

*Structures for Service  
Delivery Partnerships*

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Technical Notes

# Structures for Service Delivery Partnerships

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# PREFACE

## INTRODUCTION

This publication has been produced by DCLG to assist those in local government in England, and for potential public sector, voluntary and business partners to understand the various structures that might be used with a partner. They have been derived from an update of the publication Structures for Partnerships: Technical Notes, published by the ODPM Strategic Partnering Taskforce in September 2002. The updated notes reflect the changes to the law and the evaluation of partnership structures since that date. Most of the content will also be relevant to local government in Wales and Scotland but the notes have not been adapted to reflect the different legal and administrative arrangements that apply in those countries.

DCLG does not warrant that these notes reflect policy and they should not be used as a substitute for professional advice.

The law is always subject to change and interpretation. Whilst references to impending changes have been made, users need to be careful in ensuring that the notes reflect the current position.

## ACKNOWLEDGEMENT

This publication has been produced by DCLG with the assistance of Alan Aisbett of Pinsent Masons, John Layton Associates and Enid Allen Associates. These notes draw upon work published by Strategic Partnering Taskforce upon the same subject. Extracts have been taken from 'A Guidance Note for Public Sector Bodies forming Joint Venture Companies with the Private Sector, HM Treasury/Partnerships UK, December 2001' and various publications by Partnerships for Health and the 4Ps on NHS LIFT and Partnerships for Schools on Building Schools for the Future.

## CONTENT

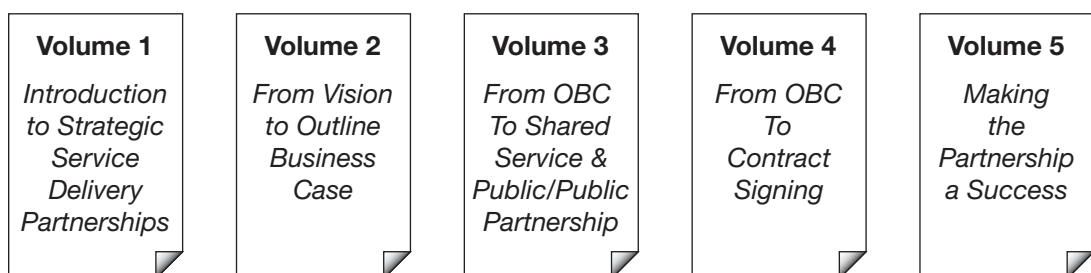
The notes deal with the structures that local authorities might wish to contemplate using in service delivery partnerships. In addition, there is a new DCLG document dedicated to the structures for collaborative arrangements between local authorities – Structures for Collaboration and Shared Services – which contains more detail for those arrangements and other supportive information. The format of both documents has been designed to cover legal, financial, employee and commercial issues. The length of the text devoted to any of the structures is not intended to imply a preference for one structure over another.

Although the notes explain the mechanics of various legal structures they are not intended to replace legal accounting, financial, tax and other technical advice which may be needed to implement a structure that is specific to a particular project.

If readers wish to make comments on these Technical Notes please contact the Local Government Efficiency and Modernisation Team on [med@communities.gsi.gov.uk](mailto:med@communities.gsi.gov.uk)

## OTHER PUBLICATIONS

There are a number of publications produced by ODPM's Strategic Partnering Taskforce (SPT) relating to service delivery partnerships and collaborative arrangements between local authorities. These notes form part of this series. Other publications include:



In addition, there are companion volumes which include:

*Strategic Service Partnerships – a Decision Makers' Guide* (ODPM 2003) – this booklet is aimed at members and chief officers to guide them through decisions and implementation.

*Employment and Partnerships – Technical Notes* (ODPM 2003 Updated by DCLG 2006) – a guide to the many complex employee issues that arise and that need to be addressed to secure successful change in partnering situations. A technical addendum has been produced to update these notes to reflect the position as at December 2005.

*The Partnership Assessment Tool* (ODPM 2003) which provides an approach to a health check of the partnering relationship.

*Risk Management in Partnerships – Technical Notes* (ODPM 2003) provides a framework for risk management at both the strategic and project level in service delivery partnerships. This document also provides generic risk registers to assist project managers in developing and enhancing their authority's approach to risk management.

*Payment Mechanisms – Technical Notes* (ODPM 2004) – provides an explanation of the payment mechanisms available for service delivery partnerships.

All the documents shown are summarised in a companion document to provide a brief overview of all the knowledge and advice produced by DCLG in support of service delivery partnerships and shared services.

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# CHAPTER 1

## Executive Summary

- 1.1 When considering service delivery partnerships, or indeed partnerships of any kind, authorities need to have, or gain, an understanding of what can be done and the benefits of the alternatives. The complexities of the alternatives can make this process daunting and some will see it as a matter better left to solicitors and accountants. Such an approach, whilst understandable, is not appropriate as the choice of preferred structures needs to be supported by the stakeholders involved and be widely seen as the best route to deliver the objectives determined for the project.
  - 1.2 The purpose of this publication is to provide an overview of the principal alternative structures that can be used for service delivery partnerships. It is designed to support and supplement the other publications that DCLG has issued, particularly those of the Strategic Partnering Taskforce (SPT).
  - 1.3 This publication will be of most use to officers in those local authorities contemplating service delivery partnerships with public and/or private sector organisations. It should be seen as a technical reference work rather than an overview of the subject. Inevitably its content considers legal and financial aspects of local government and the private sector. DCLG has sought to place these considerations in the context of the practical situations that local authorities are likely to find.
  - 1.4 Structures are akin to a framework of a building. Having the right building may assist the efficient operation of a business or service but it does not ensure it does. Conversely having the wrong building in the wrong place and of the wrong size can ensure that you cannot secure the optimum efficiency. In local government terms having the right structure can assist the delivery of continuous improvement and greater efficiency and these notes are designed to help local government and those with an interest in local government understand the options.
- So what are the alternatives?**
- 1.5 The SPT publication *Rethinking Service Delivery: From Vision to Outline Business Case* (ODPM 2003) identifies the principal alternatives that local authorities can be expected to consider and for ease of understanding they are grouped under six headings. The columns indicate the scope for involvement of different sectors in the principal alternative structures.



	<b>Public Sector</b>	<b>Not-for-profit</b>	<b>Private sector</b>
In-house	✓	–	–
Public sector consortium	✓	–	–
Joint venture through companies and trading	✓	✓	✓
Partnering contracts; and legal partnerships	✓	✓	✓
Outsourcing	–	✓	✓
Disposal/closure	–	✓	✓

- 1.6 The structures that are suitable for service delivery partnerships are largely confined to those that can be classified under the headings: public sector consortium, joint venture companies and partnerships and partnering contract. Outsourcing is an alternative and commonly used but it will not deliver a service delivery partnership unless in its operation it behaves as if it were a partnering contract. These sub-headings are used as the chapter headings within this publication. A further chapter has been added to deal with concession and franchise arrangements.
- 1.7 Potentially, service delivery could be linked to disposal or part disposal of service capability or possibly in conjunction with a form of wider markets initiative e.g. disposal of intellectual property linked with an agreement to jointly benefit in the exploitation of that knowledge. As a further illustration, an authority makes a strategic decision that it no longer needs a specialist support unit in its highways department. This unit has excellent staff, has designed and developed unique and first-class approaches. In these circumstances a partnership with the private sector may give rise to both a capital receipt and continued access to the resources. For any authority interested in this form of strategic partnership, reference may be made to HM Treasury Guidance *A Guidance Note for Public Sector Bodies forming Joint Venture Companies with the Private Sector* (December 2001).
- 1.8 This publication does not consider the in-house operation or disposal/closure options.
- Chapter 2 considers public sector consortium, pooled budgets and joint commissioning*
- 1.9 Local authorities may turn to other public sector partners with similar objectives, with a view to generating synergies and economies of scale. Indeed, this may prove the only option for smaller authorities, who may be unable to formulate a commercially attractive package for the private sector.
- 1.10 In this model, the local authority and one or more other local or public authorities join together to effect service delivery of some or all of their activities. The public authorities, whilst likely to be contiguous or neighbouring, may be located within the same government sector and hierarchy within that sector (e.g. two district councils), the same government sector but at different levels in the hierarchy, e.g. a district council and a county council and/or different government sectors (e.g. a local authority and an NHS trust). In addition, there is a new publication – Structures for Collaboration and Shared Services (DCLG 2006) that specifically addresses in detail the

arrangements that can assist authorities to deliver greater efficiency through collaboration, joint working and partnering with others in the public sector (which may or may not involve the private sector).

*Chapter 3 considers joint venture through companies with the private and voluntary sector and trading*

- 1.11 Joint ventures through companies are increasingly becoming a common feature of modern day business practice, by enabling parties to work together, utilising the collective pool of assets (whether tangible or intangible), in the pursuit of complementary objectives and the delivery of a successful business venture. The key feature is the model's ability to optimise the operation's potential by introducing resources that would not otherwise be available (e.g. start up or expansion capital).
- 1.12 The first part of the chapter considers joint venture companies. The second part addresses joint ventures involving non-profit-distributing organisations (now commonly known as the 'third sector') such as companies limited by guarantee and industrial and provident societies. Included here also are Community Interest Companies (CICs) that were introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004. CICs are companies limited by shares or guarantee formed to carry on activities for the benefit of the community and are subject to a statutory 'asset lock' which limits their ability to distribute profits to their members or shareholders. The third part of the Chapter addresses structures for local authority trading under the Local Government Act 2003.

*Chapter 4 deals with partnering contracts and legal partnerships*

- 1.13 This chapter is divided into three parts:
- Part 1 deals with partnering contracts that are contracts entered into between the local authority and a private sector partner, which build on the lessons of conventional outsourcing and the principles of *Rethinking Construction* (Egan 1998) In other words the nature of the contract envisages a collaborative role between the local authority and private sector partner in relation to the discharge of the private sector partner's obligations under the contract.
  - Part 2 deals with legal partnerships. 'Partnerships' here mean legal partnerships rather than the more general relationships (contractual or otherwise) in the nature of 'collaboration' to achieve common goals or objectives, as in the more general use of the term such as in service delivery partnerships.
  - Part 3 considers Limited Liability Partnerships. This is an option that local authorities might wish to consider for the potential fiscal benefits. It is derived from the Limited Liability Partnership Act 2000. This Act introduced a new form of corporate business association, namely the Limited Liability Partnership ('LLP') heralded by the Department of Trade and Industry (DTI) as 'the first fundamental innovation in corporate design in the 20th century' in adding to 'the choice of legal organisations available to businesses in Great Britain'. The LLP creates a hybrid model, drawing upon the flexibility of the traditional partnership and the safeguards of limited liability.

***Chapter 5 deals with service and capital outsourcing, LIFT, and Building Schools for the Future***

- 1.14 In a service outsourcing, the local authority will contract with a private or voluntary service provider for the provision of certain services. This type of contract generally involves a total transfer of the service provision to the service provider. The nature of the local authority requirements for service provision may be either input-based (i.e. a contract which specifies a detailed methodology – such as a Compulsory Competitive Tendering (CCT)-style contract) or output-based (i.e. a contract where the desired outputs are specified with the methodology for achieving the outputs at the discretion of the service provider). The recent tendency has been towards output specifications. It may be that with the advent of trading powers (Section 95 of the Local Government Act 2003) and more ‘entrepreneurial’ authorities emerging then authorities can also respond to market opportunities. This aspect is covered in Structures for Collaboration and Shared Services (DCLG 2006).
- 1.15 Capital outsourcing is often referred to as the Private Finance Initiative (PFI). In this model, a local authority (either by itself or with one or more other local or public authorities) procures investment and services in relation to an asset(s). The usual structure involves a design, build, finance and operate contract (DBFO) with a private sector service provider for a concession period of between 25-30 years. The private sector service provider is usually a special purpose company set up especially for the project. In two sectors, secondary schools and the provision of primary care accommodation the procurement of capital investment is now through a strategic partnership structure. This structure, respectively BSF and NHS LIFT, involves the local authority (and in the case of NHS LIFT, the local authority in conjunction with a Primary Care Trust) procuring a private sector partner to form a Joint Venture Company (in BSF called a Local Education Partnership and in NHS LIFT a LIFT Co). The Joint Venture Company is responsible for managing a supply chain to deliver the initial identified projects. There is then an in-built procedure to bring forward further projects during a period of exclusivity.

***Chapter 6 deals with concession arrangements***

- 1.16 A concession or franchise (to be distinguished from the public/public franchise arrangement explained in Chapter 2) involves the grant by the local authority of the right to exploit the revenues or cash flows from an asset(s). It is similar in nature to PFI save that instead of the revenues or cash flows emanating from the local authority (and dependent upon performance) the revenues and cash flows emanate from third-party users of the asset(s). The assets are the subject of the concession (and dependent upon demand).

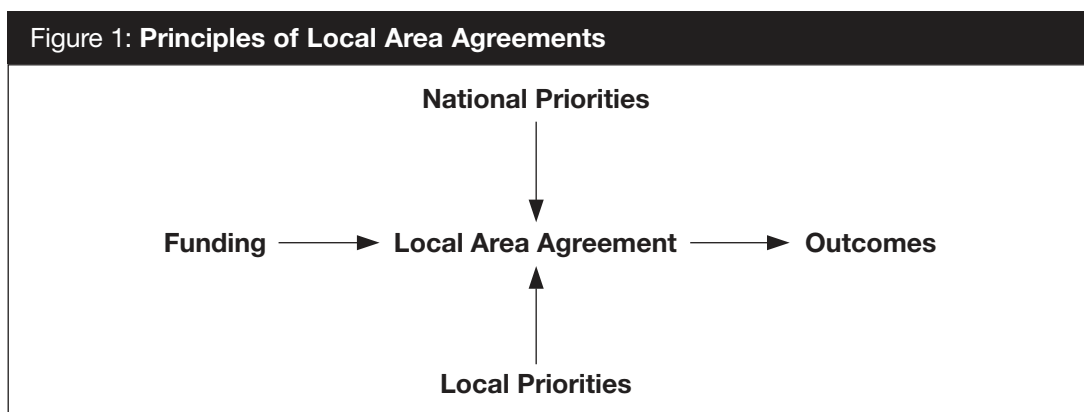
# CHAPTER 2

## Public/Public Arrangements, Pooled Budget and Joint Commissioning

### OVERVIEW

- 2.1 Local authorities are increasingly turning to other public sector partners with similar objectives, with a view to generating synergies and economies of scale and these approaches have been given greater impetus with the Gershon Efficiency Review requirements for local government that emanated from the Spending Review 2004. Indeed, this may also prove the only option for smaller authorities, which may be unable to formulate a commercially attractive package for the private sector.
- 2.2 In this model, the local authority and one or more other local or public authorities join together to share in service delivery relating to some or all of their activities. The public authorities, whilst likely to be contiguous or neighbouring, may be located within the same government sector and hierarchy within that sector (e.g. two district councils), the same government sector but at different levels in the hierarchy, e.g. a district council and a county council and/or different government sectors (e.g. a local authority and an NHS trust).
- 2.3 As with any activity a local authority (and indeed any other public authority) must have sufficient powers to enter into the arrangements with the other local authority (or public authority). Local Authorities may arrange for the discharge of one or more of their functions by another local authority under Section 101 of the Local Government Act 1972. The Local Authorities (Goods and Services) Act 1970 allows local authorities to provide professional and technical services to other local authorities and certain other public sector bodies. This power is supplemented by the new charging and trading powers contained in Sections 93 and 95 of the Local Government Act 2003. Furthermore the 'well-being' power contained in the Local Government Act 2000 allows local authorities to provide staff, goods, services and accommodation to promote the economic, environmental and social well-being of their area. There are also specific powers contained in Sections 27-32 Health Act 1999 which enable the establishment of a statutory form of partnership between local authorities and certain NHS bodies.
- 2.4 Local Area Agreements (LAAs) are providing new opportunities for pooled arrangements and it is expected that by 2007, all authorities will be engaged in a LAA along with their other public sector partners. These arrangements

are creating new opportunities for sharing resources to deliver key local and national priorities. LAAs simplify the number of additional funding streams from central government going into an area, help join up public services more effectively and allow greater flexibility for local solutions to local circumstances. They are agreements struck between Government, the local authority and its major delivery partners in an area (working through the Local Strategic Partnerships). They are structured around four blocks: children and young people, safer and stronger communities, healthier communities and older people, and economic development and enterprise. LAAs are helping devolve decision making, moving away from a ‘Whitehall knows best’ philosophy and reducing bureaucracy. Also, they are one of the first products of the Government’s 10-Year Vision strategy. LAAs are being driven through by the local authority in partnership with the local strategic partnership (to ensure engagement of local partners). However, the usual rules on local authorities being permitted to delegate decision making only to a limited number of persons (see paragraph 2.5) for example, other local authorities are equally applicable to arrangements under LAAs, for example, the local authority cannot delegate decision making on budgets to Local Strategic Partnerships. Negotiations are overseen by the respective Government Office and signed off by ministers. **Figure 1** contains a summary diagram showing the principles of LAAs.



