Procurement Policy Note – Supplier Financial Risk Issues

Information Note 02/13 18 February 2013

Issue

1. This note provides advice on issues frequently raised by suppliers through the Cabinet Office 'Mystery Shopper' scheme[1] :

    a. **Financial information required by Authorities** – filed accounts are not the only information that can be used to assess potential providers' financial standing.

    b. **The use of credit rating reports** – for above threshold contracts, these are useful as part of a broader financial assessment of potential providers but they should not be used on their own for selecting or excluding them.

    c. **Contract limits set by turnover** – a potential provider should not be deselected on the basis of turnover size alone.

    d. **Business insurance requirements** – should be proportionate to the size and nature of the contract and represent vfm.

2. In addition, the Mutuals Taskforce Report[2] recommended: "The Cabinet Office should issue guidance for commissioners setting out clear expectations in respect to the assessment of financial standing, including on the use of any requirements for performance bonds."

Dissemination

3. Please circulate this note within your organisation, its Executive Agencies and Non Departmental Public Bodies and to all Contracting Authorities for which you are responsible, drawing it to the attention of those with a purchasing role. All Contracting Authorities, including those in the wider public sector, are strongly encouraged to apply this advice

[1] http://www.cabinetoffice.gov.uk/content/cabinet-office-mystery-shopper-scheme

[2] A Mutuals Taskforce Report: *Public Service Mutuals – The Next Steps* (June 2012)

Contact

4. Enquiries about this PPN should be directed to the Service Desk 0845 000 4999 servicedesk@cabinet-office.gsi.gov.uk.

Background

5. The objectives of undertaking supplier financial assessment as part of a procurement exercise are to :

    - Assess the risk to public sector business and/or public money which would result if a potential provider bidding for a contract were to go out of business during the life of the contract, or have inadequate financial resources to perform the contract; and

    - When justified, eliminate from a procurement any potential provider whose current financial capacity would pose an unacceptable risk to business and/or public money.

6. The financial assessment of potential providers should be undertaken in a manner that is proportionate, flexible and not overly-risk averse while ensuring taxpayer value and safety is protected and the relevant EU Procurement Law complied with. **Furthermore, all potential providers, whatever their size or constitution, should be treated fairly and with equal diligence during the financial appraisal process. For example: no SMEs, public service mutuals or third sector organisations should be inadvertently disadvantaged by the financial assessment process.**

7. Financial standing should only be considered as part of the overall selection criteria. It may not, on its own, reflect potential providers' ability to deliver.

8. Only experienced staff should conduct financial assessment, calling on specialist in-house or external expertise as necessary.

Financial information required by Authorities

9. Where appropriate, potential providers should be requested to provide accounts for the past two years of trading rather than for the previous three years (which was a traditional requirement although not required by the EU rules). In the absence of audited statements, other information should be requested that is considered sufficient for assessment purposes.

10. Potential providers such as SMEs and public service mutuals may have been recently formed and unable to provide accounts for the previous two years or to provide any filed accounts at all. Authorities are therefore urged to exercise flexibility towards all potential providers when specifying their financial information requirements.

11. Examples of other information that may demonstrate the potential provider's economic and financial standing can include but is not limited to:

- Parent company accounts (if applicable)
- Deeds of guarantee
- Bankers statements and references
- Accountants' references
- Management accounts
- Financial projections, including cash flow forecasts
- Details and evidence of previous contracts, including contract values
- Capital availability.

The use of credit rating reports

12. Credit rating reports are useful for obtaining a snapshot view of potential providers' financial standing and as part of a broader appraisal, but for above threshold contracts, they should not be used as the sole assessment tool. These reports are not a substitute for an examination of the accounts and other documentation provided by potential providers to confirm financial capability. Other information in the Authority's possession may also have a bearing on financial position.

13. Information from credit rating reports may not be available for a particular supplier, or may not be complete or up to date, which will influence the report conclusions. For example, new potential providers or foreign parent companies may not have been assessed or parent companies may not have been included in an assessment at all. The reports may also be sensitive to market information that could change at short notice

Contract limits set by turnover

14. A contract limit is the size of contract considered 'safe' to award to a potential provider based on a simple comparison of the annual contract value to the annual (or average annual) turnover. Departments using this concept have tended to apply a maximum percentage threshold of annual contract value to turnover. While turnover may be a useful indicator of capacity, issues of financial position, capacity, capability and dependency should all be considered as part of the appraisal process. If a potential provider is not selected, there must be clear and demonstrable evidence of financial risks, capacity or capability issues over and above a simple turnover or ratio measure.

15. The degree of relevance of equality will vary depending on the individual procurement. 15. This principle is emphasised by Procurement Policy Note 01/12 which states that "Contracting Authorities should not impose arbitrary minimum requirements which may have the unintended effect of barring new business from bidding" and that in the spirit of encouraging supplier growth, the supplier evaluation process should not rule out a potential provider unless there is clear evidence that

the supplier's financial position places public money or services at unacceptable risk.[3]

Business insurance requirements

16. **Employers' Liability Insurance** is generally required by law to cover employees and many insurers incorporate it into their business insurance policies.

