Report: Large firms making excessive profits in children's social care; CMA ducks the challenge

BALANCED ECONOMY PROJECT

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This report, and accompanying spreadsheet, were prepared before Russia invaded Ukraine, on the basis of the Interim Report on Children's Social Care by the Competition and Markets Authority (CMA). We delayed its release because of the invasion which has naturally dominated news coverage. Our calculations below and in our Technical Note are within the range of the CMA's estimates.

1. INTRODUCTION

Around 100,000 children are currently under the care of their local authority in England, Scotland and Wales. About two thirds are in foster care, with a minority in care homes and in other settings. The current annual cost for children's services in the UK is around £5.5 billion.

Mostly, children's social services are provided by small operators, private and otherwise.[1] Increasingly, however, larger providers including private equity firms are getting involved.

The Balanced Economy Project today releases a study, using data and methods used by the Competition and Markets Authority (CMA), showing that the 15 largest providers of children's social care, either as Independent Fostering Agencies (IFAs), or of children's homes, are making large excess profits.[2] We calculated, based on the CMA's interim report and Appendices:

- The **largest children's care home companies** made an average excessive profit of £35.0m per year from 2016-2020, equivalent to £ 22,000 per child per year.

[1] In Scotland, profit-making is not permitted in fostering.

[2] Our calculations are based on data in the CMA's Interim Report into Children's Social Care, published last October. See https://www.gov.uk/government/publications/childrens-social-care-market-study-interim-report/interim-report, and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1027515/Appendices_.pdf

- The **largest IFAs** made an average aggregate excess profit of £81.6m per year from 2016-2020, equivalent to £ 7,900 per child per year.

- In total over **£116m of excessive profits** were made, on average, in children's homes and in IFAs each year from 2016-2020, or £584m over the 5 years. This is around **a sixth of the average annual income** received by the largest providers.

Our accompanying Technical Note explains the basis of our calculations.

The CMA in the Appendix to its final report published today found very similar numbers: a range of £18,400-£29,000 per child for children's homes, and about £8,000 per child for the fostering sector.

These shocking numbers show that the current market for children's social care services is broken.

1.1 The CMA pulls its punches

The CMA final report produces three core recommendations:

1. Improve commissioning processes
2. "Reduce barriers" to service provision, or deregulation
3. Improve resilience by creating a market oversight regime and contingency planning.

Unfortunately, these fall far short of what is needed. The first two can improve matters, at the margins, if done well. The third identifies a problem – a severe lack of resilience among key providers – then fails to recommend what is needed, citing unsubstantiated fears that if they try to rein in the financial excesses there will somehow be a loss of investment. We show that these fears are unfounded.

The CMA in this case appears to be adopting the talking points of private equity firms and other actors making large excess profits in this sector, thus de-prioritising the long-term interests of vulnerable children and long term resilience.

The CMA report arises out of its expansive market study remit, which goes far beyond the usual bounds of a competition infringement investigation or merger

control review. This regime allows the CMA to substantially intervene in markets to ensure they work well. Its recommendations fall far short of this.

Our core recommendations, by contrast, are:

- A **fundamental re-appraisal** of the role and functioning of this market in children's social care, to remove the several distortions we identify in Section 2 below.
- The CMA must place **clear limits on excess leverage, financial engineering and profit-making** in the sector, for example by private equity firms, and it must ban firms, managers and owners with a poor track record.
- A **fresh mandate for the CMA itself**, expanding its focus beyond questions of consumer welfare, prices and economic efficiency, to a new mandate that allows it to intervene directly and aggressively to protect a resilient, diverse and balanced landscape of different providers, and to block monopolisation and the use of extractive business models. This reform of course would have wide impact across the economy, far beyond care.

Section 3 explores our conclusions in more detail.

1.2 Our methods: how we calculated excessive profits

In 2021 we made a detailed submission to the CMA[3] about the role of large providers of children's social care, with a special focus on private equity. We found higher levels of financial engineering among private equity firms, which tended on average to have **negative net tangible assets**, **lower interest cover**, **higher levels of financial leverage**, and **less sustainable debts** than their comparable firms. All these metrics indicate higher levels of potential financial fragility, even while some of these firms may have been delivering high rewards to their owners.

