

To: City Executive Board
Date: 9 March 2017
Report of: Executive Director, Community Services
Title of Report: Establishing a Local Authority Trading Company

Summary and recommendations	
Purpose of report:	To present the business case and seek approval for the establishment of a Local Authority Trading Company
Key decision:	Yes
Executive Board Members:	Cllrs Ed Turner, Finance, Asset Management and Public Health; Susan Brown, Customer and Corporate Services, and John Tanner, A Clean and Green Oxford
Corporate Priority:	Efficient & Effective Council
Policy Framework:	None
Recommendations: That the City Executive Board resolves to:	
<ol style="list-style-type: none"> 1. Agree in principle the setting up of a Local Authority wholly owned trading group of companies ('the company') from April 2017. 2. Delegate authority to the Chief Executive, in consultation with the Council's statutory officers and Board member for Finance, Asset Management and Public Health, authority to set up an appropriate company structure, including: <ul style="list-style-type: none"> • Selection of the name of the company(s) • Approval of the type of company, the articles of the company and the size and composition of its board • Recommending to the Shareholder Committee appointments to the posts of Managing Director, Directors, Company Secretary and Non-Executive Directors of the company • Preparation of a shareholder's agreement to be entered into between the company and the Council for consideration by the Shareholder Committee • Ensuring that the company holds appropriate insurances and/or benefit from insurances that the Council holds 3. Agree that new externally traded work is managed and accounted for through the new company once appropriate arrangements are in place 	

and it is practical to do so.

4. **Approve** provision of an initial loan of £250k for working capital at state aid compliant interest rates.
5. **Delegate authority** to the Chief Executive, in consultation with the Council's statutory officers, to undertake further work and report back to the City Executive Board on matters including:-
 - Which services should be transferred or not and if so into which part of the structure principally having regard to the financial impact on the Council.
 - Which if any staff should transfer from the Council to the Local Authority Trading Company.
 - Client side arrangements as appropriate.
6. **Note** the establishment of a Shareholder Committee (comprising the members of the City Executive Board) which will represent the Council as shareholder in the company.

Appendices

Appendix 1	Legal Analysis of Council trading - exempt under Sch12A(5) Information in respect of legal professional privilege, Local Government Act 1972
Appendix 2	Risk Register
Appendix 3	Equalities Impact Assessment

Introduction and background

1. This report sets out the business case to establish a Local Authority Trading Company (LATC) under a group structure, for the work currently undertaken by Direct Services. It seeks approval to establish the company in the first instance, with further work to determine the most appropriate financial and operational arrangements (to be reported back to CEB).
2. A LATC is an independent company in which all the shares are held by the sponsoring council. So whilst it has freedom to trade for profit in the market it receives its overall direction from the Council.
3. The 2017-18 budget indicates that Council services are funded by Government Grant of £1.5m, Business Rates of £6.6m, grants and contributions of £3.7m, and income from fees and charges of £34.7m. £9m of this income is derived from trading services primarily provided by Oxford Direct Services.
4. In the face of falling Government grant the Council embarked on a strategy of seeking to make good this loss through the raising external income in order to protect services and balance the Medium Term Financial Plan (MTFP).
5. Since the adoption of the Trading Strategy in 2011 there has been continued growth in this area.

6. The Medium Term Financial Plan agreed by CEB in February 2017 identifies an additional £2m of income to be derived from trading services over the next four years. If the Council is to continue to provide essential services to the public and mitigate the need for compulsory redundancies then achievement of this additional income is essential.
7. Direct Services undertakes a significant amount of work on behalf of the Council, (£55m annual turnover provided by over 650 staff). Services include building, waste & recycling, streetscene, parks & open spaces, highways & engineering, motor transport, pest control, some estates management work and a range of operational support services. Direct Services (operating as Oxford Direct Services) have successfully traded using surplus capacity, to recover costs and make a contribution to overheads. External trading turnover was £7m in 2015/16 and is expected to be £8m by the end of this financial year with further growth planned in future years.
8. Below is the 2017/18 Budgeted Gross Cost for each of the services.

2017/18 Budgeted Gross Cost per service	£,000
Building Services	16,805
Off-Street Parking	3,353
Waste and Recycling - Domestic	5,146
Waste and Recycling - Commercial	2,445
Engineering	4,504
Streetscene	5,273
Transport	3,488
Caretaking & Miscellaneous	778
Pest Control & Dog Warden	211
Parks	3,016
Local Overheads	3,381
Total	48,400

9. To facilitate delivery of the Council's trading ambition and MTFP going forward and to allow the Council to expand these activities in compliance with the regulatory regime, we have engaged expert legal and financial advisors to advise on the pros and cons of various options.
10. This report sets out the model that we are recommending for future operations using the '5 case model' (as recommended by government when developing business cases), these being:
 - Strategic – the case for change
 - Economic – the options analysed and preferred option presented
 - Commercial – how we will grow the business

- Financial – funding affordability, income, expenditure (summarised in the ‘financial implications’ section)
- Management – including stakeholders, timelines, milestones, etc.

