

Excess Profits in Children’s Social Care – how we did our calculations

BALANCED
ECONOMY
PROJECT

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Advisory: this technical note accompanies our report on Children’s Social Care in the UK, also published today. This technical note is based on data provided in the CMA’s [interim report](#) into Children’s Social Care. We delayed publication of this report because of Russia’s invasion of Ukraine, and its effect on the news agenda. Today, the CMA also published its final report. Its numbers are consistent with our numbers.

1. Background

This report provides estimates for excessive profits being earned in the children’s social care sector in the UK. Our calculations are based on the [interim report](#) of the children’s social care market by the UK’s Competition and Markets Authority (CMA) in October 2021, in its ongoing investigation into the sector.¹ The calculations were largely carried out by Vivek Kotecha for the Balanced Economy Project, with independent verification.

The current annual cost for children’s services in the UK is around £5.5 billion (£4.5 billion for England, £650m for Scotland, and £320 million for Wales; IR p.10²) Children’s social services are mostly provided by small providers, which are outside the scope of this study. Increasingly, however, larger providers are involved. We look at the **15 largest providers** of children’s social care, which together generated average aggregate revenues of £941 million per year in 2016-20 from children’s homes, fostering services and unregulated accommodation, and £958 million in 2020 (p.A3 and p.A18).³

Children’s social care is an essential public service. In many cases, it is outsourced to private providers, who are ultimately paid by the UK government via local authorities. We do not take a view here on the relative merits of public versus private service provision, although we do comment in our press release on profound market failures.

¹ The CMA study and all associated materials are available here

<https://www.gov.uk/cma-cases/childrens-social-care-study> .

The October interim report is here <https://www.gov.uk/government/publications/childrens-social-care-market-study-interim-report/interim-report> The financial analysis underpinning our study is mostly contained in Appendix A:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1027515/Appendices_.pdf

² Regarding page numbering, e.g. “IR p.10” means page 10 of the pdf version of the CMA’s Interim Report; “p.A8” means page 8 of Appendix A. “E. L9” means Line 9 in the Excel spreadsheet. (The spreadsheet also contains its own references to page numbers e.g. A18 means p18 in Appendix A.)

³ There is overlap of ownership between some children’s homes and IFAs. Our economic profit calculation separates out the revenues from each side of the business to avoid mixing them together (E. L18-19).

This report follows a detailed submission we made in 2021 to the Competition and Markets Authority (CMA) on the problematic role of private equity in the sector.⁴

Our study uses a particular standard method to calculate acceptable rates of profit, using benchmarks and data provided by the CMA. We then compare it with the actual level of profits being made by these 15 largest providers, which are substantially higher. We call the difference “excessive profits.”

Our analysis looks at two major sectors within children’s social care:

- a) **Children’s Homes**, where the average fee is around £177,000 per child per year (E. L23), and average total annual revenues were £282 million in 2016-2020 (E. L28). Nearly 1,600 children were cared for in children’s homes (E. L29).
- b) **Independent Fostering Agencies (IFAs)** where the average fee is around £43,000 per child per year (E. L23), and average total annual revenues were £442 million in 2016-2020 (E. L28). These agencies cared for just over 10,000 children (E. L29).

2. The Results

Our new report finds that:

- The **largest children’s care home companies** made an average excess profit of £35.0m per year from 2016-2020, equivalent to £22,000 per child per year.
- The **largest Independent Fostering Agencies (IFAs)** made an average aggregate excess profit of £81.6m per year from 2016-2020, worth £7,900 per child per year.
- In total over £116m of excessive profits were being made, on average, in children’s homes and in IFAs each year from 2016-2020, or a total of £584m over the 5 years. This is over 10 percent of the total annual cost of children’s services in the UK.

Our financial analysis for the 15 largest providers is laid out in the accompanying excel spreadsheet, using referenced CMA data.

As our accompanying press release notes, organisations with extensive hands-on experience in the sector have raised extensive caveats about the whole competitive market approach to care provision.⁵ Yet even using standard economic tools and yardsticks, and a market-based analysis of profitability, our report makes it clear that the marketplace is broken, and fundamental reform is needed.

⁴ Our submission to the CMA is available here

https://assets.publishing.service.gov.uk/media/60a61e3e8fa8f520c5e44027/BEP_Children_supplementary_notes.pdf

⁵ See, for example, Children England’s submission to the CMA’s Children’s Social Care inquiry.

<https://www.childrenengland.org.uk/competition-markets-authority-childrens-social-care-inquiry-children-england-submission>

This technical explainer focuses on children's homes. We do not duplicate it for IFAs, since we used the exact same methodology in both areas.

3. Analysis in detail: how we calculated the numbers

What is profit? Economic method versus accounting method

It is common knowledge that accounting methods contain many pitfalls when calculating profits. For example, investors and shareholders in such firms may earn very large returns, at the same time as the firms engage in financial engineering and use accounting techniques to ensure that their taxable profits are very low, zero, or even negative. For example, the firms may inject large debt (or borrowing) into the corporate structure, generating large interest costs, or extract large management fees – and these costs then reduce the accounting profits, perhaps to zero. So under the accounting approach one can take different views as to what “profit” means, or what a reasonable profit should be.