In our new study released today (which does not separate private equity from the rest) we used data from the CMA's Interim Report, and used a very different method of calculating profits, as Box 1 explains.

Box 1: What is profit? "accounting" versus "economic" profit calculations.

[3] Children's Social Care: supplementary submission to the CMA (updated), Balanced Economy Project, Aug 2021.

It is well known that profit can be defined in various ways. For example, investors and shareholders may earn large returns from firms carrying out economic activities, even as those firms declare low or zero profits for tax purposes. Firms may artificially engineer lower profits by (for example) injecting large debt (or borrowing) into a corporate structure, then deducting interest costs; or by extracting large management fees and deducting them as costs, reducing profits. One can obviously take very different views as to what "profit" means, or what a reasonable profit ought to be.

Our study essentially sidesteps these particular pitfalls by taking a different "economic profit" (or "competition") approach, which is a standard methodology used by the CMA and by others.

Essentially, this method starts from the position that in a healthy competitive market, excess profits (the CMA calls it "economic profit") would be zero. In other words, investors would enter the market and earn an adequate risk-based return on capital invested that keeps them satisfied and induces them to invest, but no more. There are standard benchmarks for these rates of return: the CMA estimates this at 3.2% for low-risk water utilities, for example, and 5-8% for higher-risk adult social care. If returns on capital rise above this level then in functioning markets, other competitors ought to come in and undercut them, and profits would fall back towards zero. (The accounting methods and the 'economic' methods, of course, each have their advantages and disadvantages.)

The Technical Note accompanying this report explains the differences in more detail.

Through these two very different but complementary analytical lenses, last year and now, we have reached essentially the same conclusions. Competition in this quasi-market has become corrupted and has effectively broken down, delivering large rewards to relatively few people – who are undeserving at least based on the balance of risks versus rewards. These rewards likely come at the expense of vulnerable children and of local authorities tasked with paying for their care. Our findings also highlight severe risks to resilience in this sector.

Meanwhile, our competition authorities, blinded by a faulty paradigm of competition (Section 2.3) are failing to make the right recommendations or take appropriate action. Our solutions in Section 3 include bold new reforms that have not, as far as we know, been put forward as recommendations in this sector.

2. DISCUSSION

2.1 Brief history of the market for children's social care in the UK

The state has been caring for vulnerable children via a mix of public, voluntary and private provision in the UK for over a century. Care, once provided by state and voluntary providers, is now offered by a range of different actors: whether directly by the state, by charities, by non-profit agencies, by small private for-profit companies, by private equity firms, by other large non-profit companies, or others.

The problems we focus on in this report - a broken market for children's social care - originate in economic reforms from 1990 that created an internal market in the National Health Service (NHS), designed to "drive service efficiency."

This happened alongside privatisation of many state assets, such as telecoms or railways -- though unlike those operations which involved straight transfers from the public to the private sectors, the NHS 'internal market' created a managed fusion of public and private, where healthcare would still ultimately mostly be taxpayer-funded, but artificial market dynamics would be introduced into the system.

The spread of 'public service market' ideas inevitably affected the provision of children's social care, where local councils were already required to submit public contracts to competitive tendering. The idea was, in a nutshell, that companies, charities and others would bid for contracts to provide children's social care, paid for by the state – and may the best and most efficient providers win the contracts. Yet the parameters of the “public service market” were flawed from the outset.

For one thing, public service quasi-markets do not and cannot operate like normal commercial markets. For example, in a healthy commercial market, a company should be able to charge more for providing higher-quality goods and services, and this gives them incentives to invest in improvements. In care, however, hard-pressed councils that fund care provision effectively often cap the maximum prices they are willing to pay. So additional investment to improve care services may not be rewarded, so this incentivises a different approach: corner-cutting. Meanwhile, the true consumers of these services – vunerable children – get little or no say in how or where they get placed, so key market signals are squashed.

The current market appears, in several ways, to be prioritising the harmful over the healthy versions of efficiency, as the following sections explain.