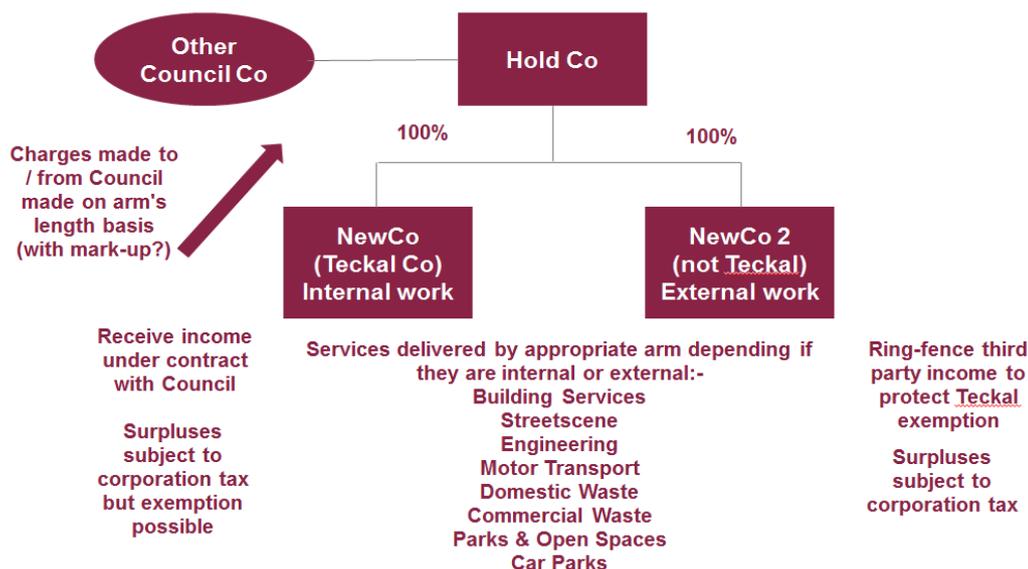
Strategic Perspective

11. Our current model has served us well, delivering a balanced budget through efficiencies and income generation. But new models are needed for changing circumstances in light of major reductions in Government funding. The creation of a Local Authority Trading Company is the next strategic step recognising the current environment and the need to significantly increase income generation.
12. The proposal (subject to further detailed analysis) is to move all Direct Services into a group LATC structure.
13. The purpose of establishing a LATC is to:
 - Sustain and grow an income stream back to the Council – Direct Services is the Council’s main contractor. With budgets diminishing external trading presents an opportunity for future income streams.
 - Drive further efficiencies – There will be further emphasis on driving down costs in order to be competitive in the market. The LATC will bring into sharp focus the need to identify and deliver further efficiencies in the Company and the services that support it.
 - Meet the requirements of the Local Government Act 2003 in relation to trading. The LATC will have the benefits of operating with a Teckal exemption (see paragraph 20) as the default internal contractor, whilst also being able to compete freely in the commercial market.
 - Establish a platform for growth with the same opportunities as other commercial companies – the widening of the market to Oxford Direct Services will present further growth potential.
 - Maintain and grow good local employment opportunities - with the same good employment practices as the Council.
14. Whilst there are risks in progressing this strategy, doing nothing will have direct consequences for the Council’s Medium Term Financial Plan (MTFP).

Economic Perspective

15. The critical success factors in establishing and trading through a LATC are:
 - Deliver then exceed the current MTFP
 - Ensure a sustainable robust structure for trading
 - Prioritise employment stability
 - Ensure a strong allegiance between Council and LATC
16. The ambition for Oxford Direct Services is clear, with further growth is set out in the MTFP.

17. An evaluation of future operating structures was undertaken in order to consider how best to deliver this ambition. The key features of each option were set out, as were the financial, legal, corporation tax, VAT and governance perspectives.
18. The options open to the Council are:
 - A. Reconsider the trading ambition within the MTFP. This will potentially impact services and delivery and of the Council's MTFP.
 - B. Create a LATC as a new operating model – there will be greater commercial opportunities and wider legal freedoms to trade, but there are financial implications to consider.
19. Given the significant disadvantages in option A, the proposal is to progress with Option B – create a new LATC.
20. To meet the Council's requirements this LATC would be a Company limited by shares with a 'Teckal' arm. A 'Teckal' exemption allows a public authority (in 'specified circumstances' – see below) to procure direct from an 'external' company outside of the public sector procurement rules. This is a significant advantage to both the Council and LATC as this arm of the group remains focused on the Council as the major client and mitigates the risk of conflict between council focus and commercial clients. The 'specified circumstances' are that:
 - i. The Teckal Co is a wholly-owned in-house company established predominantly to provide services to the Council*
 - ii. The Council exercises a "control" over the Teckal Co similar to that which it exercises over its own departments (whereby 'control' means exercising a decisive influence over both strategic objectives and significant decisions)*
 - iii. At least 80% of the activities of the Teckal Co must be for the Council*
 - iv. No direct private capital participation in Teckal Co*
21. The diagram below shows the proposed group structure. 'Hold Co' is a company owned wholly by the Council. Depending on the nature of the work (Council or private) it would be delivered either through the Teckal or non-Teckal arm.