2.5 The arrangements between the public authorities may be manifested through:

- an administrative law structure (e.g. delegation to another local authority or to a joint committee where such is permitted by statute);
- a contract between the public authorities;
- a private corporate entity established by the public sector authorities<sup>1</sup>; or
- simultaneous executive meetings.

<sup>1</sup> NHS bodies have no direct powers to participate in corporate entity formation unless a delegation by the Secretary of State can be identified under the provisions of Section 4 of the Health and Social Care Act 2001 and the powers of other public bodies to do so will need to be confirmed on an individual basis.

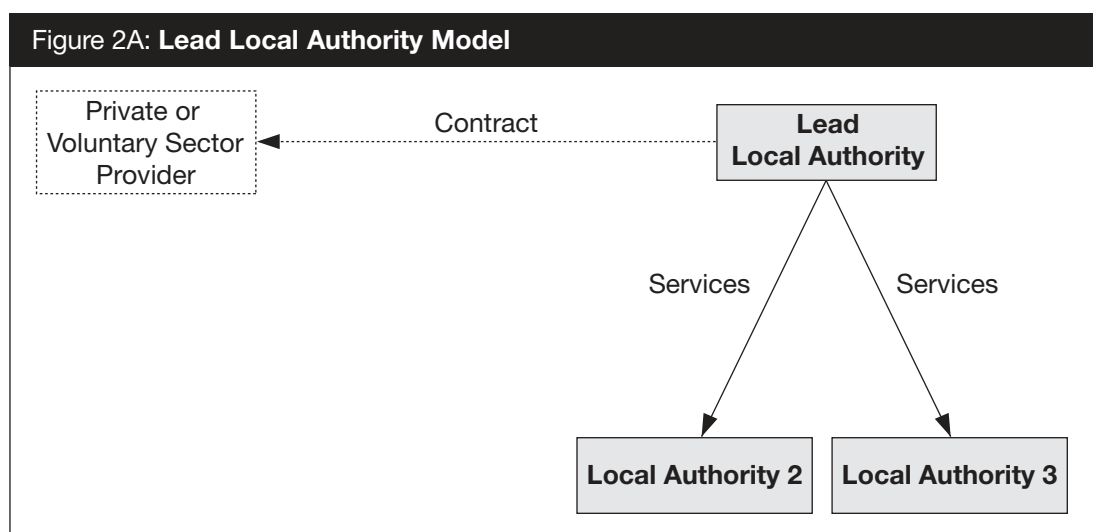
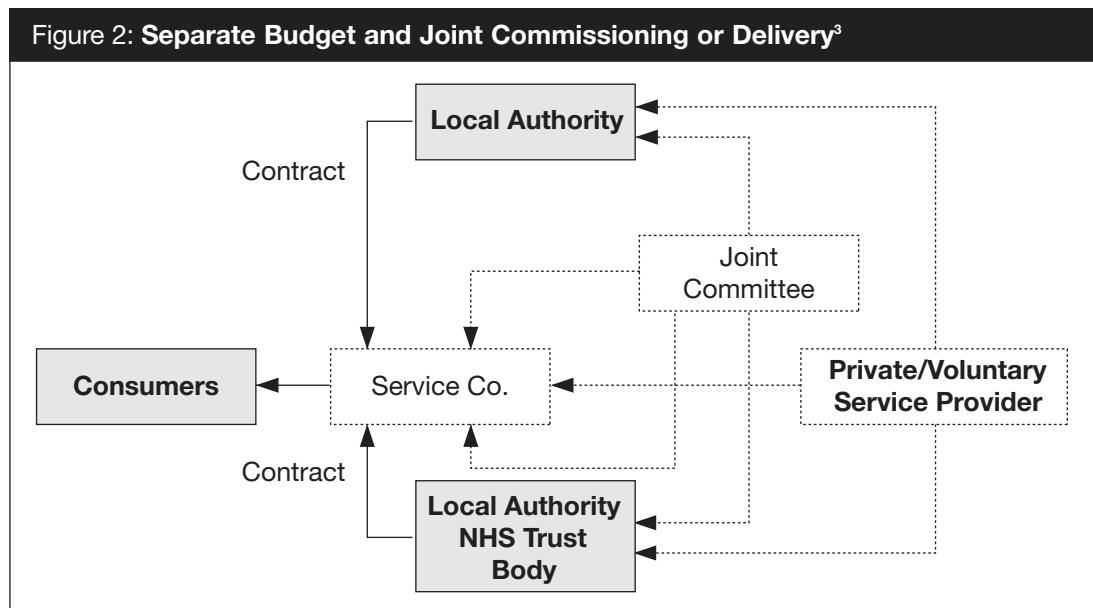
- 2.6 Local authorities have only limited statutory powers to delegate their decision making to other persons which includes other local authorities. An administrative law structure is one which is established within the statutory scheme of delegation for local authorities. This may involve one authority arranging for the discharge of their functions by another authority under Section 101 Local Government Act 1972 as part of the public public arrangement, for example one local authority may delegate decisions on certain social services matters to another as part of a drive to improve services. Alternatively one or more local authorities may decide that the preferable approach is to take decisions jointly by means of establishing a joint committee. The formation of a joint committee may empower two or more local authorities to discharge any of their functions jointly (see s101 (5) Local Government Act 1972). In forming a joint committee authorities should take account of the executive arrangements of each of the constituent bodies. Similar arrangements may be put in place for the joint exercise of functions under executive arrangements (see s20 Local Government Act 2000 and Local Authorities (Arrangements for the Discharge of Functions) (England) Regulations 2000.
- 2.7 The joint committee may in turn discharge the functions through a sub-committee or an officer of the authority. Significantly, members may be co-opted from the private and or voluntary sector, which may serve to formulate a 'best of both worlds' approach, by combining public sector regulation with private sector expertise although such co-optees may not be afforded voting rights.
- 2.8 Delegation is not confined to other local authorities. Under Sections 31 Health Act 1999 and the NHS Bodies and Local Authorities Partnership Arrangements Regulations 2000 (as amended by NHS Bodies and Local Authorities Partnership Arrangements (Amendment) (England) Regulations 2003), NHS bodies may, as part of a partnership arrangement, exercise certain local authority health-related functions and local authorities may exercise certain NHS functions. The 2000 Regulations also enables local authorities and NHS bodies pursuing such partnership arrangements to establish and maintain a 'pooled fund'. The delegation of functions by a local authority to a person is possible where that person has the benefit of an order delegating the function made under the Regulation and Contracting Out Act 1994.
- 2.9 Where one local authority delivers services to another then the local authority benefiting from the services must have regard as to whether the EU procurement (the EC Treaty and Directives/UK regulations) rules should apply to the Contract (see paragraph 2.62 onwards). Local authorities may enter into contractual arrangements for the sharing, delivery or commission of services. Such a contractual arrangement will usually involve the individual local authorities retaining decision making in respect of certain functions with the arrangement being purely a contractual relationship regulating how and when the services will be delivered. The arrangement may involve a local authority providing services to the other(s) and/or acting on that other authority's(ies) behalf. Such an arrangement may or may not have a Partnership Board made up of representatives of the local authorities to assist in decision making.



- 2.10 Local authorities may form a company for the delivery of services which are the subject of the public/public arrangements. As a collaboration vehicle per se, local authorities are likely to use a company limited by guarantee (however, where the local authorities may in the future be seeking a private sector partner a company limited by shares may be more appropriate). Once established, the company may provide services to the company's constituent local authorities without tendering under the EU procurement rules provided the local authorities exercise over the company control which is similar to that which it exercises over its own departments<sup>2</sup> and the company must carry out the essential part of its activities with the controlling authorities. The company should also be wholly owned without private sector involvement and not have commercial objects. Delegation of functions to a Company (even one which is wholly owned) is only possible by an Order under the Deregulation and Contracting Out Act 1994 (although delegation to a joint committee working alongside the Company would be possible).
- 2.11 Another structure which has been used by local authorities is that of simultaneous executive meetings (or SEM). Under SEM the partner local authorities pursue their own decision making but meet simultaneously in close proximity with a view to reaching the same decision. However, where there are more than two local authorities involved in a public/public arrangement, use of SEM may become increasingly impractical.
- 2.12 The services may be delivered solely by the local or public authorities by any of the methods outlined above. Alternatively, the local or public authorities may involve the private or voluntary sectors in the delivery of services either through a direct contractual relationship (including joint participation in a corporate entity) or an indirect contractual relationship through a corporate entity established by the public authorities.
- 2.13 Unless a private or voluntary sector service provider is involved, the risk associated with the service provision will remain with the public sector. Risk may be transferred to another local authority which has successfully competed for a contract or where the authority has delegated a function using Section 101 Local Government Act 1972.
- 2.14 **Figure 2** illustrates a structure where separate budgets and the sharing of other resources (e.g. employees) are envisaged. The collaboration between the local authorities may be by contract, joint committee or through a company (Service Co) or indeed a mix of those. For example, the local authorities may decide to work together through a company, whilst at the same time form a joint committee to work alongside the company and to whom decisions may be delegated. **Figure 2A** illustrates a local authority model where one local authority provides services to others with the possibility of the local authority contracting with third parties on behalf of those authorities (with the local authority being suitably indemnified). **Figure 3** illustrates a structure involving the pooling of budgets. The pooling of budgets is permissible between local authorities and NHS Bodies in relation to certain defined functions but it is doubtful whether pooling

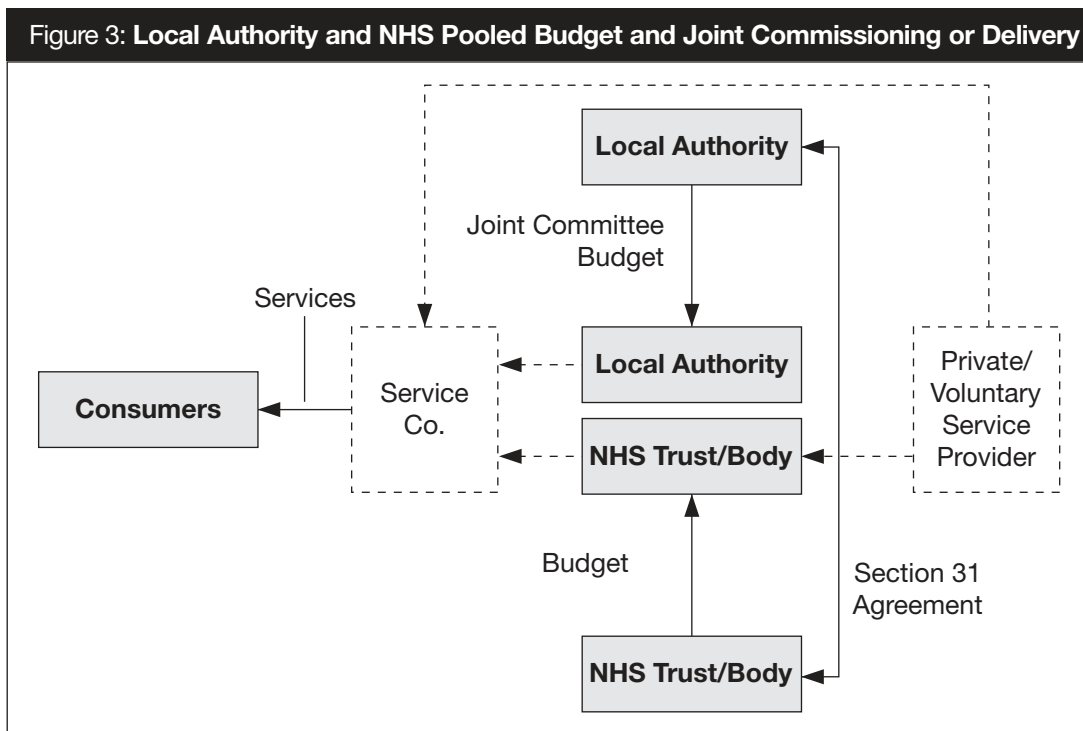
<sup>2</sup> See a line of ECJ cases starting with the Teckal (case (-107/98) and explained below in paragraph 2.62 onwards.

of funds between local authorities is lawful as one local authority may technically be funding a deficit in another (any similar arrangements between local authorities would need to involve the delegation of functions). It is likely that the delivery of services would be by the entities themselves. **Figure 3** shows the potential of delivery through a company although this will require formation or delegation by the Secretary of State under Section 4 of the Health and Social Care Act 2001 where the delivery of goods, services or facilities are the object. In each case, where an NHS Body is involved, the collaboration arrangements must comply with the requirements of the Health Act 1999 and the NHS Bodies and Local Authorities Partnership Arrangements Regulations 2000 (as amended by NHS Bodies and Local Authorities Partnership Arrangements (Amendment) (England) Regulations 2003). Both examples illustrate the possible involvement of private or voluntary sector service providers.



<sup>3</sup> In all of the tables throughout the notes, dotted paths are options or choices that an authority can consider. The solid lines represent key relationships that will exist in the type of structure being contemplated.





## DESCRIPTION

- 2.15 The local authorities will enter into an arrangement to share their resources and to provide the services. The legal structure of the arrangement will depend upon the nature of the services which are to be shared and the extent of the collaboration. Clearly the less extensive the collaboration (for example the secondment or sharing of a few employees) the less need there will be for a form of ongoing collaboration structure. However, the heavier and more extensive the collaboration (for example a joint procurement of a complex project) the more need there will be for a formal ongoing collaboration structure.
- 2.16 Where a formal collaboration structure is needed the local authorities will need to determine the nature of the structure which will best suit the needs of the arrangement. Five options are suggested below.

### Options for collaboration:

- contractual arrangement (with or without a Partnership Board) with no corporate status but defined in contractual agreements between the parties
- a Joint Committee established under the terms of the Local Government Act 1972 or any other legislation (e.g. Section 31 Health Act 1999 and the NHS Bodies and Local Authorities Partnerships Arrangements Regulations 2000 (as amended by NHS Bodies and Local Authorities Partnership Arrangements (Amendment) (England) Regulations 2003))
- a non-profit distribution entity (probably a company limited by guarantee or an industrial and provident society)
- a profit distribution entity (probably a company limited by shares or a Limited Liability Partnership)
- simultaneous executive meetings

- 2.17 One of the options that is not listed is that relating to Joint Boards. Joint Boards have been used for a number of years to facilitate joined-up working by and between local authorities to discharge specific functions such as in public health. Joint Boards are separate corporate bodies and often have levying or precepting powers. They can award contracts and own property in their own right. Where joint boards currently exist there are specific-enabling powers facilitating their establishment.

### **Advantages**

- 2.18 The principal advantages of the public/public arrangement include:

- improved efficiency gains;
- economies of scale;
- ability to demonstrate best value;
- avoiding duplication and/or competition between activities;
- added value in pooling know-how, expertise and experience;
- specialisation and centres of excellence;
- one-stop 'seamless' service delivery involving more than one activity and public service provider;
- 'best of both worlds' as the arrangements can be structured for potential involvement of the private sector;
- potentially greater resilience regarding staff retention and recruitment;
- may provide increased commercial bargaining power for subsequent involvement with any private sector partner.