2. 2 Market failures in action

We believe in "competition in the right places," in heathy and balanced markets. Competition can be and often is a force for good. But if a market is corrupted or malfunctioning, it can do great harm. For example, companies may win market share by being more willing than others to pollute, or more aggressive in taking profitable risks at taxpayers’ expense, as happened ahead of the last global financial crisis, or more willing to accept and handle tainted Russian oligarchs’ money, than their

competitors. Unbridled competition in these respects is harmful.

Furthermore, competition in the public-private market sphere is supposed to drive efficiency. Yet "efficiency" is a loaded term. A company may drive efficiency in healthy ways, such as by investing in better computer systems, or by eliminating unnecessary duplication of services. On the other hand, a firm may increase profits by sacking essential care workers and overloading their remaining colleagues, or reducing safety guardrails. This may, in accounting terms, look like improved "efficiency," via higher profits, but it is frequently the opposite, with the costs of poorer care externalised as worse long term outcomes for children and society.

We now identify a number of specific market failures in children's social care.

2.2.1 Excessive profits.

Our striking new data, showing excessive profits equivalent to 12-18% of annual revenues, provides a clear and explicit signal that healthy competitive processes are not working or driving 'efficiencies.'

Indeed, the CMA's interim report into children's social care already carries explicit indicators of market failure here. High demand and high profits should be met by expanding supply. "The fact that this does not appear to be happening," the CMA's interim report states, "suggests that there must be factors that are acting to deter new provision."

2.2.2 Fragility and loss of resilience

As the CMA confirms in its interim report, and as we showed in our submission to the CMA last year, a number of apparently successful firms in the sector appear to be earning profits at the expense of economic resilience. The Interim Report says:

"We are concerned that high and increasing debt levels among independent providers may be leading to an increased risk of unexpected disorderly exit from the market, with negative impacts on children and local authorities."

This could lead to state bailouts (as has happened in adult care), or higher prices, especially for complex short-term contracts where pricing is more opaque and easier to game. Our last report noted that this problem was especially evident for private

equity (PE) firms. We noted that for the 13 largest providers:

- PE firms had strongly **negative net tangible assets**, on average, at -£80m, while for large non-PE firms they are positive (+£37m)[4];
- **Interest cover** (a measure of whether cash generated from operations is sufficient to cover debt interest payments) is many times higher on average for non-PE firms (13.4) than for PE (1.5);
  iii) PE firms had very high **leverage/gearing** compared to non-PE firms[5];
  iv) PE firms need many more years (11.1 versus 1.7 years) to **repay their external debts** than non-PE firms.

2.2.3 Market power and monopolisation.

As an anti-monopoly organisation, Balanced Economy Project is concerned about power imbalances in the economy. The CMA's interim report has included testimony from local authorities that "it is very much a provider-led market, and we can find ourselves at the behest of providers."

There is also an imbalance between smaller and larger providers, potentially leading to increasing market concentration. Many factors can push markets in this direction (for instance, smaller providers in this quasi-market must deploy relatively much larger shares of their internal resources and staffing time assembling bids for contracts in competitive tendering processes.)

Market power, often at a local level, is potentially a rising threat to the sector. This is usually not about a single dominant provider across the country, but instead the growth of local market power. The CMA's interim report stated: "in England, in 52 out of 147 local authority areas the largest provider has a market share of more than 50%." This is far, far above levels where we should be concerned, and surely a reason for high excess profits.

A submission by Children's Commissioning Consortium Cymru decried "a lack of healthy local competition of foster care provision, with market dominance by one

[4] Net assets are a measure of whether a business has more assets than liabilities. Net tangible assets assumes that intangible assets (e.g. goodwill from purchasing businesses) has a zero value: this is an important metric for resilience, because the value of these intangible assets can collapse towards zero if a company's business becomes unviable or has to be wound up.
[5] Gearing is (short-term loans + long-term liabilities) / Net assets – a measure of financial leverage: essentially, to what extent is the company's operations funded by lenders versus shareholders?

private provider." Children England summarise: "Having fewer larger providers with greater market power is what enables them to break free of council fee-caps altogether, and to charge almost any price they want."[6]

Our excess profits analysis supports this conclusion. It is also consistent with others' analysis of what is happening. Children England added recently that "The operations of the so-called care 'market' are fuelling the growth of a small cartel of big companies, growing in dominance and profitability by acquiring smaller, struggling companies at increasing pace . . . The 'market' is not a level playing field for charities any more than it is for small local providers trying and struggling to compete with the most profitable giants."