17. **Public Liability Insurance** provides cover where a client, contractor or member of the public is injured and the service provider is at fault. This is also often combined with Employers' Liability Insurance.

18. **Professional Indemnity Insurance** is typically required to cover the provision of professional services such as financial services or IT consultancy. It may be required if advice is being provided to clients, if data belonging to a client is being handled or the service provider is responsible for a client's intellectual property.

Levels of Cover

19. The customer will often specify the level of cover and client expectations should be known before commencing a procurement. However, a problem arises if contracting authorities take a blanket approach to levels of cover rather than basing it on the risk inherent in the contract. As a result, they often appear to insist on requirements that are the same for all contracts irrespective of the size and risk.

20. The issue tends to come to light when a small business that traditionally trades with the private sector bids for a public sector contract and finds it requires insurance levels vastly greater than a private company would ask for the same work.

21. Unless the employer is exempt, Employers Liability Insurance minimum cover of £5m is fixed by law but other insurance is different and the required cover should be proportionate, reflective of the nature of the work and the risk involved.

22. Contracting Authorities should therefore be proportionate in their specification of insurance requirements having appropriate regard to the balance of risk and vfm in setting the level of cover required. Contracts should be considered on an individual basis.

23. If at the selection stage a potential provider cannot provide the level of cover required, an undertaking to secure the insurance should be sufficient. It is not, at this stage, appropriate to insist on the evidence that cover already exists.

Deeds of guarantee

24. Guarantees and bonds can be either financial or performance guarantees, or a hybrid of both. However, they only come into effect after the service provider has failed to perform its contractual obligations, a drawback when what is ultimately important is the provision of the service rather than the availability of a remedy once the service fails

25. Under a deed of guarantee, a third party, the guarantor, often the parent company, undertakes to fulfil the terms of the contract and/or a financial guarantee that ensures

[3] https://update.cabinetoffice.gov.uk/resource-library/procurement-policy-note-0112-use-pre-qualification-questionnaires

the Authority receives financial compensation if the contract is not fulfilled.

26. The contracting authority may need to obtain a deed of guarantee, particularly where a potential provider's financial position is less robust than that of its parent company.

27. The deed of guarantee is not always sought from the direct parent company. A parent company guarantee is only as good as the financial standing of the parent company providing it. Sometimes, the direct parent company is a mere 'shell' and another group or associate company, with adequate assets, should be the guarantor.

28. In cases where the Authority is considering a contract with a Joint Venture Company (JVC) or a Special Purpose Vehicle (SPV) company, which may have two or more parent companies and which may not be adequately capitalised or have sufficient financial strength on its own to support the risk and obligations it has under the contract, the Authority can seek 'joint and several' guarantees / indemnities from the parent companies of the JVC or SPV. The objective is to avoid a situation in which identified risks that the Authority has placed with the contractor, are passed back to the Authority by virtue of the JVC or SPV having insufficient financial standing on its own to support those risks.

29. One of the possible consequences of not seeking 'joint and several' guarantees / indemnities is the risk that the Authority may not achieve full recovery if the JVC or SPV and one or more of the parent companies were to fail. If the Authority has accepted only proportionate liability (that is, 'several' guarantees / indemnities only) from the parent companies it risks a shortfall.

30. A deed of guarantee can also be provided by a bank or insurance company. This can be a financial guarantee where the guarantor agrees to indemnify the Authority against specific losses, liabilities and expenses incurred if the supplier defaults on its contractual obligations. This may be less advantageous than a parent company guarantee which obliged the guarantor to complete the contract.

31. It may also be possible, subject to completing all necessary due diligence, for a public sector customer to provide a guarantee with additional controls built into a pension admission agreement. This is particularly relevant to start-up mutual service providers seeking to join an existing pension fund for staff transferred to the new bodies (see paragraphs 45 to 48).

Bonds

32. There are a variety of alternative financial instruments that can be provided by the financial market. These may be financially onerous on the potential provider, particularly in the current economic climate and are likely to be appropriate only in the absence of other credible guarantees, such as a parent company issuing a bond to cover a subsidiary supplier.

33. A **performance bond** can provide some compensation if the contractor is proven to have defaulted on its obligations. It is usually provided at contract award, for an agreed percentage of the total contract value until its expiry date. A performance bond will not of itself ensure that contracts are carried out efficiently and to time, but it will be an additional incentive on the contractor to perform well.

34. **Conditional bonds** can usually only be called (invoked) following a serious breach by the contractor (including becoming bankrupt, which would normally allow the client to terminate the contract). Properly expressed, these bonds provide a third-party incentive to

the contractor not to default from a contract it has entered into and they also provide compensation to the customer where there is a proven default. They may be required where there are identifiable risks of default by the contractor, subject to value for money considerations.