### **Disadvantages**

- 2.19 The principal disadvantages of the public/public arrangement include:

- potential impact of future changes in political control;
- inconsistent statutory provisions applying to different public authorities, e.g. powers and VAT;
- potential difficulties in assimilating different objectives and requirements of each of the local or public authorities;
- potential difficulties in assimilating procedures and systems of each of the local or public authorities (particularly IT systems);
- consequences of any disagreements, 'fall out' or deadlock between the authorities;

- possible local consumer opposition to ‘sharing’;
- available capital resources will not be increased without a private or voluntary sector partner;
- staff concerns and perceived threat to middle management;
- no risk transfer unless authorities appoint a private or voluntary sector partner, and hence may be more difficult to demonstrate best value;
- there is a risk they are seen as an end in themselves and not a means to an end;
- there is a risk that they will be supported/underpinned by layers of bureaucracy within parent authorities.

## THE COLLABORATION OPTIONS

### Partnership Boards, Joint Committees and Corporate Entities

2.20 The main features of each of the collaboration options identified are set out below together with the respective advantages and disadvantages of each option.

<b>Contractual Arrangement – Partnership board</b>		
<b>Features</b>	<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Contractual arrangement between local authorities</li> <li>• Partnership board is made up of representatives of each local authority</li> <li>• Composition of board determined by the contractual documentation as in its operation, influence and duration</li> <li>• No formal delegation of decision making to board</li> <li>• No separate entity created</li> <li>• Specification will determine agreed service levels</li> </ul>	<ul style="list-style-type: none"> <li>• Tailored solution</li> <li>• No corporate entity</li> <li>• Local authority member/officers do not take on additional legal responsibilities</li> <li>• Procedures not prescribed</li> <li>• Public sector audit regime</li> <li>• Not inherently regulated by legislation (e.g. Companies Acts)</li> <li>• More recognisable by and more affinity with members</li> </ul>	<ul style="list-style-type: none"> <li>• Time limited</li> <li>• Remit cannot be easily expanded</li> <li>• Opaque accountability</li> <li>• No independent supervision</li> <li>• Opaque contractual role</li> <li>• No corporate entity to be able to contract or own property in own name</li> <li>• Cannot be delegated functions</li> <li>• Query real role beyond ‘talking shop’</li> </ul>

<b>Joint committee</b>		
<b>Features</b>	<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• A formal local authority committee constituted under Section 101 of the Local Government Act 1972</li> <li>• Policy determined by local authority councillors for the purpose determined/ delegated by the principal authorities</li> <li>• Managed by designated officers</li> <li>• No separate legal entity created</li> </ul>	<ul style="list-style-type: none"> <li>• Established arrangement</li> <li>• Legal structure well known and understood</li> <li>• Open democratic accountability (member involvement is brought into the heart of the entity)</li> <li>• Local authority members/ officers do not take on additional responsibilities</li> <li>• Procedures prescribed in local government law</li> <li>• Public sector ethics and audit regime</li> <li>• Can be delegated functions</li> </ul>	<ul style="list-style-type: none"> <li>• Unwieldy for a large number of local authorities</li> <li>• Can be bureaucratic</li> <li>• May not be focused solely on managing the contract</li> <li>• May not promote 'difference' in approach</li> <li>• Cannot directly employ staff (accommodated through transfer or secondment to a lead authority)</li> <li>• External organisations cannot vote</li> <li>• Not a separate corporate entity to be able to contract or own property in own name</li> <li>• Continued scrutiny arrangements linked to the originating authorities</li> </ul>

### Non-Profit Distributing Organisation e.g. Company Limited by Guarantee, Industrial and Provident Society

Features	Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• A separate entity from participating local authorities</li> <li>• Objects of company set out in Memorandum of Association</li> <li>• Regulation and Management of the Company will be set out in the Articles of Association and/or accompanying Agreement</li> <li>• Company will agree with Constituent Members to carry out the agreed activities</li> <li>• The agreed activities will be carried out to an agreed specification</li> <li>• No formal delegation of functions to company (other than pursuant to a Deregulation and Contracting Out Order)</li> </ul>	<ul style="list-style-type: none"> <li>• Distinct legal status</li> <li>• Tailored solution</li> <li>• Permanence</li> <li>• Capable of being used for multi-purposes</li> <li>• Private sector accountability and audit regime</li> <li>• Retained earnings used for agreed objectives</li> <li>• Can contract and own property</li> <li>• Can raise finance 'on the back' of significant and certain cash flows</li> <li>• A company limited by guarantee can be used to give different 'stakeholder weighted interests'</li> <li>• Can grant a floating charge over assets by way of security</li> </ul>	<ul style="list-style-type: none"> <li>• Need to consider vires issues</li> <li>• Potential exposure to taxation</li> <li>• Conflict of interest issues need to be monitored</li> <li>• Independently monitored</li> <li>• Regulated by Companies Acts, Industrial and Provident Societies Acts and Insolvency Acts</li> <li>• Cannot raise finance through 'issues' (by itself) – only debt</li> <li>• Cannot include an NHS body as shareholder unless a direction from the Secretary of State exists</li> </ul>

### For Profit Entity e.g. Company Limited by Shares

Features	Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• As for not-for-profit but dividends payable</li> <li>• The normal preferred structure if profits are a key motivator and/or private sector involved.</li> <li>• Preferred entity for trading vehicles (under Section 95 Local Government Act 2003 trading must be through a company)</li> </ul>	<ul style="list-style-type: none"> <li>• Familiar to the private sector</li> <li>• Distinct legal status</li> <li>• Tailored solution</li> <li>• Permanence</li> <li>• Capable of being used for multi-purposes</li> <li>• Private sector accountability and audit regime</li> <li>• Recognisable vehicle for raising finance (albeit for types of finance other than debt)</li> <li>• Shares easily recognisable interest and transferable</li> </ul>	<ul style="list-style-type: none"> <li>• Need to consider vires issues</li> <li>• Potential exposure to taxation</li> <li>• Conflict of interest issues need to be monitored</li> <li>• Independently monitored</li> <li>• Cannot be used as a charitable entity (but a Community Interest Company may give community protection)</li> <li>• Cannot include an NHS body as shareholder unless a direction from the Secretary of State exists</li> <li>• Company filing requirements</li> </ul>

<b>Limited Liability Partnership</b>		
<b>Features</b>	<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• A corporate entity in its own right</li> <li>• No maximum numbers of members to a LLP</li> <li>• Limited liability</li> <li>• Not a preferred entity for trading vehicles (under Section 95 Local Government Act 2003 trading must be through a Company). However, can be included in a trading structure for beneficial tax reasons (see paragraph 4.112)</li> </ul>	<ul style="list-style-type: none"> <li>• Transparent for tax purposes, members being taxed on their share of income/gains from the partnership hence reflecting the authority's tax position</li> <li>• Limited liability for the partners</li> <li>• Familiar to the private sector</li> <li>• Distinct legal status;</li> <li>• Private sector accountability and auditability</li> <li>• Can contract and own property</li> <li>• Liability of members restricted to their contribution</li> </ul>	<ul style="list-style-type: none"> <li>• Need to consider vires issues</li> <li>• Protection may be limited if negligence</li> <li>• Cannot be used for S95 trading but can form part of the structure for fiscal advantage</li> <li>• Similar reporting arrangements to private sector companies</li> <li>• Little practical experience to date (2006) in local government</li> <li>• Same member/officer conflict of interest issues as with companies</li> <li>• Cannot be used for non-profit making activities</li> </ul>

A table comparing in more detail limited companies and limited liability partnerships can be found at paragraph 4.113

- 2.21 There are also some sub-options which may be relevant. For example, companies limited by guarantee or by shares can, if they comply with the relevant statutory requirements, be Community Interest Companies (CICs) (see Chapter 3, para 3.167). Whether they are limited by shares or by guarantee, CICs have less freedom to dispose of their assets, or distribute profits to their members / shareholders than ordinary companies.
- 2.22 Subject to considering vires issues on a project specific basis, local authorities also have the option of a Limited Liability Partnership (LLP) as a profit entity under the Limited Liability Partnerships Act 2000. An LLP is an incorporated partnership with characteristics which are similar both to a partnership and a company. An LLP is a corporate entity which can be formed and governed by a simple partnership agreement. However, an LLP is subject to most of the regulatory provisions binding upon companies. Its general benefit to local authorities is its tax transparent status which means that the local authority itself will be taxed on its share of the partnership profits rather than, for example, all profits being taxed in the hands of a Company. It is therefore a useful vehicle for a joint venture with a private sector partner. However, other than in the unlikely event of significant profits being created in a public/public arrangement (where its tax transparency will be a benefit), an LLP is unlikely to yield significant advantages.<sup>4</sup>

<sup>4</sup> See Part 2 of Chapter 4 for more explanation on LLPs.

2.23 The option tables above refer to public and private sector auditing and accountability. The ODPM's Strategic Partnering Taskforce produced Frequently Asked Questions notes that provide a high level explanation of the differences between the two regimes. These notes can be found on the DCLG website.

### **Simultaneous Executive Meetings (SEM)**

2.24 One recent public/public arrangement has pioneered a new form of working. Each council retains its own identity and does not delegate power or authority. Nonetheless it facilitates joint working in a practical way.

2.25 What happens is the executive of each local authority meets in a single place and it is described as a SEM. In law separate meetings take place but with one debate and one agenda. In other words, to an outside observer one meeting is taking place but under local government administrative law, two meetings are taking place. There is a distinction made between the chairing of the debate and chairing of the separate meetings. The authorities have different constituents and make individual decisions on the basis of individual authority votes. The authorities retain their individual overview and scrutiny roles.

<b>Features</b>	<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• Executives of each local authority meet in a single place</li> <li>• In law separate meetings take place</li> <li>• There is a distinction between chairing of the debate and chairing of separate meetings</li> <li>• The local authorities have different constituents and make individual authority votes</li> <li>• The local authorities retain their individual overview and scrutiny roles</li> </ul>	<ul style="list-style-type: none"> <li>• Can be modified, expanded and created quickly</li> <li>• The SEM does not require a new organisation and existing rules of law, governance and behaviour apply</li> <li>• The decisions are taken at the highest level and strategic cohesion is supported</li> <li>• Encourages expansion of joint working beyond the original concept of the scheme</li> </ul>	<ul style="list-style-type: none"> <li>• Lacks permanence and is capable of being terminated rapidly</li> <li>• The SEM approach may not be suitable where the number of authorities working together is more than two or three</li> <li>• Requires members to travel to other authorities in order to take decisions</li> <li>• Does not facilitate joint working beyond local government e.g. NHS</li> </ul>

2.26 The SEM approach is seen as having the advantage over a Joint Committee since it ensures that the key policy makers are involved in decision making and does not require a delegation of powers from one or other authorities. Unlike a company type structure there is no need to become familiar with new responsibilities and behaviours.

2.27 However, there are significant practical limitations on SEM approach. Firstly in order to justify a SEM approach, the partnership needs to be of similar strategic importance for all participating authorities. This seems to suggest that it works best for authorities of similar standing i.e. district councils. Secondly, the size of the meetings, the differing locations and the number of separate decision-making processes may impose practical difficulties.

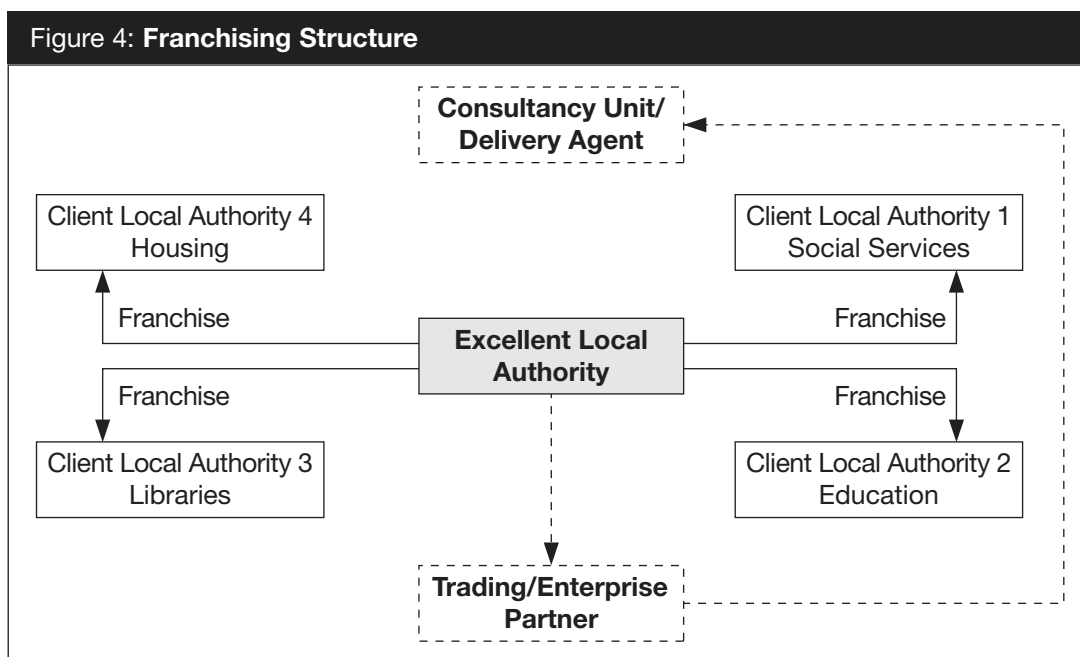


## **Franchising**

- 2.28 This is a contractual or administrative structure where:
- one local authority provides direct support to another (or others); or
  - one local authority provides methodologies to another (or others).
- 2.29 The term 'franchising' has been used to describe many different forms of business relationships, including licensing, distributor and agency arrangements. The more popular use of the term has arisen from the development of what is called 'business format franchising'.
- 2.30 Business format franchising is the granting of a licence by one person (the franchisor) to another (the franchisee), which entitles the franchisee to trade under the trade mark/trade name of the franchisor and to make use of an entire package, comprising all the elements necessary to establish a previously untrained person in the business and to run it with continual assistance on a predetermined basis.
- 2.31 The principle is simple – some companies choose to grow, not by developing in the conventional way, but by granting a licence to others to sell their product or service. There are clear advantages to this:
- you don't have to come up with a new idea – someone else has had it and tested it;
  - larger, well-established franchise operations will often have national advertising campaigns and a solid trading name;
  - good franchisors will offer comprehensive training programmes in sales and indeed all business skills;
  - good franchisors can also help secure funding for your investment as well as, e.g. discounted bulk-buy supplies for your outlets; and
  - if aware that you are running a franchise, customers will also understand that you will be offering a service that has been fashioned across a wide base.
- 2.32 Each business outlet is owned and operated by the franchisee. However, the franchisor retains control over the way in which products and services are marketed and sold, and controls the quality and standards of the business.
- 2.33 In local government, similar concepts can apply (although not necessarily always tied to intellectual property rights). Local authorities have aspects of their service package that are capable of being packaged into a 'franchise' operation that can then be sold to other public service bodies (for example the development of a maths teaching pack). They also have skilled officers that can be made available to other local authorities. The legal powers for this can be initially found in the 1970 Act. However, as franchising grows, it will cease to be collaboration and will become a trading activity and trading powers in Section 95 of the Local Government Act 2003 will become relevant.



- 2.34 The Government wants to develop a strong, vibrant, innovative and responsive local government community which will be mutually supportive. The aim of franchising is to achieve performance improvements in one (weaker) local authority using the experience and knowledge of managers and employees of another (excellent) local authority. In order to create the necessary capacity and consultancy services input, the excellent local authority may need to procure (in accordance with EU procurement rules) an appropriate consultant or create a consultancy unit or delivery agent itself.
- 2.35 In one example, the excellent local authority has created its own delivery agent with the aim of extending its ambit to the other excellent local authorities. In this particular example, it is the delivery agent which holds the 'intellectual property' of the excellent local authority(ies). Using business format franchising, the delivery agent has granted a licence to the excellent local authority (the franchisee) which entitles the franchisee to distribute the best practice products under the delivery agent's name. Local authorities who are under-performing can elect to work with a chosen high-performing local authority from the delivery agent. In this example, the delivery agent will take care of the administrative, financial, programme management, product development, training and national learning responsibilities. This is intended to release the provider and client local authorities to concentrate on delivery and increases efficiency every time the franchising arrangement is used.
- 2.36 Payment will be made by the local authority receiving the benefit by reference to the cost of services and the achievement of outcomes. Franchisors will need to consider the potential for the application of the EU procurement rules and, as explained later in this Chapter<sup>5</sup>, where the franchising operation involves trading (using powers under Section 95 of the Local Government Act 2003), then the operation will need to be undertaken through a company. **Figure 4** illustrates the structure.