We are especially concerned that private equity firms and other large providers are seeking to participate in a "roll-up" of children's social care, as has happened in many other parts of the UK economy.

2.2.4 The competitive disadvantage of more scrupulous firms

The Balanced Economy Project promotes a balanced and diversified economy, where better outcomes are achieved via diverse and healthy ecosystems of different providers, and where genuinely better actors are rewarded.

Yet in this market, profit-making firms, and especially those most willing to use unproductive extractive financial techniques to maximise profits, appear to be able to use those extractive techniques to obtain a competitive advantage over those more focused on providing the best care at reasonable cost. Those techniques may include (for example) greater willingness or ability to use tax havens to escape tax, or to use debt to increase financial returns at the expense of longer-term resilience.

Higher rewards obtained through such unproductive techniques can confer competitive advantage in two areas: i) in bidding for local government contracts; and ii) in acquisitions, where they can purchase other providers in the market.

[6] To illustrate, Barnardo's identified a "Friday afternoon bidding war", where a child urgently needs a placement before the weekend and local authorities scramble to find a place for them: this drives up the price and often results in children ending in an inappropriate place." (See Barnardo's submission to the CMA's Children's Social Care Market Study Interim Report.) See also How finance drives monopoly Part 1: Private Equity, *The Counterbalance,* Nov 19, 2021.

Meanwhile organisations with potentially healthier organisational models, such as charities – which legally or otherwise are required to devote themselves to serving children and their families – find themselves at a competitive disadvantage. These competitive dynamics, in the long run, risk turning children's social care into a market increasingly dominated by players more focused on profit than on care, for reasons that are not the fruit of genuinely more efficient service provision, but because of the use of unproductive techniques such as tax avoidance via tax havens.

2.2.5 Competitive Contagion

When one player gains a competitive advantage on the basis of a harmful factor, this has knock-on effects in the market. Weak regulation allows the emergence of "competitive contagion" where more scrupulous operators feel compelled to adopt more extractive practices, if they wish to keep up and justify the same high level of bids of more extractive firms. So in addition to a market becoming dominated by more extractive firms, those that remain will feel pressured to adopt extractive techniques, to stay in the race.

In children's social care we are seeing a version of Gresham's Law, where "bad money drives out good."

2.3 A bad competition paradigm

Our competition authorities, notably the CMA, have allowed destructive competitive processes to flourish in the children's social care market, as in many others.

We contend that this is in significant part because the CMA operates under a restricted and inappropriate mandate, and more broadly under a harmful competition paradigm.

This is, in turn, the fruit of a technocratic 'competition consensus' that emerged in the U.S. in the 1970s and spread globally. This paradigm priorities consumers and the internal efficiency of corporations, and de-prioritises stakeholders such as workers or taxpayers, the wider public interest, and ignores economic power. It also, ironically, often harms actual consumers. A loss of focus on power opened the floodgates to a global 'tsunami' of mergers and widespread monopolisation, across the economy.[7]

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[7] See The US is taking on its corporate monopolists – now the rest of the world must follow, Michelle

And in the case of children's social care, a focus on prices, while important, obscures other factors such as high leverage, going on beneath the surface.

The CMAs core mandate – on its website it describes its mission as being "to promote competition for the benefit of consumers" – reflect this flawed competition consensus. (Indeed, the CMA has publicly admitted that its restricted, consumer-focused mandate largely prevents it from tackling risky levels of leverage and other problems introduced by private equity firms, for instance.[8])

This historical background points to new starting points for tackling many problems in children's social care.