35. **On-demand bonds** should include within their terms and conditions the trigger and mechanism for calling in. These are expensive and therefore more onerous for the contractor and would only be used for high risk and/or high value projects where the costs and/or consequences of default of the contractor are high. They can be called at the sole discretion of the customer, i.e. there may be no need to establish that the contract has been breached, accordingly if the agreed conditions for calling are met, the payment must be made.

36. Contracting authorities are advised to seek professional advice on the best choice, use and drafting of guarantees and bonds. In particular, they should be used proportionately; they are burdensome requirements for small value contracts.

Other methods to mitigate risk

37. Additional ways to apply pressure on the supplier to comply with its contractual obligations without recourse to financial instruments are outlined below.

38. **Contract management and monitoring procedures**, which should ensure that contractual services are delivered in accordance with the terms and conditions of the contract. Active and thorough contract management is essential; monitoring reports provide the basis for deciding whether action should be taken if there is a specific performance issue. In many cases there will also be specific financial (service credit) and non financial (correction plan) remedies available in the event of poor performance.

39. **Step-in rights written into the contract**, where 'Step-in' means another party, other than the supplier, takes over some or all of the supplier's contractual obligations for a temporary period to rectify a problem (usually a major performance failure), after which control is returned to the supplier. A trigger could be the breach of a statutory duty where the customer is obliged to assume control of the service after the service provider has had an appropriate time to remedy the trigger event. A permanent replacement supplier cannot be appointed under these measures; that would require a fresh competition in accordance with the applicable procurement law.

40. **Escrow arrangements**, where appropriate, to protect business critical software and technology assets. These services are provided by third party neutral escrow and verification specialists. Risk is mitigated by assuring the Authority has access to source code and other proprietary information needed to maintain technology should the service provider go out of business or fail to provide support. The trusted third party escrow specialist will securely hold the source code and release it under specific contractual conditions.

41. Whether an escrow arrangement is entered into and who bears the cost[4] is subject to agreement between the parties. Escrow arrangements should not be required for open source software since the source code would normally be provided with the software.

[4] These arrangements normally attract charges/fees

Public service mutuals and the LGPS[5] Regulations

42. Public service mutuals are part of a wider movement towards the development of independent organisations to deliver public services, led by entrepreneurial employees, leaders and communities, supported by civil society organisations and endorsed by the Government. The emphasis on employee control does not preclude the participation or co-ownership of additional parties, such as community members, service users, joint venture partners or Government.

43. Staff and leaders within mutuals often have substantial relevant experience and expertise in providing public services, even if they have not had previous contracts. It is essential that as part of the procurement process, this experience gained while a service was provided 'in house' is taken into account. Contracting authorities should therefore fully consider the appropriate options available where they require financial security.

44. In a situation where a public service organisation sets up as a company limited by guarantee under a cooperative model to provide support services and council staff TUPE across to the new organisation – it may be difficult for the new body to secure admission to the existing pension fund if it cannot provide the finance for an indemnity or bond – particularly if it is a start-up without a financial track record or assets to secure the bond against. Details of greater flexibility provided by revised Local Government Pension Scheme (LGPS) Regulations are outlined below.

45. The Local Government Pension Scheme[6] (Miscellaneous) Regulations 2012, which came into force on 1 October 2012, stipulates that an agreement to join the pension scheme requires the admission body[7] to carry out, to the satisfaction of the administering authority, an assessment, taking account of actuarial advice, of the level of risk arising on premature termination of the provision of service or assets by reason of insolvency, winding up or liquidation of the admission body.

46. Where the level of risk identified by the assessment is such as to require it, the admission body shall enter an indemnity or bond in an approved form with a person or firm who has permission under the Financial Services and Markets Act 2000 to accept deposits or to effect and carry out contracts of general insurance; or a person who does not require permission under that Act to accept deposits, by way of business in the UK.

47. The Regulations state that: "Where, for any reason it is not desirable for an admission body to enter into an indemnity or bond, the admission agreement shall provide that the admission body secures a guarantee in a form satisfactory to the administering authority from-

    a. a person who funds the admission body in whole or in part;

    b. a person who-

        (i) owns, or

        (ii) controls the exercise of the functions of, the admission body; or

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[5] Local Government Pension Scheme

[6] Employers in the Scheme include Local Authorities and public service organisations as well as other employers which provide the Scheme for their employees by becoming Admitted Bodies

[7] Organisation that chooses to be admitted to the LGPS in order to provide access to the scheme for some or all of its employees.

c. the Secretary of State in the case of an admission body-

    (i) which is established by or under any enactment, and

    (ii) where that enactment enables the Secretary of State to make financial provision for that admission body."

48. So while the administering authority has to be sure the admission body is sound, there is now greater flexibility for new admission bodies to enter the LGPS. The requirement for the provision of a bond or indemnity is now extended to community admission bodies. The admission body can obtain a guarantee where it is not possible or desirable to obtain a bond or indemnity. It also, undertakes the prior risk assessment, which was previously undertaken by the letting authority. If a letting authority wishes to act as guarantor, subject to completing all necessary due diligence, this remains possible and can be indicated prior to the need for the admission body to carry out a risk assessment required under the LGPS Regulations.