<sup>5</sup> Paragraph 2.62 onwards.

The term 'franchise' has also been used in the NHS Sector where external managers were awarded a Contract to manage certain under performing NHS Trusts.

## REGULATORY ISSUES

### Powers

- 2.37 Local authorities will need to verify that the arrangements proposed by them fall within existing powers.
- 2.38 There are several helpful general powers, *Section 101 of the Local Government Act 1972* which enables local authorities to arrange for the discharge of their functions by other local authorities, *Section 111 of the Local Government Act 1972* which enables a local authority to do anything which is incidental, conducive to or facilitates any of its functions. The *Local Authorities (Goods and Services) Act 1970* has allowed local authorities to provide goods and services to other authorities to secure the benefit of economies of scale. The 1970 Act restricts the type of services provided and the bodies with whom an authority can trade. The trading powers contained in section 95 of *Local Government Act 2003* contain no such restrictions and a local authority using those powers can trade with whomever it wishes and at whatever scale of trade it determines.
- 2.39 Section 2 of the *Local Government Act 2000* allows local authorities to provide staff, goods, services and accommodation to any person in connection with their power to promote the economic, environmental and social well-being of their area. This power is constrained by a requirement within the 2000 Act which prevents authorities from exercising their 'well-being' powers in order to raise money, as raising money was not seen as a well-being purpose. Section 93 of the 2003 Act now provides that the supply of goods and services can be made at a charge where these are provided in connection with a well-being purpose but in this instance a charge is one that cannot exceed cost i.e. a contribution of cost incurred but not to generate a surplus.
- 2.40 There have been comparatively few legal arrangements whereby local authorities can trade in a classic sense i.e. act in a manner which is designed to generate income and profit. Statute has allowed a few exceptions, for instance, the disposal of surplus computer capacity. However, with the Trading Orders<sup>6</sup> giving effect to Section 95 of the Local Government Act 2003 the landscape has begun to change especially for better performing local authorities (i.e. those currently achieving a 'top 3' CPA rating) who can trade for profit as entrepreneurs, if they wish.
- 2.41 The published ODPM trading guidance lists the following statutory provisions as the principal sources of trading activities:

- *Civic Restaurants Act 1947*

<sup>6</sup> The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2004 (SI 2004/1705) applies to local authorities and two others. Orders (SI 2004/2307 and 2004/2573) apply to Fire Authorities.

- *Local Authority (Goods & Services) 1970*
- Section 145 of the *Local Government Act 1972* (Provision of entertainments)
- Section 19 of the *Local Government (Miscellaneous Provisions) Act 1976* (Recreational facilities)
- Section 38 of the *Local Government (Miscellaneous Provisions) Act 1976* (power to provide computers and computer facilities and making use of spare capacity)
- Orders made under section 150 of *the Local Government & Housing Act 1989* (i.e. HMOs Charges for Registration Schemes, Recovery of Costs for Public Path Orders, Charges for Land Searches and Charges for Overseas Assistance and Public Path Orders)
- Section 2 of the *Local Government Act 2000*, the well-being provisions

2.42 Section 95 of the *Local Government Act 2003* now allows goods and services to be made available for trading purposes, i.e. at a commercial rate. This is a stand alone power although it must be exercised in connection with its ordinary functions and through a company. An activity undertaken in connection with the exercise of the well-being function under Section 2 of the *Local Government Act 2000* would be regarded as something which authorities are ‘*authorised to do for the purpose of carrying on any of their ordinary functions*’ under Section 95 and therefore any restrictions in the well-being powers will not apply.

2.43 The ODPM guidance states that ‘*authorisation to trade conferred by the Order amounts to an entirely separate free-standing and specific primary power. There is therefore, no basis for regarding the restrictions on raising money as set out in section 3(2) of the 2000 Act as having any application to the exercise of the trading power. This is because the authority is not actually doing something for a commercial purpose under section 2(1) of that Act*’. Further guidance on the trading powers is referred to in Part 3 of Chapter 3.

2.44 Local authorities should also be conscious of any restrictions on the exercise of their powers such as ministerial consents and/or restrictions on trading by the local authority and of the differing executive arrangements established under the *Local Government Act 2000*. In addition the guidance referred to in Part 3 of Chapter 3 refers to issues which should be considered in exercising the trading power.

### **Partnership Arrangements with NHS Bodies**

2.45 Powers for other public bodies to enter into the arrangements (e.g. NHS bodies and companies) will need to be verified. NHS bodies generally have fewer freedoms than local authorities to create entities. At the moment NHS bodies have no powers available to them unless delegated by the Secretary of State for Health, as the power granted by sections 4 and 5 of the *Health and Social Care Act 2001* rests with the Secretary of State. Restrictions apply to the Secretary of State’s powers. It is envisaged that NHS bodies will be

able to take up the benefit of such powers, but this will be the subject of a business case submitted to the relevant strategic Health Authority by the body requesting the delegation.

- 2.46 The Secretary of State has exercised powers under section 4 in connection with Partnerships for Health and for the purpose of formation of LIFT companies.<sup>7</sup> The powers under section 4 have been fully delegated to Primary Care Trusts with approved business cases for the delivery of facilities and services relating to primary and social care (see the Strategic Health Authority and Primary Care Trust Functions Directions and Administration Arrangements 2002). Local authorities may participate in such companies if they choose. (Health bodies also have powers to participate in corporate structures for the purpose of income generation initiatives under the provisions of section 5 of the 2001 Act. These provisions will not be considered here.) By far the most common structures for partnering with NHS bodies relate not to the establishment of corporate vehicles but to arrangements that have been used to facilitate joint social services and health working contained in section 31 of the Health Act 1999 ('the 1999 Act'). These are examined in the following paragraphs.
- 2.47 These provisions contain specific powers to enable NHS Bodies and local authorities to enter into arrangements between themselves ('Partnership Arrangements') in relation to certain prescribed functions of NHS Bodies ('NHS functions') and prescribed health-related functions of local authorities ('health-related functions'). Such partnership arrangements may be entered into if they are likely to lead to an improvement in the way in which those functions are exercised.
- 2.48 For the purposes of enabling Partnership Arrangements, an 'NHS Body' includes a Health Authority, Primary Care Trust or NHS Trust and a local authority means a district council, county council, metropolitan council, unitary council or London Borough. Although most Partnership Arrangements will involve county councils, metropolitan councils, unitary councils or London Boroughs, district councils are not precluded from participating in such Partnership Arrangements for discharge of their functions, for example, in pursuit of their well-being objectives.
- 2.49 Although the primary enabling powers are contained in Section 31 of the 1999 Act, the detailed implementation is through regulations made pursuant to that section, namely the NHS Bodies and Local Authorities Partnership Arrangements Regulations 2000 (as amended by NHS Bodies and Local Authorities Partnership Arrangements (Amendment) (England) Regulations 2003) ('the 2000 Regulations'). The 2000 Regulations prescribe both the NHS functions and the health-related functions that may be the subject of Partnership Arrangements. The NHS functions are set out in **Figure 5** and the health-related functions in **Figure 6**. In addition, the regulations detail the matters which must be set out in a written agreement between the bodies concerned. See **Figure 7**.

<sup>7</sup> See further in Chapter 5.

**Figure 5: NHS Functions**

The function of providing or making arrangements for the provision of the following services:

- Hospital accommodation
- Other accommodation
- Medical, dental, nursing and ambulance services
- Facilities for the care of expectant and nursing mothers and young children
- Facilities for the prevention of illness, the care of persons suffering from illness, together with the appropriate after-care for such persons
- Diagnosis and treatment of illness
- Prevention activities intended to avoid patient admission to hospital
- Medical inspection at appropriate intervals of pupils in attendance at schools maintained by local education authorities and the treatment of such pupils
- Provision of advice on contraception, medical examination of persons seeking advice on contraception, the treatment of such persons and the supply of contraceptives
- Dental inspection of pupils in attendance at schools maintained by local education authorities, together with the provision of any dental treatment and education of such pupils in dental health
- The provision of medical or dental inspection or treatment or education in dental health of: Senior pupils attending an education establishment other than a school, which is maintained by the authority and at which full-time further education is provided; or any child or young person receiving primary or secondary education in a pupil referral unit, or through some other arrangement, due to the pupil's illness, exclusion or special educational needs
- Functions relating to the provision of after-care services for a patient, who has attained the age of 16 years, and is liable to be detained in a hospital due to a mental disorder and the belief that there would be a substantial risk of serious harm to the health or safety of the patient, of other persons, or of the patient being seriously exploited if he did not receive such after-care services
- The functions listed do not include: surgery, radiotherapy, termination of pregnancies, endoscopy, use of Class 4 laser treatments and other invasive treatments and emergency ambulance services

**Figure 6: Health-Related Functions**

Provisions of the following social services:

- Protection of young people in relation to criminal and summary proceedings, children appearing before court as in need of care, protection or control, committal of children to approved school or care of a fit person and the provision of remand homes, approved schools and appropriate care
- Provision of residential accommodation for the aged, infirm, needy and expectant mothers in need of care, welfare of persons who are deaf, blind, dumb or otherwise handicapped or are suffering from a mental disorder and the temporary protection of property belonging to persons in hospital or alternative accommodation
- Provision of facilities for enabling disabled persons to be employed or work under special conditions

**Figure 6: Health-Related Functions** *(continued)*

- Provision of welfare and accommodation for mentally disabled persons
- Research into matters relating to local authority welfare services and functions of local authorities
- Powers relating to young persons in need of care, protection or control and their protection in relating to criminal proceedings
- Provision of the welfare of old people
- Financial and other assistance to voluntary organisations
- Care of mothers and young children including protection, after-care, home help and laundry facilities
- Supervision of ward of court
- Obtaining information as to the need for and publishing information as to the existence of welfare services
- Applications by local authorities for revocation or enquiries in relation to custodianship orders
- Provision and maintenance of resettlement units for persons without a settled way of living
- Welfare of the mentally disabled, guardianship, exercise of functions of nearest relative in relation to applications to Mental Health Review Tribunals, together with the appointment of approved social workers
- Burial or cremations of persons dying in accommodation provided by local authorities
- Child welfare reports, family assistance orders, inspection of children's homes, research and functions in relation to children's accommodation
- Preparation of plans and assessment of needs for community care services
- Assisting local education authorities in providing educational services
- Assessment of carers and their needs, to provide care and provision of services and vouchers to carers
- Co-operation in respect of (inter-county) adoption
- The functions relating to disabled persons leaving special education, patients suffering from mental disorders or receiving treatment for mental disorders being discharged from hospital
- The duty of local authorities to take into account the abilities of carers (except in so far as any such functions are assigned to local education authorities)
- The functions of local education authorities under the Education Acts
- The provision of grants from local housing authorities towards the cost of works required for facilities for disabled persons in dwellings, houseboats and park homes and in common parts of buildings containing one or more flats
- The allocation of housing accommodation, the provision of free advice and information about homelessness, the prevention of homelessness and assistance to homeless persons through the provision of accommodation, furniture or other goods and the availability of staff support
- Power of the Secretary of State to give financial assistance for regeneration and development of an area, including contributing to economic development, preventing crime, improving housing, social or recreational facilities, providing employment, training, educational or health services and assisting local people with special needs



**Figure 6: Health-Related Functions** *(continued)*

- Regulatory functions of waste collection or waste disposal in connection with the improvement of the control of pollution
- The functions of providing environmental health services
- Representation and assessment of disabled person
- Provision of road safety information and training, and the maintenance and improvement of highways
- The provision of appropriate passenger transport, especially taking into account the transport needs of disabled or elderly members of the public and travel concession schemes for travel on public transport
- Where partners enter into Partnering Arrangements, the functions of charging for residential accommodation for the aged, infirm, needy and expectant mothers in need of care
- Where partners enter into Partnering Arrangements for the care of mothers and young children, the prevention of illness, the provision of care and after-care, home help and laundry facilities, the functions of charging for such services

- 2.50 The Partnership Arrangements must fulfill the objectives of the health improvement plan of the Strategic Health Authority in whose area the Partnership Arrangements will operate. Before entering into Partnership Arrangements, the partner NHS Body and local authority must consult jointly such persons as appear to them to be affected by the Partnership Arrangements.
- 2.51 One of the principal novel areas of Partnership Arrangements under the 1999 Act is that the partner NHS Body and local authority may establish and maintain a 'pooled fund'. This pooled fund is made up of contributions by the partners and from which either or both partners are entitled to defray expenditure in the exercise of any NHS function or health-related function (the pooled fund can only be operated in respect of these functions and not others).
- 2.52 There are detailed provisions in the 2000 Regulations dealing with the operation of any pooled fund. First, an NHS Trust may not enter into a pooled fund arrangement with a local authority partner unless it obtains the consent of each Primary Care Trust with which it has an NHS contract for the provision of services to persons who will be affected by the pooled fund arrangement. Secondly, where the partners decide to enter into a pooled fund arrangement, they must have an agreement in writing detailing the functions which are the subject of the pooled fund as set out in **Figure 6**. The agreement must contain certain prescribed information detailed in the regulations, set out in **Figure 7**.
- 2.53 The partners must agree which one of them will be the 'Host Partner' for the pooled fund. The Host Partner will be responsible for the accounts and audit of the pooled fund arrangement. The Host Partner must appoint a person as the 'Pool Manager'. The Pool Manager is responsible for firstly, managing the pooled fund on behalf of the partners and, secondly, for submitting to the

partners quarterly reports and an annual return relating to the income and expenditure in the pooled fund together with other information by which the partners can monitor the effectiveness of the pooled fund arrangement.

**Figure 7: Prescribed Contents of a Pooled Funds Agreement**

The agreed aims and outcome of the pooled fund arrangements:

- The contributions to be made to the pooled fund by each of the partners and how those contributions may be varied;
- Details of the NHS functions and local authority health-related functions which are the subject of the pooled fund arrangements;
- The types of persons and services in respect of which the NHS functions and health related functions will be exercised;
- The staff, goods, services or accommodation to be provided by the partners in connection with the arrangements;
- The duration of the arrangements and provisions for the review, variation or termination of the arrangements; and
- How the pooled fund is to be managed and monitored including the partner who is to be the 'Host Partner' for the pooled fund.

- 2.54 The Host Partner must arrange for the audit of the pooled fund accounts and for the Audit Commission to make arrangements to certify an annual return of those accounts. Finally, the partners may agree that an officer of either partner may exercise both the NHS functions and health-related functions that are the subject of the pooled fund arrangements.
- 2.55 The underlying legal basis for the partnering arrangements involves enabling an NHS Body to exercise local authority health-related functions and enabling a local authority to exercise NHS functions, in either case, in conjunction with, respectively, their NHS functions or health-related functions. This enables the NHS Body or the local authority to undertake the other's prescribed functions or for them to exercise such functions jointly.
- 2.56 Where NHS functions or health-related functions are exercised by the other party, there must be an agreement in writing between the parties. Whichever of the NHS body or the local authority is exercising the prescribed functions, they must report to the other, both quarterly and annually, on the exercise of the prescribed functions which are the subject of the Partnership Arrangements.
- 2.57 Any partner may agree to provide staff, services or accommodation to another partner in connection with the Partnership Arrangements. However, with fixed and current assets the partners need to decide which partner is to retain ownership and/or which partner is to obtain the benefits of the assets on dissolution of the arrangements. There are legal difficulties, in particular, with jointly owning land in that NHS bodies cannot jointly own property. The partners need also to be cognisant of any VAT consequences of providing services from one to the other.