22. A group structure (rather than a single company model) comprises a commercial trading subsidiary (non-Teckal) and a Teckal subsidiary would enable the company to trade back to the Council unfettered by public sector procurement regulations, while still being able to trade freely in the commercial world.

Commercial Perspective

23. The commercial ambition for the new LATC will be to grow the business in the trading arm free from the legal constraints of public authority regulation and enhance margins through efficiencies and cost reductions.
24. In the Teckal arm the ambition will be to optimise best value in the delivery of the Council's services.
25. Preliminary work has identified potential growth which if achieved would deliver an additional net contribution back to the Council. There are some critical dependencies which need to be addressed in order to achieve this, such as capital investment geared in line with business growth (e.g. additional vehicles), a depot expansion and changes in the way support services are delivered.
26. In the short to medium term there are three potential growth areas:

Commercial Waste

The Council has a relatively small percentage of the market inside the ring road which presents an opportunity for growth.

Highways & engineering

The opportunity here (in addition to significant internal projects such as the Seacourt extension) is the potential to deliver other schemes which in the market are seen as too big for small contractors and too small for large national contractors.

Building

Due to the reductions in volume and value of internal work over the life of the MTFP and further uncertainty arising from government policy changes that impact our HRA business plan, a significant increase in external work will be required in order to maintain the current workforce. There is growth potential in repairs and maintenance for others, as well as undertaking small housing developments

27. To drive the business, a Group Board structure will provide the strategic, entrepreneurial, financial and reputational leadership including agreeing commercial objectives, monitoring performance against those aims and ensuring effective controls and resources are in place. 'HoldCo', 'NewCo' and 'NewCo2' all have boards and the same individuals could sit on all three.
28. The Board will likely comprise the Chief Executive, Director for Community Services, Director for Organisational Development and Corporate Services and the Managing Director for Oxford Direct Services (who will run the company operations day to day). Two non-executive directors will be recruited, one with commercial experience in the services to be traded and one with finance and risk management experience in the commercial sector. Importantly, the Board will also safeguard the public service ethos and set the tone for the culture, values and behaviours for commercial success. The idea of appointing a Director from the staff cohort to give a different perspective to the strategic direction of the business is also being explored.
29. The members of the City Executive Board, sitting as the Shareholder Committee, will represent the Council's Shareholder interest and oversee the company under the terms of a Shareholder Agreement.
30. The Scrutiny Committee will be able to review or scrutinise decisions taken by the Shareholder Committee.
31. Subject to further evaluation of the most appropriate way to resource services, it is likely that all Direct Services staff associated with the delivery of transferred functions will be transferred into the company ('HoldCo') via a TUPE agreement prior to the end of the calendar year. This will form part of the subsequent report back to CEB.
32. TUPE ensures that if staff transfer in they move across on existing terms and conditions of employment. As in the Fusion contract, regardless of the legal conditions for TUPE, the Council and the Company will assume that TUPE does apply in the event of a transfer and will be obliged under contract to guarantee the protections that TUPE brings.
33. Further work will also be done to explore more choice and flexibility in terms and conditions for new employees hired to the company after transfer. Again this will be subject to a further report to CEB.
34. The proposal assumes the company will continue to buy support services from the Council. Service contracts will be established to enable the company to procure these services. The company will work with the Council's support services to minimise costs, maximise effectiveness and therefore increase surplus to the Council.

VAT, Corporation Tax, Pensions, Transfer Pricing, etc.

