goals.

Beyond this it is clear that when it is safe to outsource operationally that buyers should have in place a methodology to understand how to avoid adverse selection and also post-contractual moral hazard. It is our view that the power perspective provides the most effective mechanism for buyers to understand the objective pre and post contractual power situations that they face, so that the appropriate relationship management choices can be made with selected suppliers.

It is also clear that, if buyers are to avoid the problems of post-contractual moral hazard in outsourcing decisions in the future, they must understand the need for general clause contracting strategies. General clause contracting strategies are those that provide general agreements about post contractual opportunism, which suppliers have to accept before the buyer is prepared to enter into what is likely to be a long-term relationship with the supplier.

What is clear in practice is that, despite the many thousands of words written on the subject of outsourcing, most organisations we have worked with appear to be guilty of sub-optimal strategies. This is because the problem of post-contractual moral hazard is simply not well understood amongst practitioners, as the Carillion case clearly demonstrates in the UK public sector.

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Professor Cox and his colleagues have worked closely with a number of major global organisations to operationalise a way of thinking about better practice in outsourcing and supply chain management. The essential ideas that underpin this approach can be found in a number of IIAPS White Papers (available at www.iiaps.org) as well as in publications that include:

Further Reading

Relevant IIAPS Blogs (www.iiaps.org/blog):
1. 12 Causes of Sub-Optimal Category Management & Strategic Sourcing
2. Improving Category Management & Strategic Sourcing
3. The Problem with Cross-Functional Involvement & Buy-In
4. Tactical Solutions to the Lack of Cross-Functional Involvement & Buy-In
5. Value Flow Management: Value-Driven Category Management & Strategic Sourcing

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1. Beyond Kraljic (IIAPS White Paper 2010/1)
2. World-Class or Best-in-Class (IIAPS White Paper 2010/2)
3. The QV Way (IIAPS White Paper 2012/1)
4. Improving Procurement Competence, (IIAPS White Paper 2014/1)
5. Developing Competence in Procurement & Supply: The Two Options of Tactical Spend Management or Strategic Value Flow Management (IIAPS White Paper 2015/1)
6. From Spend Management to Supply Management - Improving Category Management & Strategic Sourcing (IIAPS White Paper 2015/2)