Our study, however, sidesteps these pitfalls by taking a very different “economic profit” approach, which is a standard methodology used by the CMA (and by others.) Essentially, this method starts from the position that if a market were genuinely competitive, then excess profits (the CMA calls it “economic profit”) would be zero. In other words, investors enter the market and earn an adequate risk-based return that keeps them satisfied, but no more. If there are excess profits, other competitors will come in and undercut them, and profits will fall back towards zero. We provide further detailed explanation of this, below.

While our more economic approach has many advantages over the accounting approach, we recognise (of course) that it, too, fails to take into account many issues and misses important explanations. Even so, our analysis unequivocally raises major red flags about this supposedly competitive market in an area of enormous need, deprivation and vulnerability.

Rates of return and excessive profits

In any well-functioning market, it is widely accepted that investors' rewards should be commensurate with the risks they take. Higher risks should be matched with higher rewards, and vice versa. But in UK children's social care, we find that risk and reward are seriously out of kilter, which suggest something is wrong. In short, investors are earning very large rewards whilst taking relatively very little risk.

It is standard practice for regulators to check for rip-offs by determining an appropriate real (ie inflation-adjusted) rate of return in key sectors, based on levels of investor risk. This rate of return should provide adequate compensation for the business' shareholders and lenders so that they will continue to own and run it or lend to it.

For instance, the CMA states that regulated monopolies such as utilities with relatively stable customer bases would historically expect reasonable real returns on capital of 2.5% -

4.5% annually. Water companies, for example, are given an allowed real return of 3.2% (A.p11) while for adult care homes, which are somewhat riskier for investors, the expected real rate of return on capital is 5-8% (p.A10).

Children's social care is lower risk than adult care homes, because, as the CMA put it: "self-funders account for more than half of the care homes for the elderly sector's revenue, which increases bad debt risk and makes revenue more volatile." (A p.10) No vulnerable children fund themselves, so care is paid for by the state, a reliable payor.

So for the purposes of this study we take the lower end of this estimate of 5-8% for adult care homes and assume a reasonable real rate of investor return on capital of 5% annually, taking the lower end of the CMA's estimate. This figure of a 5% return on capital is the basis on which we calculated reasonable profits. (If we had gone for 6.5% or even 8% the results would still have been dramatically high.)

(Note that under standard methodologies, as here, this is assumed to be the same whether the properties are owned (with e.g. interest paid to bankers), or rented (and rent paid to landlords.)

How do we calculate expected reasonable profits for children's care homes?

In a competitive market, companies should make enough to cover their **operating costs** (e.g. wages, utilities, meals, consumables) and to compensate their investors/lenders for the money they have put into the business to buy equipment, buildings etc. (called **capital costs**.) For example, the annual rate of return of 5% is meant to cover costs including the yearly costs of paying rent on a care home or the costs of a bank loan to buy the home. This is the level of reward at which investors judge it worth investing in a home, given the risks.

Economists describe this situation in terms of there being zero economic profits in a competitive market. Investors get the rewards they would expect based on risks taken, and excess profits are zero.⁶ Put in more mathematical terms, in a properly functioning competitive market we should expect:

$$\text{Economic profits} = \text{Revenue} \text{ minus } \text{Operating Costs} \text{ minus } \text{Capital Costs} = 0$$

What does excessive/economic profits mean?

If these economic profits are greater than 0, then those profits are considered **excessive** because they are higher than what is needed to compensate a firm for both its operating costs and provide a reasonable return to its lenders and investors (i.e. capital costs).

High levels of economic profit (i.e. far greater than 0) suggest that some feature(s) of the market are giving rise an adverse effect on competition (AEC). In theory, these excess profits

⁶ This approach is subject to caveats. Economic profits may not be evenly distributed across an industry, which may indicate that some firms are more efficient than others. For firms with a large proportion of intangible assets (e.g. patents, customer lists) this approach may unreliably estimate the 'capital costs'.

would attract in external competitors or increase competition between existing firms until the economic profits drop to zero. Competition could achieve this through price cutting or a gradual rise in costs due to higher investment or competition for scarce resources (e.g. skilled staff).

However, it's important to note that by itself excessive profits may not indicate a lack of competition. For example, if economic profits are concentrated in only a few firms then it may be that they are more efficient than others, have undertaken higher levels of investment, or offer a more attractive product.

How does this differ from accounting profits? Is it impacted by financial engineering?

As mentioned above, a different approach to assessing profitability involves looking at the profits stated in company accounts at the end of a financial year. This analysis is useful and widely used, but fails to provide an estimate of what a reasonable level of profit is. In addition, care needs to be taken in order to account for profit that is extracted via costs, such as interest charges, property costs, and management fees.