3. SOLUTIONS AND RECOMMENDATIONS

The problems in children's social care are many and varied, and many if not most solutions – such as a long-term lack of funding – lie outside the scope of this report. We focus on an important subset of the problems – the operations of the market for children's social care.

Competition authorities are potentially incredibly powerful - because they have, in theory, the capability to fundamentally restructure our economies and promote balanced, diversified and resilient economic ecosystems, and to disperse concentrations of economic power. And yet this bad consumer-focused paradigm described above has weakened them, to the point where they are often relatively ineffective. Our research into children's social care provides clear evidence that markets are broken.

We will first identify the CMA's proposed solutions to the problems in children's social care in the UK, then offer our own.

3.1 The CMA's proposed interim solutions

Partly as a result of its restricted mandate and paradigm, in its interim report on

Meagher, Nicholas Shaxson, Open Democracy, Sept 17, 2021.

[8] For example, Darren Jones, BEIS Committee Chair, in July 2021 asked the head of the CMA, Andrea Coscelli if it could intervene in potential private equity takeovers of British supermarkets. Coscelli replied, saying the CMA's ability to do so was highly limited by its mandate, though it was not entirely powerless to act. For more details, see The Counterbalance [the newsletter of the Balanced Economy Project], Nov 19, 2021.

children's social care, its recommendations are mostly too timid to make a serious dent on the problem. The CMA's solutions are, essentially:

- **Streamline and improve procurement processes**, such as using regional or national framework agreements, block contracts and bulk-purchase discounts.
- **Improve forecasting of care needs**, for example by developing regional support mechanisms.
- **Achieving better scale for local authority operations**, including creating regional or national level support bodies.
- **Removing regulatory and other barriers to the supply of care**.
- **Supporting economic resilience in the market, including a financial oversight regime for providers**, including early-warning systems for failure, and limits on financial leverage.

This package of recommendations could potentially help, though mostly at the margins. It is highly speculative to think that the above reforms, especially the first four, could deliver major improvements.

The last recommendation could *potentially* have the greatest potential for tackling the market failures, yet it remains to be seen what will be in the final report, and everything will depend on the details. Even then, the CMA's interim report undercuts it by rejecting direct or indirect measures to curb excessive profits (such as by restricting leverage), citing fears that this could scare off market participants. This is not a valid concern.[9] Investors routinely threaten to disinvest if they face taxes, regulations, price caps and so on – and yet talk is cheap. Even if excess profits were a quarter or a tenth of current levels, experience shows that there would be no incentive to disinvestment.

3.2 Our Recommendations

The Children's Social Care market needs deep reform. Given the depth of the problems, we are sympathetic to others who have proposed (for example) restricting the role of for-profit companies in children's social care, or for capping profits.

[9] First, if more predatory actors leave a market, less predatory ones will likely replace them. This is a benefit. Second, extractive investment such as where providers are able to earn very large excess(ive) profits, as our study reveals, should be considered as "investment for shareholders" rather than as "investment for care." If economic profits are channeled into financial rewards rather than upgraded care facilities or the creation of new capacity, then it makes no sense to keep the system in place.

However, our core proposals and solutions take a different, longer term approach. We make three broad recommendations only. Each applies not only to children's social care, but to a wide range of economic sectors.

Recommendation 1: recognise and tackle 'corrupted competition.'

This recommendation is primarly for the CMA, which can act to some degree, even on its currently narrow and strongly consumer-focused mandate.

Recognise and tackle **'corrupted competition'** -- competition on exernalities such as being more willing to use debt to maximise acquisition prices -- and intervene to prevent this, when it is evident. This would among other things require the CMA to go beyond ensuring that competition or consumer welfare are being promoted, to more actively check the credentials and behaviour of actors in the market and allow or disallow their participation on this basis. This could allow a range of interventions. For example, the CMA could:

- Monitor long term economic and financial resilience for providers, alongside price or quality, as the interim report already suggests. The CMA could monitor and track on a historical and ongoing basis metrics such as: i) overall debt levels; ii) net assets; iii) net tangible assets; iv) years to repay external debt and all debt; v) interest cover; vi) gearing; vii) EBITDA and related ratios, indicating how much is being taken out as profit; viii) levels of capital expenditure over time; ix) changes in depreciation or amortisation over time.