- 2.58 The partners need also to be cognisant of any VAT consequences of providing services from one to the other. The position of employees may be particularly complex due to the different legislation affecting employees and terms and conditions of employees of NHS Bodies and local authorities. The partners will have to decide how they wish to treat employees. Various options are available; a transfer from one partner to the other under TUPE, the secondment from one partner to the other or one partner retaining the employees and acting as an agent for the other. A transfer, if under TUPE, can bring about issues associated with a 'two-tier' workforce since there will be two sets of employees under two sets of terms and conditions. Pension issues also arise as to whether one partner's employees may be able to join the pension scheme of the other or, if so, at what cost? (E.g. is the pension scheme fully funded?). There will also be VAT consequences for the party benefiting from the secondment.
- 2.59 The partners may form a joint committee to take responsibility for the management of the Partnership Arrangements that may include monitoring and receiving reports and information on the operation of the arrangement. If the relevant local authority partner is operating executive arrangements, then any joint committee may include any member whether or not he or she is a member of the executive of that local authority. Where the partners have formed a joint committee, they may agree that a sub-contractor or member of the joint committee may consider complaints about the Partnership Arrangements made by or on behalf of service users.
- 2.60 Where the partners do form a joint committee, the committee is only for the management of the Partnership Arrangements. As a consequence, the partners themselves retain legal responsibility for the provision of their respective services. There is also no specific power to delegate functions, (which remain with the NHS Body or the local authority exercising the relevant prescribed functions) as opposed to management decision-making.

### **EU Procurement Rules**

- 2.61 To what extent do the EU procurement rules apply to public public arrangements? The application of the EU procurement rules depends upon the extent to which the arrangements between the local authorities (and other public bodies) involve entering into public contracts for the provision of services, works or supplies above the threshold of the value of contracts for the application of the rules (although as will be explained below, local authorities still need to demonstrate transparency where the value of the contract is below the relevant threshold).
- 2.62 There is no specific exemption from the EU procurement rules where one public body (or contracting authority) contracts with another public body (or contracting authority) for services, works or supplies where there is a public contract. The EU procurement rules must be complied with in relation to the award of all public contracts above the relevant threshold. A public contract is a contract for pecuniary interest (consideration in English law) concluded in writing between one or more economic operators and one or more contracting authorities which has as its object the execution of works, supply

of products or provision of services.<sup>8</sup> Economic Operator is defined in the Consolidated Directive as a contractor, supplier and service provider. These latter terms are defined as national or legal persons and/or bodies which offers on the market, respectively, the execution of works and/or a work, products or services. The Public Works Contracts Regulations 2006 which implements the Consolidated Directive defines a public contract by reference to either of public services, public supply or public works contract. These in turn are defined by reference to contracts in writing for consideration under which a contracting authority engages a person to provide either services, goods or works. The 2006 Regulations refer to a persons whereas the Consolidated Directive an economic operator. However, throughout the 2006 Regulations (including in the definitions of the various procedures) there are references to economic operators. The latter are defined in a similar way to the Consolidated Directive.

- 2.63 Whether or not there is a contract has been interpreted widely by the ECJ.<sup>9</sup> The definition of a contract is likely to cover documents which ordinarily may fall short of being a contract, for example, a document which arranges for the provision of services but bears an unrelated name.
- 2.64 Where a public body (or contracting authority) performs an activity or task using its own resources without calling upon outside entities, there is no contract and the EU procurement rules need not be applied. However, it needs to be determined where one contracting authority ends and another begins. For example, it is assumed that a public public arrangement (e.g. a shared services arrangement) between central government departments (e.g. DCLG and DfES sharing an HR system) will not involve a public contract between these bodies (i.e. the respective Secretaries of State), as all are part of the Crown and are indivisible. On the other hand, where a regional or local body (e.g. a local authority) is involved, there will be a separate legal entity.
- 2.65 As indicated previously, there are an array of powers which enable local authorities to provide services to other local authorities (and indeed other public bodies), particularly the Local Authorities (Goods and Services) Act 1970 and the trading powers under Section 95 of the Local Government Act 2003. On occasions the powers under the 1970 Act have been exercised without recourse to the EU procurement rules. This is probably because the service provision has been undertaken without the local authority realising that a contract has been put in place or more likely, because the value of the services has been below the threshold for the application of the rules to the services. However, these powers are being increasingly used by local authorities in contracts with other local authorities for:
- shared services; and
  - service improvement (where a high performing local authority may provide services to improve a poor performing authority e.g. franchising (see above)).

<sup>8</sup> See Article 2 of the Consolidated Directive 2004/18/EC.

<sup>9</sup> See ECJ Teckal case (Case C – 107/98).

- 2.66 Where local authorities seek to engage in public public arrangements such as shared services activities, the activities they are undertaking need to be examined to determine whether the contract between them for shared services is a contract to which the EU procurement rules apply. That is, it has to be determined whether the arrangement amounts to a public contract and/or otherwise the arrangement is not one to which the EU procurement rules apply. The EU procurement rules should not apply where:
- there is an administrative arrangement between the local authorities;
  - the local authority (or local authorities) contract with an entity over which it exercises a control which is similar to that which it exercises over its (or their) own departments and the entity carries out the essential part of its activities with the controlling authority (or authorities);
  - the local authorities are involved in the alignment of processes rather than a contract for services; or
  - the local authorities establish a central purchasing body. Although the constant restrictive interpretation by the ECJ of the EU procurement rules should be borne in mind, there may be occasions where the local authority may not be construed as ‘offering on the market’ and thereby not an economic operator.
- 2.67 Where local authorities (or indeed other contracting authorities) collaborate in shared services arrangements and, where permitted to do so, delegate one or more of these functions to the other, then the EU procurement rules should not apply to such administrative arrangements. This is because firstly, the delegating local authority has divested itself of the decision making on that function to the other authority as opposed to that other authority providing services and/or, secondly, that the other authority is given an exclusive right to provide the services (as local authorities can only delegate by law to another local authority). The latter is a specific exemption to the application of the rules.<sup>10</sup> However, local authorities should not use this exemption for an improper purpose to circumvent EU procurement rules.
- 2.68 The EU procurement rules apply where a local authority concludes a public contract with an entity distinct from it. However, the position may be different where a local authority (or more than one local authority) forms an entity to contract to deliver services and the local authority (or authorities) exercises a control which is similar to that which it exercises over its (or their) own department(s) and the entity carries out the essential part of its activities with the controlling authority or authorities.<sup>11</sup> This exception is limited and effectively only applies to contracting with wholly owned entities and the introduction of a private sector third party to the entity is likely to nullify the exception as the local authority (or authorities will no longer control the entity in the same way as its (or their) department(s). In the Stadt Halle Case, where the local authority owned 75.1 percent of the capital in a

<sup>10</sup> See Article 18 of the Consolidated Directive 2004/18/EC and Regulation 6 (l) of the Public Contracts Regulations 2006.

<sup>11</sup> See ECJ cases of Teckal (Case C – 107/98) and Stadt Halle (Case C – 26/03).

company to whom it granted a waste contract, the ECJ determined that the local authority did not exercise sufficient control. Similarly in the Brixen case,<sup>12</sup> where the local authority had converted a special undertaking to a company, in doing so the company had become increasingly independent and market orientated making the local authorities control tenuous. Finally, as a more obvious example the EU procurement rules were deemed to apply to a contract between a public body and an entity which was wholly owned at the time of the contract but in which a 49% stake was subsequently sold (the stages in the transaction as a whole had to be looked at)<sup>13</sup>. Generally, subsequent case law has confirmed that the two tests in Teckal must be applied strictly and as this is derogations from EU principles the burden of proving the two conditions is on the local authority. The Brixen case confirms that the very nature of the company can militate over the first condition. This is likely to mean that a limited liability partnership or a general trading company is unlikely to be capable of being brought within Teckal.

- 2.69 Some shared services activities may involve two or more local authorities aligning their processes by pooling their resources, people, assets and equipment and, as a consequence, reducing the resources and necessarily the cost. This may involve, for example, employees from each local authority sitting side by side in a contact centre (working on both their and the other local authorities' activities/tasks). Access may be granted to each other's hardware and software (and any consents required for this being obtained). Essentially, the overall activities are the same, it is just that, overall, less people are doing them. In which case there will not be a procurement of services as such as any contract entered into would regulate how the authorities work together. Where any additional hardware, software or services are required, then the local authorities will procure such in accordance with the EU procurement rules.
- 2.70 Where a local authority provides services to another local authority (for example, as above to improve that other's services, for example in franchising), as opposed to sharing services, then again the position is dependent upon whether or not the local authority is providing the services under a public contract. Again the EU procurement rules should not apply where it is administrative rather than contractual arrangements, for example, they involve the delegation of functions (see paragraph 2.55 above) or where the arrangement falls short of service provision (e.g. where there is a mere secondment of employees).
- 2.71 However, It should always be borne in mind that as a consequence of recent case law<sup>14</sup> even where services are Part B services (or indeed where the value of the services is below the relevant threshold) or outside of the rules e.g. public services concessions then the local authority still needs to apply the EC Treaty principles of equal treatment and non-discrimination on the grounds of nationality. These principles imply, in particular, an obligation of transparency in order to enable the local authority to satisfy itself that the

12 Case C – 458/03.

13 Commission v Republic of Austria (Case C – 29/04) Judgement 10 November 2001.

14 See ECJ Case of Telaustria (Case C – 324/98).

principles have been complied with. This obligation of transparency consists of ensuring, for the benefit of any potential tenderer, a degree of advertising sufficient to enable the services market to be opened up to competition and the impartiality of procurement procedures to be reviewed (obviously in the case of contracts with a value below the threshold a degree of proportionality should be taken into account).

- 2.72 Where the shared services involve shared or joint procurement, then one or other of the local authorities could be established as a central purchasing body which could then procure on behalf of the named participants in the arrangement. This arrangement would be particularly useful where a joint procurement is proposed (for example five districts in a county jointly procure an ICT solution by one acting as a central purchasing body). However, care needs to be taken with the drafting of the OJEU advertisement to ensure that other local authorities are able to join in later.<sup>15</sup>
- 2.73 Private sector contractors with existing service contracts with local authorities have been exploring how they might extend their remit to provide the same or similar services to other local authorities. Other than service provision which is not material in the light of the subject matter of the existing contract (i.e. it is not a material variation) or (subject to complying with the EC Treaty principles of transparency and non discrimination) below the threshold value for service contractor, such service provision will need to be procured by the local authority benefiting from the services in accordance with the EU procurement rules.

### **Capital Expenditure**

- 2.74 The impact of any capital expenditure by one or other of the local authorities involved in the public/public arrangement will need to be considered by the authority incurring the expenditure in the light of that authority's prudential borrowing limit. Under Part 1 of the Local Government Act 2003 authorities have been given the ability to determine their own levels of capital investment based on whether their consequences can be afforded from future revenues. The position is the same where a company is established, in that authorities need to consider any financial assistance provided to the company, as opposed to the indebtedness of the company itself. However, it is possible that local authorities will need to guarantee the financial obligations of the company to any third party where the company does not possess significant assets. The potential for the use of the prudential framework to finance capital investment through borrowing is covered in more detail in Appendix 1.

## **COMMERCIAL AND LEGAL ISSUES**

- 2.75 The public authorities need to address the following strategic issues:
- the current service delivery arrangements within each of the authorities to ascertain the extent of alignment of service approaches and how greater alignment might be achieved including consideration of the use of assets;

<sup>15</sup> See Article 1 (10) Directive 2004/18/EC.

- the need for a robust business case for the project (*see Volume 2 Rethinking Service Delivery 'From Vision to Outline Business Case' produced by the Strategic Partnering Taskforce*);
- the organisational structure between them (whether a corporate entity e.g. a company or an unincorporated entity e.g. a joint committee or board (and whether statutory or not));
- whether to pool their individual budgets and functions (provided there is an express statutory power to do so) and the extent of pooling of other resources;
- the principal issues in the arrangements between themselves which need to be documented through a contract and/or through the constitution of the chosen corporate entity;
- whether they should seek to involve the private or voluntary sector and if so, how they will fit within the proposed structure.

2.76 Once the above strategic issues have been addressed, the public authorities will need to address the following more detailed commercial and legal issues covering the arrangements between themselves:

- the duration of the arrangements;
- the extent of the activities to be the subject of the arrangements;
- whether to establish a vehicle or single contractual entity (if so, whether a company limited by shares or guarantee, an industrial and provident society, community interest company or a limited liability partnership);
- the extent to which each public authority is to contribute financial and other resources (e.g. employees, property and equipment) and any valuation issues;
- any third-party funding requirement and if so, what will be the source of such funding and the impact of third-party funding on the structure (e.g. the need for the establishment of a separate entity);
- the funding of any increased costs, losses or shortfalls and the mechanism for managing this;
- any issues raised from each authority undertaking a detailed due diligence on their asset contributions including any encumbrances on ownership, consents needed (leases, software licences etc), fetter on intellectual property rights, prohibitions on the assignment of contractual rights and contracts with onerous terms;
- will the arrangements involve a TUPE transfer (more likely in the case where a separate entity is established), and have the authorities addressed the extent of the transferring employees (particularly in the light of any proposed management structure), adherence to the Workforce Code of



Guidance (ODPM circular 3/2003) and the Code of Practice (Cabinet Office 2005), any employees to be seconded rather than transferred and the consents to be obtained from such employees, the statutory consultation of all relevant employees, the admission of any separate entity to one or other of the public authority pension funds or whether equivalent pension arrangements be provided<sup>16</sup>;

- the levels of service to be provided and whether there will be any differences between the public authorities, how the levels of service will be determined and managed and the extent of any step change or continuous improvement;
- the arrangements for changes to the service by one or more of the authorities and how such will be funded;
- whether they will need to procure works or services and if so how will this be undertaken, for example, by one authority on behalf of the other(s) or the entity if one has been established. What procedures will be followed and how will these reconcile with each authority's financial regulations, how will the contractor be selected and the terms of engagement settled, and to what extent will one authority need to indemnify the other(s) against costs, expenses and liabilities;
- how will the arrangements be managed, by a joint committee (with delegation of functions) or partnership board or through a corporate entity. What will be the membership of the joint committee/joint board and/or corporate entity, what procedural requirements will be needed (meetings, quorum, voting rights etc);
- what rights will each authority have to appoint to the joint committee/board or corporate board of directors, how will the joint committee/board or corporate entity be accountable to each of the public authorities, how will decisions be made, by simple majority, or are there important issues requiring unanimity or special majorities;
- will any provision be made for withdrawal of one (or more authorities), could the arrangements continue without the withdrawing authority and the assets contributed by it, can the withdrawing authority's assets be identified (e.g. in a situation where they may have been pooled), are there any outstanding liabilities to be met by the withdrawing authority, which employees will transfer to the withdrawing authority;
- how will any deadlock between the public authorities be resolved, casting vote, reference to an independent party, withdrawal of one or other authority or a winding up of the arrangements;
- will any authority be able to terminate the arrangements before their expiry and, if so, on what grounds;

<sup>16</sup> For employee issues see ODPM's SPT publication Employment and Partnerships : Technical Note 2004 (Updated by DCLG 2006) available on the DCLG website.

- what arrangements will apply on termination for the distribution/retransfer of assets and employees, the discharge of outstanding contracts and the assumption or discharge of any other liabilities relating to the arrangements.

### **Documentation**

- 2.77 This option will involve an agreement between the public authorities regulating their relationship, agreeing service levels and establishing the organisational structure.
- 2.78 If the authorities establish a company, then additional documents will be necessary:
- Memorandum and Articles of Association (agreed by the authorities); and
  - Shareholders' Agreement.
- 2.79 If the private or voluntary sectors are involved, then additional documentation will be necessary:
- Operating Agreement (the authorities and/or company and the private or voluntary sector service provider) covering:
    - output specification;
    - payment mechanism;
    - transfer of assets;
    - treatment of employees.

### **Risk Transfer**

- 2.80 This option will result in risk being wholly retained by the public sector unless the public authorities involve the private or voluntary sector where the risk of attainment of service levels can be transferred through the payment and performance mechanism, although risk can be transferred to another authority under contractual terms.
- 2.81 If the private or voluntary sector is involved and if capital expenditure is to be incurred, then either:
- the capital expenditure is wholly incurred and the assets remain with the private or voluntary sector and do not revert to the public authorities; or
  - the capital expenditure is incurred by the private or voluntary sector and if the assets are to revert to the public authorities, there is sufficient risk transfer to achieve 'off balance sheet' treatment.