Economic/excessive profits is an approach that explicitly calculates a reasonable profit level, which makes it possible to identify when excessive profits are being made. In addition, it looks at profits before interest, rent, and management fees are deducted which therefore avoids the distortions on profit of financial engineering. The rate of return is assumed to be the same, regardless of how money is provided to the company (whether by shareholders or lenders, for example) and whether the property is owned or rented.

Another advantage to using the economic profits approach is that the CMA was able to analyse data at the home level and agency level for each of the largest providers. This means that the profit and costs figures are more accurate than standard accounting profitability analysis, which often relies on less relevant aggregate figures across a group of homes and other business lines.

Our calculation of Excessive/Economic profits for Children's Homes

As a reminder our calculation boils down to:

$$\text{Economic profits} = \text{Revenue} \text{ minus } \text{Operating Costs} \text{ minus } \text{Capital Costs}$$

Taking each of these in turn.

1. Revenue

The total average yearly (2016-2020) revenue for the largest providers was £941m, of which 30% is revenue from children's homes, so the average yearly revenue was £282.3m (E. L26-28). During these years the average yearly fee per child was £177,000 and so on average just under 1,600 children were cared for by the largest providers (E. L23,29).

2. Operating costs

The average yearly (2016-2020) operating profit margin for children's homes operated by the largest providers was 22.6% (E. L34). This operating profit margin refers to pre-exceptional EBITDARM (earnings before interest, tax, depreciation, amortisation, rent, and management fees). (Therefore the operating cost margin is 77.4% (ie 100% minus 22.6%).

The average yearly operating costs for children's homes operated by the largest providers is therefore 77.4% of total average annual revenue of £282.3m, which equates to **£218.5m**, or £137,000 per child (E. L37-38).

3. Capital used, and capital costs

Overall, we take the estimated average total value of the capital invested for 2016-2020, then apply this 5% return on capital, to estimate expected rate of return (or "cost of capital" for the sector).⁷

Capital cost = Total value of capital used x 5% rate of return

What is the total value of capital used? For the care homes sector this has three components: i) property, ii) equipment, and iii) working capital.

i) Property

Care homes require a building. Whether this building is owned or rented, the landlord or lender needs a return. This is the biggest component of the capital costs.

We have imputed the capital costs of care home properties, from the CMA data. The CMA obtained property market values from nine providers that had recently valued their properties. They matched these to those properties' revenues, to obtain an average ratio of property values to revenue of 0.52 (i.e. annual revenue was 52% of property values.) We then extrapolated and applied this ratio to the total revenues for all the largest providers, to estimate total property values of £542.9 million (E. L53-54).⁸

ii) Equipment

Care homes need equipment (e.g. vehicles, photocopiers etc.) to provide care or run/maintain the home. The CMA estimated average equipment costs at £13,335 per child (p. A13). We multiplied this by the number of children to obtain total equipment costs of £21.3 million for the children's homes run by the largest providers (E. L58-59).

iii) Working capital

All businesses need some cash (or ways of receiving cash quickly) so they can pay suppliers and staff even if local authorities haven't paid them yet for the services provided. The

⁷ The CMA assumes that the cost of owning and rental is the same. So we assume a rate of return that will either be a return on owning the property or used to pay return/rent to the landlord.

⁸ I.e. Revenue / 0.52

difference between these two flows is working capital that the owners of the business provide so it can keep paying bills. The CMA estimates that these businesses need working capital of an average of two months of revenue. (p. A14) So total working capital is estimated at £10.6m (E. L68).

Total value of Capital Used

This is the sum of property, equipment, and working capital. It provides us with an estimate of how much capital is invested in these businesses. Overall, total capital for children's care homes are estimated at i) £542.9m + ii) 21.3m + iii) £10.6m

= **£572.4m.**

Capital costs

Applying the 5% expected return on capital (see above) to this number, we get an expected **capital cost of £28.7m** for children's care homes run by the UK's largest providers, based on total capital invested and a reasonable expected rate of return.

The cost of capital calculated this way is another way of describing an expected reasonable rate of profit for both the lenders and investors in this sector. It is the *expected* profitability of this sector, if markets were functioning well. Now, we need to compare this with the *actual* profits being earned.

Excess(ive) profits.

We are now in a position to calculate excess(ive) profits. As mentioned above, it is:

Economic profits = Revenue minus Capital Costs minus Operating Costs

So average yearly (2016-20) Excessive Profits = £282.3m (Revenue) - £218.5m (Capital Costs) - £28.7m (Operating costs)

= **£35.1m.**

So excess profits for children's care homes (operated by the largest providers) are £35.1 million. For the 1,595 children cared for by these large providers, the **excess profits in children's care homes work out at £22,000 per child per year**, equivalent to 12% of annual revenues.

For the **Independent Fostering Agencies (IFAs)** total excess profits work out through the same method comes to **£ 81.6 million, or £7,900 per child per year**, equivalent to 18% of annual revenues.