- Require information about and examine the track record of acquiring companies, owners, and managers to check for problematic historical rent-seeking behaviour. For example, it could require that large firms provide the five latest audited annual reports at the investment entity level, including before the entry into the capital of the PE firm.[10] It could also obtain from investors in the sector financial information on all acquisitions older than 3-4 years that are still in the portfolio of the PE firm (because with older firms, they will have had time to put asset-stripping structures in place). This should be obtained at the level of the whole PE firm, rather than just the relevant PE fund.

[10] It is important to ask for information on *all* acquisitions, rather than merely a selection, or companies will 'cherry pick' the most flattering ones.

(Our August 2021 submission to the CMA, focused on private equity, provides a longer list of recommendations on pp22-26.)

Recommendation 2: Transform the CMA's mandate

Our most important proposal is to broaden the mandate of the CMA, beyond its heavy focus on consumers and corporate efficiencies, to mandate it to intervene more directly and explicitly **in the broad public interest**.

There is a clear and ringing opportunity here for civil society to intervene now: we are expecting a new Competition Act, probably in 2023, to overhaul Britain's outdated competition policy landscape. [11]. It is necessary to prepare now to shape changes that will likely affect the UK economy for many years to come.

Specifically, the government should change the CMA's mandate so that it is explicitly allowed to intervene directly on the basis of:

- Taking properly into account the interests of **a wider range of stakeholders** -- such as workers, taxpayers, small businesses, consumers, and in this particular case, children, instead of tending to prioritise consumers.

- A focus on **power**, especially economic power, and the closely related issue of the **structure of markets**.

  Children's Commissioning Consortium Cymru decries market dominance by one provider and have stated that "Local authorities would like to see more charitable, co-operative and SME provision available within their area." Yet the "Gresham's law" market dynamics we identify above and associated "Competitive Contagion" (Section 2.2.5) will tend to push children's social care steadily towards one model only: large provision by firms most willing to use unproductive techniques to maximise financial rewards for investors, thus steadily denuding the landscape of vibrant, diversified ecosystems of providers that are essential in any economic sector.

  As the largest provider has market shares above 50% in 52 out of 147 local authority areas, a change in the CMA's mandate would force a transformation

[11] As mentioned in, for instance, the Penrose Review of competition policy.

of the landscape of provision, promoting a more balanced, diversified and resilient economic ecosystem of care, with many beneficial effects such as the promotion of healthy charitable, co-operative or small-business providers.

Recommendation 3: Democratise competition policy

This related proposal is aimed at those active in the children's social care sector, and more broadly in civil society.

As mentioned, competition policy, *potentially,* is one of the most powerful levers for delivering a better economy. Yet it has been sidetracked and severely weakened by a bad competition paradigm. This weakness has led many in civil society to ignore competition policy, and seek remedies elsewhere. As a result, policy tends to get made in rarefied technocratic circles, which tend to reflect the dominant and harmful consumer-efficiency paradigm. This is a vicious circle, which can be disrupted by civil society engagement.

Our recommendation is that **civil society actors must actively to engage in, and to understand, competition policy**, and embrace the potential now emerging for a large-scale paradigm change. As we explained above, competition policy *could* potentially be the most powerful economic lever a government has. Without this engagement, this lever will remain in the hands of technocratic "competition establishment" pushing a pro-monopoly agenda. With better engagement, especially if leading to a better mandate and paradigm, the CMA would have taken the interests of children into account in a more holistic way.

Deep change is now underway in the United States in this respect, with the emergence of an immensely influential anti-monpoly movement, some of whose radical leaders have now been promoted to top positions in the Biden administration.[12] The Balanced Economy Project was set up to help promote such change in the UK and beyond, and to help spur a cross-sectoral movement to promote this paradigm change.

[12] See The US is taking on its corporate monopolists – now the rest of the world must follow, Michelle Meagher, Nicholas Shaxson, Open Democracy, Sept 17, 2021.