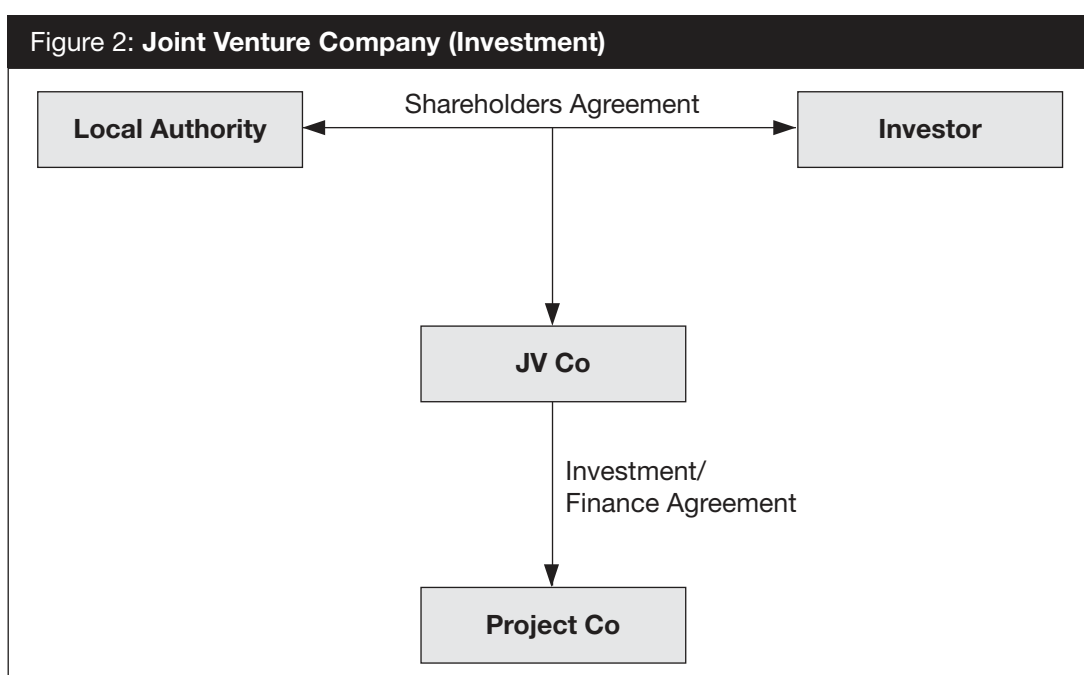
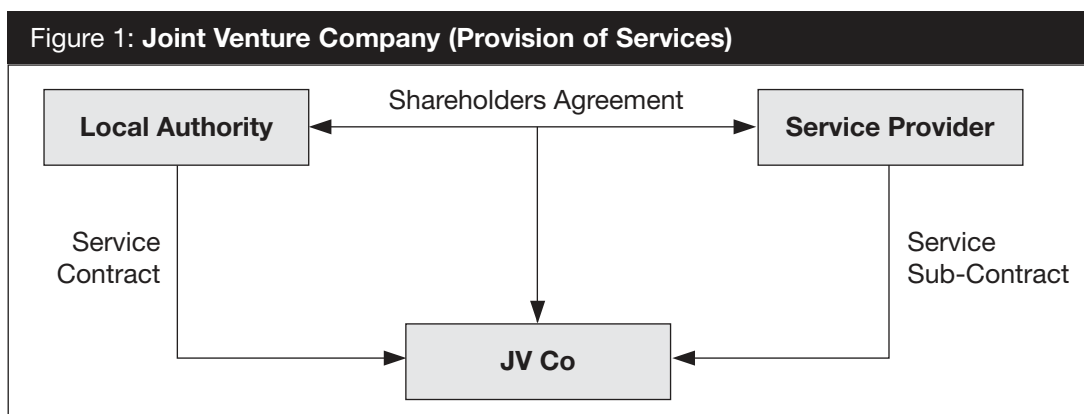


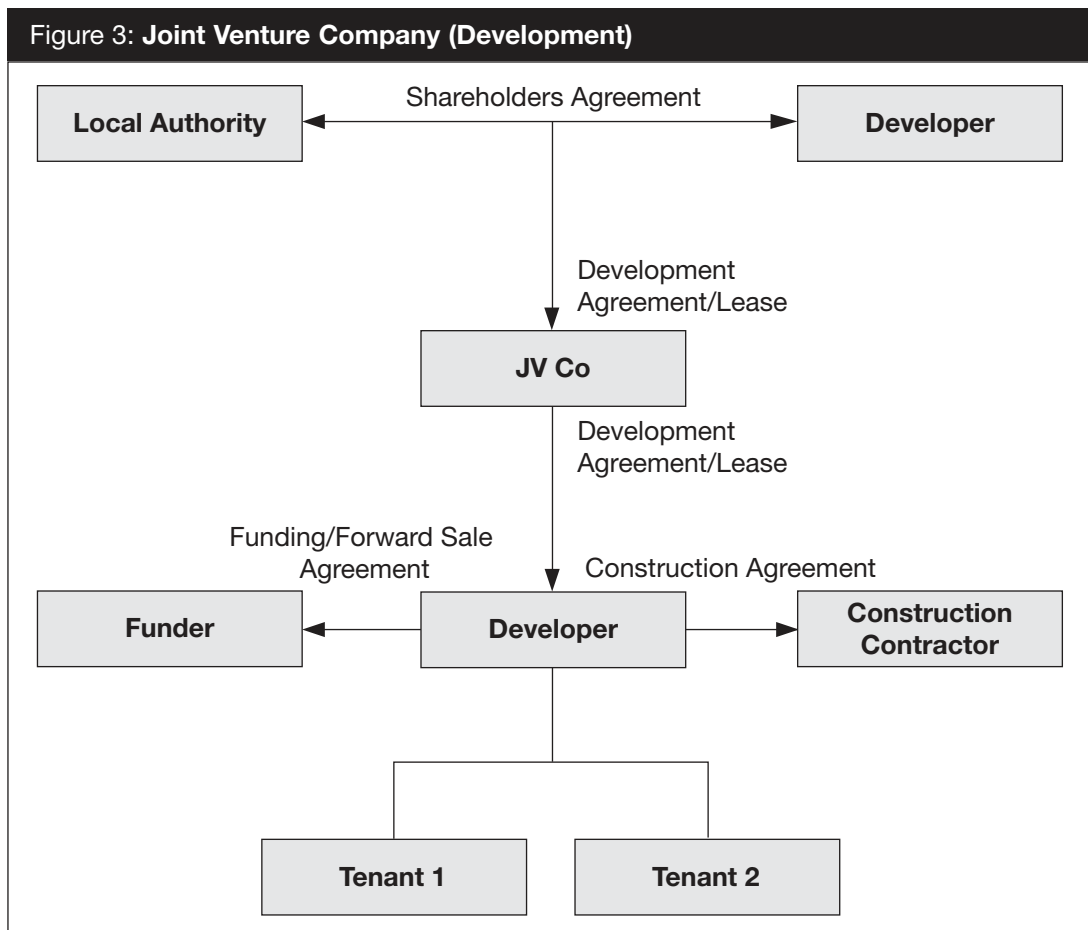
# CHAPTER 3

## Joint Venture/Companies and Trading

### Part 1 – Joint ventures with the private/voluntary sectors

#### JOINT VENTURE COMPANY





## OVERVIEW

- 3.1 Joint ventures are increasingly becoming a common feature of modern day business practice, by enabling parties to work together, utilising the collective pool of assets (whether tangible or intangible), in the pursuit of complementary objectives and the delivery of a successful business venture. The key feature is the model's ability to optimise the operation's potential by introducing resources, which would not otherwise be available to the individual (e.g. start up or expansion capital).
- 3.2 This option involves a local authority entering into a joint venture with a private or voluntary sector partner to facilitate the provision or delivery of services, investment or development. **Figures 1, 2** and **3** above illustrate three potential models for each. **Figure 1** is quite a frequently used model and illustrates a local authority and service provider forming a joint venture company to deliver services. The local authority will have a minority interest in the joint venture company and a contract with the joint venture company to provide the services. Staff and other assets will be included within the joint venture company or there will be a pass through to the service provider by way of a sub-contract. Alternatively, the service provider may enter into a management contract with JV Co to enable delivery of the services to the local authority. **Figure 2** illustrates a local authority and investor forming a company to invest in future projects. This is a model which has been used in strategic partnerships for capital outsourcing (see Part 3 of Chapter 5). **Figure 3** illustrates a model which is often used in property development.

The local authority and developer form a joint venture company to undertake a development. The local authority may contribute land to the joint venture. The joint venture company procures the development and the local authority extracts its share of the profit and has a say in the development through the joint venture company. This option will not include joint ventures between local authorities and/or other public sector bodies as these are covered in Chapter 1.

- 3.3 A 'joint venture' describes a range of different commercial arrangements between two or more separate entities. However, in this part of Chapter 3 consideration will be confined to a joint venture company with partnerships and limited liability partnerships being considered in Part 2 and 3 of Chapter 4.
- 3.4 A joint venture under these considerations will generally mean a company controlled by the private sector or where there is no control by either party. A joint venture may have one or more participants from the public and/or private sector.
- 3.5 Part 1 of this chapter focuses on the situation when the parties to the joint venture create a new, separate legal entity in which each has an interest (JV Co). JV Co may be a company limited by shares or by guarantee, or an industrial and provident society. The more complex the economic relationships and financial arrangements between the joint venture partners are, the more likely it is that a company limited by shares will be the more suitable form. If JV Co is not primarily set up with a view to trading or distributing profits to the joint venture partners, use of forms such as the company limited by guarantee, the industrial and provident society or the community interest company (CIC), which may be either limited by shares or by guarantee, is more likely to be appropriate: see Part 2 of this chapter. Part 3 of this chapter looks at some of the different kinds of trading in which local authorities can be involved and the legal framework for local authority commercial activity.
- 3.6 If a joint venture is intended to be profit-making for its participants or, if significant private-sector funding is involved, then a company limited by shares is likely to be more attractive, partly because it can pay dividends to its members and, most importantly in practice, because its structure and operation is most readily understood by potential private-sector participants. The company limited by shares is a much simpler structure to enable a change in participants, since a withdrawing or retiring participant(s) simply transfers its shares to the remaining participant(s) or new participant(s) (although the complexity at arriving at a purchase price for the transferring shares should not be underestimated).
- 3.7 Of course, any particular project may at various stages involve a combination of structures particularly, for example, where the strategic partnering structure may involve a strategic 'board' overseeing the carrying out of work and/or services with the underlying joint venture for profit being undertaken at a tier below, for example, Urban Regeneration Companies.
- 3.8 The shares of JV Co will be owned by the local authority and the private sector partner when it is established. These parties will become the JV Co shareholders. The shares may be held in any proportion but are generally

held in proportion to each shareholder's investment, although a shareholder can have preferential rights attached to its share.

- 3.9 JV Co will have a board of directors, usually consisting of representatives of the shareholders (or appointed by them) roughly in proportion to the size of the shareholding, who will have legal responsibility for managing JV Co. The board and/or the executive management will take most of the decisions with regard to the management and operation of JV Co, although some matters will be reserved to the shareholders by statute or identified in JV Co's constitution as being reserved for decision of the shareholders.
- 3.10 Where each party to the joint venture is providing some asset(s) or skills to the joint venture (which is invariably the case), then each party will enter into an agreement with JV Co (and probably also the other shareholders) in relation to the provision of those assets and skills and the rights, obligations and liabilities of each party in respect of them.
- 3.11 Where JV Co is providing services to a local authority, then there will be a services contract between the local authority and JV Co setting out the terms upon which the services are provided and a payment and performance mechanism relating payment to the standard of the services to be provided. Before entering into any such contract, however, local authorities will need to ensure that the EU procurement rules are complied with.
- 3.12 The joint venture company is a sufficiently flexible vehicle to be used by local authorities for any joint venture with the private sector and is suitable for the investment in assets, the development of land and/or buildings and/or the provision and delivery of services.
- 3.13 However, local authorities should not assume that every joint venture should be constituted as a joint venture company. A joint venture company is not necessarily the right vehicle for every joint venture and some arrangements may lend themselves better to a simple contract. Drivers, advantages and disadvantages of joint venture companies are set out below.

#### **Drivers**

Key features of a joint venture company from a local authority point of view include the following:

- It will have its own legal capacity, separate from its founder shareholders. Consequently, JV Co can own and deal in assets, employ people, enter into contracts in its own right, and will be subject to private sector accounting and tax considerations.
- It has a permanence and indefinite life. Unlike some other options a JV Co life will continue beyond a contract period and this provides the basis for a long-term relationship.
- It can create wealth based on the performance of its operations. The value of a JV Co will reflect its business success and potentially its value can be realised through disposal of shares.
- The joint venture company can be linked to a service contract, investment agreement or development agreement.

These benefits need to be considered along with the advantages and the disadvantages listed below.

### **Advantages**

The principal advantages of a joint venture company include:

- Using a company structure can improve access to the skills and other resources of the private sector partner(s), such as commercial acumen, finance and technology.
- The company structure provides a mechanism for capturing longer-term value, as the local authority will hold an equity stake in the company.
- Joint venture companies provide flexibility in respect of both management and returns.
- Employees can be given a greater incentive to succeed, through the prospects of higher salaries and rewards such as bonuses or share options.
- A skilled independent management team can be put in place in the new company.
- A company structure encourages greater focus on the business plan and achieving goals.
- A joint venture company can allow better management of risks and can be used to limit liabilities to the local authority.
- Where necessary, it is still possible for local authority policy objectives to be preserved by securing the desired level of control in the decision-making of JV Co as a shareholder or on the board, or by including provisions in the legal documents.
- JV Co may raise finance off balance sheet of the local authority.

### **Disadvantages**

The principal disadvantages of a joint venture company include:

- The risk of directors' liabilities arising from directors' fiduciary duties generally and those which may arise from insolvency legislation (although this has been alleviated somewhat by the Local Authorities (Indemnities for Members and Officers) Order 2004 (SI 2004 No. 3082)) which enables the indemnification of members and officers appointed to companies and other corporate bodies.
- Potentially, a loss of public accountability and audit requirements.
- The risk generally of the insolvency of JV Co, loss of equity stake, potential personal liability of directors and discontinuity of service.
- The time and costs involved in establishing and operating the company, particularly requirements in relation to the preparation of accounts.
- JV Co may not necessarily be attractive to the private sector due to a perceived lack of control over its 'own destiny' and the fragmentation of corporate structures if the private sector company enters into multiple JV Cos.
- The difficulties in matching public and private sector cultures in one vehicle.
- 'Conflicts of Interest' which will inevitably arise between the duties owed by members and/or officers to the local authority and to JV Co. Potentially similar issues for private sector board members/directors.
- Depending upon the level of local authority interest in the company, the local authority may need to prepare group accounts (see current CIPFA Statement of Recommended Practice).
- HM Treasury's reserve power to control local authority borrowing may extend to companies controlled or dominantly influenced by the local authority (see paragraph 3.46 below).

- 3.14 Reference may be made to *A Guidance Note for Public Sector Bodies forming Joint Venture Companies with the Private Sector* (December 2001, HM Treasury). Guidance prepared by Partnerships UK (*Treasury Guidance on Joint Venture Companies*) covers more detailed considerations.