35. VAT will be charged on services to Oxford City Council as well as third parties. We would not expect this to create an additional cost to the Council due to its ability to recover VAT under the 5% rule. The 5% rule broadly says that, if VAT on costs attributable to exempt business activities is less than 5% of total VAT incurred (business and non-business), then the authority can recover all of its input VAT. Where third party customers are VAT registered, this is likely to be tax neutral as input VAT would be fully recoverable for them.
36. However, customers that are education bodies (academies, schools, etc.) will suffer an input VAT cost. Management are currently exploring opportunities to mitigate this and will seek to obtain a non-statutory clearance from HMRC on the proposed structure to confirm that it is not viewed as abusive and subject to anti avoidance rules.
37. The Council will also seek an exemption from HMRC from corporation tax on profits earned on services provided to the Council through the Teckal arm of the company
38. The Local Government Pensions Scheme (LGPS) is a significant issue to be addressed. A key requirement will be to ensure that current Council employees transferring into the LATC continue to benefit from LGPS (through 'Designated' or 'Admitted Body' status, whichever best meets the financial, individual and administrative perspectives), that there is no significant additional cost to the Council and that the LATC can bear the pension cost. The provision of the LGPS for any transferring staff will be a contractual condition.
39. Whilst the details of the exact arrangements to be followed are being determined, a potential model exists with our Leisure Services provider Fusion Lifestyle whereby they agree to meet the costs of the employer's pension contributions plus or minus an agreed percentage, after which point the Council underwrite any difference. This arrangement has served the Council well in guaranteeing the LGPS for transferring staff whilst managing the cost and the risk.
40. Stamp Duty Land Tax group relief should be available for the granting of market rent leases from the Council to the wholly owned companies and a claim will need to be filed in the SDLT return within 30 days.

Management Perspective

41. The project is being managed using the Council's agreed project management methodology. The Direct Services Board have approved the initial business case and are overseeing the further work required for implementation. A project board of officers is also in place meeting regularly to progress the workstreams. A Project Initiation Document and a Project Plan have both been drafted and approved.
42. The project is in two phases; drafting a business case to support the establishment of the new company with effect from 1 April 2017, and; delivering an implementation plan to ensure the company is running effectively by November 2017.
43. The implementation plan will set out the key work streams in detail, including:
 - Financial controls & procedures
 - Legal & contractual documentation
 - Licensing
 - Banking & insurance

- Health & safety
- TUPE of staff (if appropriate)
- Pensions
- Support service provision, contracts and charges
- Procurement
- ICT
- Any interim arrangements prior to full implementation e.g. loans for working capital,
- Employee relations
- Communication

44. The implementation plan will also guide the realisation of benefits set out in the PID and include an evaluation of implementation.

Other implications

45. The company will be required to formally recognise the existing trade unions Unison and Unite the Union in the same way the Council does. Trade union colleagues will have the opportunity to work with officers on the implementation plan, including the management of any TUPE arrangements.

46. Management and trade union colleagues continue to meet regarding this matter (noting that it is subject to Member approval). Trade unions are supportive of the proposals and keen to play into the finer details. They have some concerns, principally around continuing job security and terms and conditions of employment (and in particular the desire to continue as members of the Local Government Pension Scheme). Meetings with all staff in Direct Services have commenced to reassure them that if the proposal goes forward, terms and conditions will be protected for current Direct Services staff including the components of the new pay deal (when agreed) and their continued access to the LGPS will be assured. We will also discuss with them how this proposal potentially increases job security and creates further employment opportunities as it enables growth whereas the current arrangements do not.

47. The good management of Health & Safety is a priority for Direct Services with risk not only to individuals but the business as a whole if it is not managed effectively. This approach will continue as part of the local authority trading company and the aim will be an exemplar in good practice.

Financial implications

48. The Council's Medium Term Financial Plan requires an increase in turnover for Oxford Direct Services of £2m over the next four years ending 2020/21 to ensure that the Council can continue to balance its budget and deliver vital services within the City. Establishing a wholly owned company will facilitate delivery of the Council's trading ambition and Medium Term Financial Plan going forward, allowing the Council to expand these activities within the legal framework. Should the Council have to retract from this planned increase, then other savings would need to be found to balance the budget or services cut accordingly.

49. The Council has sought external advice from Grant Thornton and Trowers and Hamlins. Early financial analysis would indicate that the Company structure could be financially beneficial to the Council although there is a significant amount of work to be undertaken to complete the project. Obtaining member approval to establish a company (noting the further work to be done to prove the financial viability) would allow Council officers to move forward with the project and once appropriate financial management is in place commence trading.

Legal issues

50. A local authority is able, under the Local Government Act 2003 and the Localism Act 2011, to establish a wholly-owned company or companies to carry out trading activities. These companies can “trade” with their parent authority, i.e. they can sell services back to their parent authority (for example they can be contracted to supply the services to residents traditionally provided by the Council itself), and with external customers. A local authority is, of course, able to carry out certain “trading” activities with third parties in its own right, but some limitations apply to activities of this nature, and so to facilitate significant growth of such external trading activities, local authorities are increasingly looking to establish their own trading entities. Further analysis of the legal position of authorities wishing to carry out external trading is set out in the exempt legal appendix (appendix 1) attached to this report.

Level of risk

51. A Risk Register is attached at appendix 2.

Equalities impact

52. An Equalities Impact Assessment is attached at appendix 3.

Report author	Simon Howick
Job title	Service Transformation Manager
Service area or department	Direct Services
Telephone	01865 252547
e-mail	showick@oxford.gov.uk

Background Papers: None