## DESCRIPTION

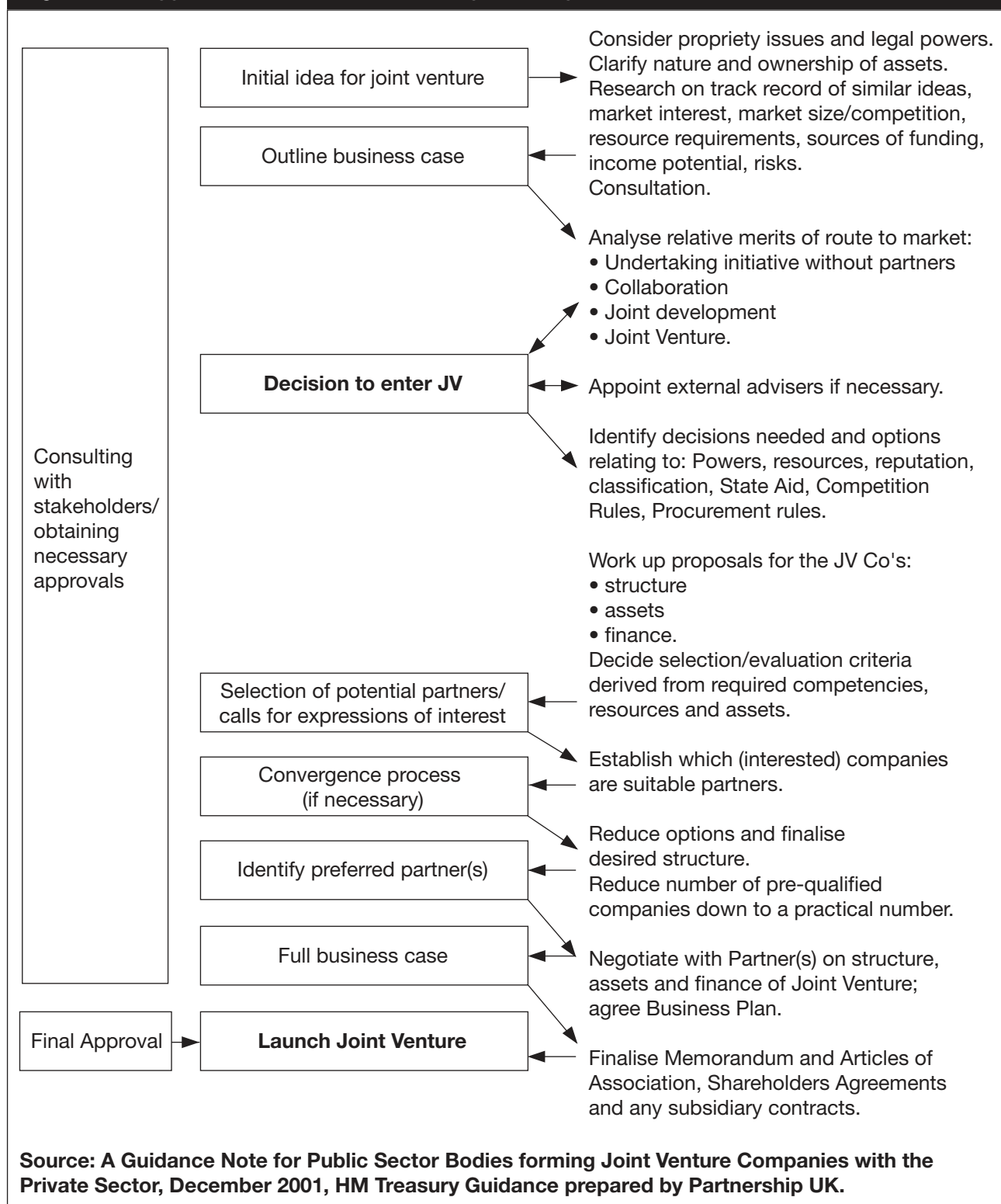
- 3.15 Certain factors may tend to shape and influence the use of a JV Co by a local authority:
- Nature of the Joint Venture : the extent to which the joint venture with the private sector partner is indeed a joint venture with both the local authority and private sector partner contributing to the venture in cash or kind (i.e. it is not merely a contract for services). Is the nature of the joint venture best served by a corporate entity and is a corporate entity the best way of management?
  - Financing: is the joint venture to be financed mainly by external bank borrowings or by the participants themselves and what security will be available in the joint venture to support that finance? (The joint venture company can grant security itself without the shareholders being liable, at least on the premise that no shareholder guarantees are sought).
  - Returns and tax treatment: the manner in which a local authority's returns are to be extracted from the joint venture may be a crucial factor in determining the appropriate structure for a joint venture. Tax considerations are also likely to be of considerable importance, particularly to private-sector participants (a JV Co may enable borrowing to be undertaken off balance sheet of the local authority).
  - Limitation of liability: what limitations are to be placed on the liability of participants for the debts and obligations of the joint venture? (JV Co will enable liabilities of the shareholders to be 'ring fenced' in the company, to the extent that no guarantees are procured from the shareholders in relation to JV Co liabilities.)
- 3.16 The local authority will form the JV Co with its chosen private sector partner. Each will subscribe for shares in JV Co, the amount usually being determined by reference to their respective levels of investment (whether in cash or kind, e.g. land or other assets). The number of shares will in turn usually determine the number of directors each shareholder may appoint to the board of directors. Although the larger shareholder will have the majority of votes at meetings of shareholders and directors, a shareholder with a minority interest can invoke various statutory and constitutional protections.

- 3.17 The business case and the protection of investment should determine participation in the company rather than artificial limits. Although the propriety rules still apply to companies which are regulated companies as a consequence of the local authorities level of participation there is at worst now a limited or no impact upon the local authority of the borrowing and capital expenditure activities of the company<sup>17</sup>.
- 3.18 The parties to the joint venture will agree its objectives that in turn will govern and/or limit the activities of the JV Co. The JV Co may:
- in itself be the end vehicle for discharging the object of the joint venture i.e. where JV Co acquires all the necessary assets (including employees) to be able to undertake itself the activities required to discharge the objects and taking the service delivery or works risk; or
  - be an intermediary investment or procurement vehicle which procures the activities necessary to discharge the objects of the joint venture from a sub-contractor. This may include a full procurement from a sub-contractor (possibly involving a transfer of local authority employees to the sub-contractor) or a more limited support or consultancy contract (where the employees may remain with JV Co); or
  - play a more 'strategic role' supervising a private sector partner providing services under a contract with the local authority.
- 3.19 Local authorities need to determine the nature and extent of its interest in JV Co and hence the level and type of controls they will need over JV Co's activities. Current and future public service requirements from any assets that will be contributed to JV Co by the local authority must be clearly defined, and mechanisms put in place to ensure that those public service requirements are met. At the same time, steps must be taken to ensure that any such controls will not unnecessarily hamper JV Co in fulfilling its objectives or undermine its commercial viability.

<sup>17</sup> See paragraph 3.37 onwards for further explanation.



Figure 4: A suggested process for establishing a trading joint venture company



- 3.20 The local authority percentage shareholding in JV Co, and particularly the fact of whether the local authority is a majority or minority shareholder will govern control. However, controls can also be put in place through the governing legal documents, typically the Shareholders' Agreement. Consideration needs to be given to the following issues:

- Public or private sector classification: Although, as mentioned above, classification of the company as public or private sector controlled is no longer an important issue for the local authority for reasons of capital expenditure and borrowing, it still may be an issue for HM Treasury where the size of borrowing is extensive. However, local authorities will still need to have regard to any financial obligations to JV Co under the Prudential Code and HM Treasury do have a reserve power to impose controls over borrowing (see paragraph 3.37). Control will be crucial in determining whether JV Co is 'classified' to the public or private sector for local authority accounting purposes. This is a key issue and the decision on whether the local authority will be a minority, majority or equal shareholder should be taken after careful consideration of all the pros and cons. In most cases, JV Co's founders will want it to be classified to the private sector because of the greater commercial freedom this brings. The local authority should, however, be wary of yielding control of JV Co in return for investment alone, and options such as a 50:50 (deadlock) joint venture and/or certain 'class rights' attaching to the local authority's shares may be appropriate in some circumstances.
- Value assets: Shares in JV Co are given in return for the assets and resources each partner contributes. Financial investment in JV Co will normally be provided by the private sector. The local authority needs to ensure that its equity properly reflects the value of the assets (e.g. property, equipment, skills/expertise, etc) which it contributes.
- Protection of investment: The local authority needs to consider how it will realise returns on its investment in JV Co, how this investment can be protected if JV Co is unsuccessful and under what conditions it or the private sector partner can exit JV Co and/or JV Co be wound up.
- Future developments and fund raising: Consideration will need to be given to how the local authority interest might change as JV Co develops.
- Reputation and public policy concerns: Controls may be needed to protect the local authority reputation and ensure that JV Co does not act counter to public policy concerns.

An overview of typical key steps and actions for the local authority to take in order to set up JV Co are shown in **Figure 4**.

- 3.21 Local authorities will need to assess the risks they are taking, and establishing responsibilities for those managing those risks. The aim is to manage the risks in a manner that is consistent with the achievement of continuous improvement and the authority's community strategy. This will involve obtaining timely information, making contingency plans, and being alert for opportunities, because there are upside risks as well as downside risks. Authorities may wish to refer to *Risk Management – Technical Notes* (ODPM 2004) which addresses risk management in partnering arrangements. It is also important that the staff of the local authority engaged in negotiating the joint venture have the necessary skills, or access to those skills through advisers, and have clear responsibilities.

- 3.22 Once the local authority policy and commercial drivers warrant forming a joint venture company, the decision to proceed with JV Co will depend on a number of issues including statutory powers, reputation, public expenditure and accountability, state aid, competition law and classification. The local authority should also produce a robust business case (*see Volume 2 Rethinking Service Delivery 'From Vision to Outline Business Case' published by the Strategic Partnering Taskforce*). Consideration also needs to be given to how a private sector partner or partners will be selected. Determining the skills, competencies and other attributes needed from the private sector to deliver a particular project is clearly an essential prerequisite to this process.
- 3.23 Before engaging with prospective private sector partners, the local authority will also need to consider options, and its requirements and negotiating flexibility, in terms of: JV Co's structure (shareholding, membership of the board, governing legal documents, termination and exit strategy etc); its assets (valuation of assets and staffing contributions) and finance (funding, and division of profits and dividends). Subsequent discussions and negotiations with prospective private sector partners are likely to focus on these sets of issues.

## **REGULATORY ISSUES, RISKS AND CONSIDERATIONS**

### **Reputation**

- 3.24 In order to protect the reputation of the local authority, its sponsors and stakeholders, the local authority should consider as early as possible issues where there may be potential for JV Co, in fulfilling its objectives, to make decisions or act in a manner contrary to the public interest. In general, selecting a reputable partner will help the local authority maintain its own reputation.
- 3.25 The local authority will also need to consider any potential conflicts of interest if JV Co will be competing against other companies to provide goods or services to the local authority.
- 3.26 Protection may be needed if JV Co's name is closely linked to that of the local authority. In such cases, the local authority will need to ensure that it can insist on a change in the name of JV Co if it ceases to have a significant interest in the company.
- 3.27 Reputation issues could also arise if JV Co is seen to be paying excessive salaries. Depending on the relevant issue, protection could be sought as follows:
- an express provision in the Shareholders' Agreement imposing a contractual obligation on JV Co and/or the private sector partner;
  - a provision in the Memorandum and Articles (e.g. the objects clause which sets out the nature of the business);
  - reservation of the matter to be decided by the shareholders, and an express right of veto attached to the class of shares held by the local authority (whatever the % shareholding of the local authority); or
  - adoption by JV Co of a specific 'corporate policy'.

- 3.28 The local authority should ensure that the controls it puts in place do not undermine the JV Co's ability to be effective in delivering the objectives for which it is being established.
- 3.29 If JV Co is set up to fulfill a specific contract role and the contract is terminated, the viability of that JV Co will be jeopardised. In the risk assessment carried out as part of the business case such scenarios need to be contemplated and appropriate exit strategies developed.

### **Grant support**

- 3.30 Projects often receive grant aid from central government or the EU. Typically such support will be payable to the local authority making the application and not the JV Co. The payment arrangements between local authorities and the JV Co may reflect the terms of the grant and incorporate milestone events.
- 3.31 In some instances local authorities might make grant or subsidy payments to a JV Co. The terms of such grants or subsidy payments need to be set out in an agreement between the bodies concerned. Grants and subsidy payments are likely to be payable only in limited circumstances where, for example, the JV Co is providing a service such as leisure provision/ social services and the powers for making grants have been identified. In making any grants or subsidy payments care will need to be taken to comply with the EU State Aid rules.<sup>18</sup>

### **Regulatory issues**

#### *Powers*

- 3.32 The local authority planning the formation of a joint venture should first consider whether it has the necessary powers including that:
- it has legal powers to set up the company.
  - it is not using its powers for an improper purpose or unlawfully delegating its powers.
  - it has the power necessary to cover the business activities of JV Co.
  - any expenditure and other expenses in relation to JV Co have been properly authorised in accordance with legislation and the local authority's own internal rules and regulations.
  - it is acting in a way that is compatible with the Human Rights legislation (where a provider that is not a public authority provides a service to the public under contract to a public authority, that service needs to be provided in a way that takes account of the content of the Human Rights Act 1998 relevant to that contract).<sup>19</sup>
- 3.33 There are limited specific express powers for local authorities to subscribe for share or loan capital in a JV Co. Local authorities are more likely to rely upon the general power found in Section 2 of the Local Government Act

<sup>18</sup> See paragraph 3.40 onwards.

<sup>19</sup> Guidance has been produced on this subject by the Department of Constitutional Affairs and can be found at [www.dca.gov.uk/hract/contrguide.pdf](http://www.dca.gov.uk/hract/contrguide.pdf)

2000 (assuming one or other of Section 2 (1) objects are present). The fact that the local authority has no strategy under Section 4 of the 2000 Act does not in DCLG's view preclude the exercise of the power under Section 2. If, as a matter of fact, the subscription for share or loan capital constitutes financial assistance then the subscription for share or loan capital will fall within Section 2(4)(b) of the 2000 Act (it is also likely that such would also fall within Section 2(4)(a)). The payment of dividends on shares would only fall within the restriction under Section 3 if the exercise constituted a disguised form of raising money, which is unlikely.

- 3.34 Whilst Section 2 of the Local Government Act 2000 is likely to apply in the majority of circumstances, there may be circumstances where it does not apply (i.e. where the local authority cannot demonstrate well-being). Depending upon the individual circumstances, local authorities may be able to rely on the incidental power in Section 111 Local Government Act 1972 in conjunction with their substantive power. The power to trade contained in Section 95 of the Local Government Act 2003 is a stand alone power (although must be undertaken in connection with the local authorities ordinary functions) and requires all such trading to be undertaken through a company. It is therefore implicit in the drafting of this section that there is a power to set up the company for such purposes.
- 3.35 A local authority charged or empowered to perform a particular task may make use of a company to carry out that task or some aspect of it, provided it does not delegate to the JV Co its discretionary decision-making functions (without the necessary Order under the Deregulation Contracting Out Act 1994).

### **Capital Expenditure**

- 3.36 Until 2004 it was always contemplated that capital funding for JV Co would be through finance raised by JV Co or the private sector partner. This was due to the constraints over borrowing placed on local authorities. However, the prudential framework for capital investment has opened up increased opportunities for local authorities through being able to access significantly cheaper funding, provided such is affordable and prudent. Appendix 1 contains more detail on the prudential framework.

### **Classification**

- 3.37 As mentioned previously, the classification of a company as public or private sector plays only a limited, if any, role in borrowing and capital expenditure terms for a local authority. If, however, significant borrowing is concerned then there may be considerations for HM Treasury. HM Treasury have a reserve power in Part I of the Local Government Act 2003 to impose borrowing limits on local authorities. This is likely to extend to companies and other entities which are controlled or dominantly influenced by local authorities. However, classification of a company still has a role in determining whether the local authority should adhere to certain propriety rules relating to that company. These are identified in **Figure 5** below. The extent to which these propriety rules apply will in turn depend upon whether the company is a regulated company. Whether a company is a regulated company is determined by whether it is local authority 'controlled' or 'public sector influenced', as governed by Part 5 of the *Local Government and Housing Act 1989* and the *Local Authority (Companies) Order 1995*.

3.38 The relevant definitions are:

- a ‘controlled’ company is a company which is effectively a subsidiary of the local authority (where the local authority controls meetings of the company and/or the board of directors); and
- a ‘public sector influenced’ company is a company in which the local authority or personnel associated with the local authority have 20% or more of total voting rights, there exists a ‘business relationship’ between the local authority and the company and the local authority exerts, or has the right to exert, a dominant influence (in accounting terms) over the activities of the company;

3.39 See **Figure 5** for a table illustrating the meaning of the different categories of company.

**Figure 5: Part 5 Local Government and Housing Act 1989**

**Table 1: Organisations Covered by Part V**

<b>Organisations covered by Part V (S.67)</b>	<b>Organisations not covered by Part V</b>
Companies limited by shares	Charitable trusts (unincorporated)
Companies limited by guarantee with and without share capital	Non-charitable trusts (subject to powers to introduce controls)
Industrial and provident societies	Exempt and excluded companies
Unlimited companies	Joint Committees and Joint Boards
	Limited and unlimited partnerships (as per 1890, 1907 and 2000 Partnerships legislation)

**Table 2: Categories of Company**

<b>Category</b>	<b>Definition/description</b>
Controlled S.68 Each of the following will fulfil the controlled company definition: <ul style="list-style-type: none"> <li>• 100% owned LA companies;</li> <li>• 100% public sector companies (e.g. LA);</li> <li>• 51% LA voting rights (or powers to control votes or Board composition) plus other partners.</li> </ul>	<p>To be a controlled company, one or more of the following criteria must be satisfied – the company is:</p> <ul style="list-style-type: none"> <li>• A subsidiary of the LA (as defined in Companies Act S.736);</li> <li>• Not a ‘subsidiary’ but LA has power to control majority of votes at General Meetings;</li> <li>• Not a ‘subsidiary’ but LA has powers to appoint/remove a majority of directors;</li> <li>• The company is under the control of another LA controlled company.</li> </ul> <p>There are anti-avoidance provisions in S68 (3) and (5) re powers to control voting rights e.g. extends to nominees and those acting under instructions or by contract to vote in a particular way.</p>



Table 2: **Categories of Company** (continued)

Category	Definition/description
Arm's length controlled companies e.g. LAWDCs S.68	Must fall within 'controlled' definition but in addition the LA must fulfill following criteria: <ul style="list-style-type: none"> <li>• Pass arm's length resolution;</li> <li>• Meet the criteria set out in S 68 (6) (a-h) at all times from passing of resolution to the end of the financial year in question e.g. fixed-term appointments for directors, no removal of directors by Companies Act resolution, no occupation of LA land at less than best consideration, not more than one fifth of directors are members or officers of the LA etc.</li> </ul>
Local Authority Influenced Companies S.69	LA must fulfill two tests: <ul style="list-style-type: none"> <li>• <b>'Personnel association'</b> = 20% or more of total voting rights of members or directors held by existing LA councillors, officers or ex-councillors (ex = up to 4 years);</li> <li>• <b>'business relationship'</b> = Payments, grants, income from assets, turnover etc derived from LA and which exceed 50% of company's turnover or land occupied at less than best consideration by company.</li> </ul>
Joint control or influence S.73	If two or more LAs participate in a company the actions and interests of all LAs involved are taken into account for purposes of above tests – Reg. 18 LACO – where several LAs participate in a regulated company they must agree extent of each authority's involvement.
Minority interest (authorised) companies S 71 and Reg. 11 LACO	Everything else i.e. where LA has an interest which does not comprise control or influence under the 1989 Act e.g. <ul style="list-style-type: none"> <li>• LA 'associated persons' hold less than 20% voting rights at company or board meetings;</li> <li>• LA 'associated persons' hold 50% or less voting rights but no 'business relationship' exists;</li> <li>• Companies which are 'influenced' but are 'effectively controlled' by the private sector (see below);</li> <li>• Companies excluded or exempt by direction.</li> </ul>



Table 2: **Categories of Company** (continued)

<b>Category</b>	<b>Definition/description</b>
Excluded and exempt companies	<ul style="list-style-type: none"> <li>Banking and insurance companies excluded from influence category by 1989 Act;</li> <li>Transport (bus) companies and airport companies excluded by schedule to LACO;</li> <li>Other companies exempted by specific direction of the Secretary of State e.g. registered social landlords.</li> </ul>
Regulated and non-regulated (or public sector and private sector influenced) companies LACO	<ul style="list-style-type: none"> <li>Regulated (public sector influenced) companies – ‘effectively controlled’ by local authority;</li> <li>Non-regulated (private sector influenced) companies ‘effectively controlled by private sector (or non-local government body e.g. voluntary sector).</li> </ul> <p>Of the above:</p> <ul style="list-style-type: none"> <li>Controlled companies are regulated companies;</li> <li>Industrial and provident societies which fulfill S69 definition for influence are regulated companies;</li> <li>Any other companies fulfilling S.69 definition of influenced must be analysed to determine, according to tests borrowed from private sector group accounting principles, whether those companies are ‘effectively controlled’ by way of a ‘dominant influence’ being exerted by the LA or by applying a hypothetical test (borrowed from Companies Acts) to determine whether, if the authority were a company, it would be required to prepare group accounts.</li> </ul>

Table 3: **Consequences of falling within categories**

<b>Category</b>	<b>Controls</b>
Regulated Companies (i.e. controlled, arm’s length and public sector influenced companies)	<ul style="list-style-type: none"> <li>Propriety controls (see below)</li> </ul>
Non-regulated (private sector influenced and minority interest) companies	<ul style="list-style-type: none"> <li>Reduced Propriety controls (see below)</li> </ul>

**Table 4: Propriety Controls – Summary**

<b>Provisions and article number</b>	<b>Controlled companies</b>	<b>Arm's length companies</b>	<b>Regulated influenced companies</b>
Identify LAs on documents – 4(1)(2)	Yes	Yes	Yes
Director's remuneration etc should not exceed that from the LA – 5(1)(a) & (b)	Yes	Yes	Yes
Disqualified councillors barred from directorship – 5(2)	Yes	Yes	Yes
Ban on party political publicity – 5(1)(c)	Yes	Yes	Yes
Provision of information to auditors – 6(a) and (b)	Yes	Yes	Yes
Provision of information to councillors – 7(1) and (2)	Yes	Yes	Yes
Audit Commission's approval of auditor – 9	Yes	Yes	No
Public inspection of minutes of meetings – 10(1),(2) and (3)	Yes	No	No

**Table 5: Unregulated Influenced and Minority Interest Companies**

<b>Summary of provisions in section 71 of the Local Government and Housing Act 1989</b>	<b>Unregulated influenced</b>	<b>Ordinary minority interest</b>
Disqualified councillors barred from office – 71(4)	Yes	Yes
Local authority access to information via a councillor or officer who is a director – 71(5)	Yes	Yes
No access to confidential information – 71(6)	Yes	Yes

### **State Aid**

- 3.40 Consideration of State Aid issues is particularly important where any element of a transaction between a local authority and JV Co is undertaken other than on a commercial arm's length basis. For example, where JV Co is granted the benefit of the use of land or buildings other than at a market rent or the local authority undertakes work or provides financial assistance to benefit the project other than on commercial terms. It also may be particularly pertinent where the local authority decides to assist a fledgling trading business of its own.

*What is State Aid?*

- 3.41 Although there is no definition of State Aid, Article 87(1) of the EC Treaty sets out four elements all of which must be satisfied to constitute State Aid. These are:
- the aid in any form must be granted by the State or through State resources;
  - the aid favours certain undertakings or the production of certain goods;
  - the aid affects trade between Member States; and
  - the aid will distort, or has the potential to distort competition.
- 3.42 Clearly if sums (by way of a grant, subsidy or rebate) are effectively given to an entity in order to allow it to undertake activities on its own account there is a benefit to the recipient of such sums. The entity will be placed in a better position than its competitors as a result of the grant/subsidy/rebate it receives.
- 3.43 Subject to the other necessary elements of State Aid being present, these being:
- the recipient being engaged in economic activities;
  - the subsidy resulting in the distortion of competition (this is generally presumed if there is a benefit resulting from the subsidy); and
  - there being an effect on intra community trade (it is sufficient generally for the activities to what the subsidy is applied being those that are or could be undertaken by entities located in other member states).

the provision of a subsidy by way of a grant will amount to State Aid.

- 3.44 Local authorities should therefore ask themselves the following questions:
- does the measure involve the use of State resources?
  - does the measure result in a benefit to an undertaking?
  - does the measure have an effect on trade between Member States?
  - might the measure result in a distortion or threat of distortion to competition?

*Is there a subsidy?*

- 3.45 As mentioned above, it would be necessary to show that the 'benefit' in this case involves the use of State resources in order for there to be a State aid concern. Evident examples include subsidies, loans on preferential interest rates, guarantees on especially favourable terms, provision of goods or services on preferential terms and indemnities against operating losses. In this regard, there must be a charge on State resources such that there must be some sort of financial burden on public funds. This may be self evident where there is a direct subsidy, grant or other similar subsidy. However, there has been a case where State Aid has been deemed by the European

Courts to arise where no charge on public funds was involved – in that case, an undertaking was released from public law obligations which entailed financial savings for that undertaking.<sup>20</sup>

***Consequences of State aid and possible exemptions***

- 3.46 If it is determined that the benefits accruing to the JV Co constitutes State aid for whatever reason (e.g. as discussed above, a subsidy or sale of land at an undervalue, etc.), the principle is that illegal aid is automatically repayable to the body that granted the aid, unless it has been pre-notified to the European Commission and approved. In that case, the following points should be considered in order to ascertain whether the aid can nevertheless be ‘cleared’.
- 3.47 In respect of a payment for the provision of a service, if it can be demonstrated that such payment does not represent an over-compensation for the services provided then there is no benefit to the service provider as they can be shown to have simply been paid no more than the market rate for the provision of such services. The method (generally accepted by the European Commission) by which market rate can be established is through a competitive procurement (whether or not use of the OJEU procedures is necessary will depend on such matters as the value of the services to be provided).
- 3.48 It should be noted that a competitive procurement exercise in itself will not always address State aid, as it is possible to have a competition for subsidy (i.e. the entity which requires the smallest amount of subsidy wins), as in such circumstances the competitive exercise will demonstrate only the minimum amount of subsidy required, but will not eliminate a benefit from accruing to the recipient of the subsidy.
- 3.49 One issue that might be considered is whether any financial advantage that does arise could be classed as *de minimis* aid if it is of a value less than €100,000 over 3 years and it can also be established that the recipient has not received other *de minimis* aid over the past 3 years that would exceed €100,000. This can be an onerous administrative task as the aid administrator must write to the recipient to obtain this information and check these figures before granting the aid. It must also retain a record of all *de minimis* aid paid for 10 years.
- 3.50 A second possibility is that the financial benefit or return can be considered under the European Commission’s block exemptions for aid to SME’s, employment or training. However, there are conditions attached to these exemptions, for example, under the SME block exemption, the SME must make a 50% contribution to the total cost of the project.

Details of exemptions can be found at  
[http://europa.eu.int/comm/competition/state\\_aid/overview](http://europa.eu.int/comm/competition/state_aid/overview)

***Compensation for public service obligations***

- 3.51 There are some services which are not profitable which the private sector left to its own devices would not support. These services may be essential

<sup>20</sup> See paragraph 3.51 below.

e.g. rural transport. The intervention of the State in the economy by funding 'services in the general economic interest' ('SGEI's') and more specifically 'public services obligations' ('PSO's') in the transport sector has been the subject of legal challenges. It may be necessary to consider whether the financial benefits paid to the third party JV Co can be classified as compensation for the operation of public service facilities. Not every compensation for the costs of providing services in the general economic interest amounts to State Aid. However, this exemption will only apply in limited circumstances. The conditions relating to compensation for the performance of public service obligations are set in the *Altmark Trans GmbH*<sup>21</sup> decision:

- the public service obligation must be clearly defined;
- the calculation of compensation must be established in advance in an objective and transparent manner;
- the compensation must not exceed the costs of discharging the public service obligation taking into account revenues received and a reasonable profit; and
- a tendering procedure should be used but where it is the compensation should not exceed the costs of a well-run typical undertaking that is adequately equipped with the means to provide the public service.

The above criteria is very exacting and a great deal of compensation is unlikely to meet them and therefore be aid. In order to ensure legal certainty the EC Commission has published two texts: a Decision exempting from notification small SGEI's below a threshold and a framework for everything else for example exempt from notification is annual aid for SGEI of less than 30m Euros given to undertakings whose annual turnover in the last two financial years was less than 100m Euros. Aid of any amount for social housing and hospitals is exempt, provided that they are carrying out SGEI's. The framework sets out the criteria the EC Commission will apply in clearing aid. The measures were officially published in the OJEU in November 2005. (OJ 2005 L312/67 and C297/4).

#### ***UK approvals for regeneration activities***

- 3.52 There are special rules in place that allow certain types of projects and funding to benefit from exemption or special treatment under the State aid rules. For example, there are a number of UK Approvals that are used specifically for regeneration projects: commercial and business property development, land remediation, housing for owner occupation and renting, historic buildings and the English Cities Fund. These are designed for local authorities to grant subsidies or aid to certain types of regeneration projects in the UK but it might be possible to consider whether, if necessary, the aid created by the current proposal could come within the scope of one of these approvals.
- 3.53 The DTI produces thorough guidance on the State Aid rules and is available at the DTI website [www.dti.gov.uk/Europe/state aid](http://www.dti.gov.uk/Europe/state%20aid).

<sup>21</sup> Case – 280/00 2003 ECR I – 7747.

### **Competition law**

- 3.54 Competition laws are likely to apply to JV Co regardless of its classification, as it will be engaged in commercial or economic activities and thus is likely to come under the definition of ‘undertaking’ in both UK and EC competition law.
- 3.55 Local authorities wishing to establish joint venture companies should not see competition law as a barrier, especially if their activities are aimed at increasing competition in a market.
- 3.56 The two main aspects of competition law to be considered when setting up JV Co are:
- merger control (under the 2002 Enterprise Act and the EC Merger Regulation); and
  - anti-competitive agreements (the Chapter I prohibition of the 1998 Competition Act, and Article 81 of the EC Treaty).
- 3.57 A further aspect of competition law, abuse of a dominant position in a market, may also be relevant after JV Co has been set up, particularly if the activities of JV Co are in a niche or uncompetitive area.

Further guidance on competition law refer to the Office for Fair Trading guidance at <http://www.oft.gov.uk/Business/Legal/Modernisation/publications.htm>

### **EU Procurement Rules**

- 3.58 The EU public procurement rules make particular requirements of public sector bodies which are ‘contracting authorities’. In most cases, the view taken in the UK is that an agreement to establish a joint venture company by a local authority in itself is unlikely to constitute a contract for goods, services or works, and as such the EU procurement rules should not apply. However, the distinction between partnership arrangements involving a procurement and those not involving a procurement is not always clear cut, and every case should be looked at individually. For example, if there are contracts for services between the local authority and private sector parties engaged in JV Co, the EU rules are likely to apply to such contracts, and account needs to be taken of this in structuring the selection process for the joint venture partner. Where they do apply in full, local authorities must comply with specific transparency, non-discrimination and competition provisions for contracts above specified value thresholds. Where it is intended that the JV Co will provide services back to local authority shareholders then the local authorities concerned should consider forming a Central Purchasing Body (see paragraph 2.71). For a more detailed consideration of the EU procurement rules reference should be made to the ODPM publication *Rethinking Service Delivery: From OBC to Contract Award* (2004) (see also Chapter 4 paragraph 4.59 onwards).
- 3.59 Even where there is no strict requirement to apply the EU rules to their selection of a partner the principles derived from the EU treaties may apply and local authorities may wish to consider voluntary compliance with the rules. This has the advantage of being a well-known route for finding a private sector partner, and can avoid subsequent difficulties if it turns out

that JV Co does need to enter into a contract for services (if, for example, the nature of the joint venture company agreement changes during negotiation). However, there may be some disadvantages to voluntary application of the EU procedure, in particular if it is not made clear precisely which parts of the process are being followed. For example, voluntary application raises the possibility of implied contractual obligations, which, if breached, could provide bidders with a right of challenge.

## COMMERCIAL AND LEGAL ISSUES

3.60 This section describes some of the decisions that a local authority needs to make in establishing JV Co and its business, to ensure that the structure fulfils the local authority's objectives and a deliverable commercial solution. In particular:

- the allocation of shares to each partner;
- different types of shares;
- managing the joint venture company;
- policies on the payment of dividends;
- the role of the business plan;
- minority shareholdings;
- dealing with potential deadlock situations;
- strategy and controls for the shareholders to exit the joint venture company;
- funding;
- tax issues; and
- assets.

### Allocation of Shares

3.61 The issues between local authorities in multi-local authority schemes are not referred to in detail in this section (See *Structures for Collaboration and Shared Services* (DCLG 2006)). The principal issues for consideration are:

- each authority to be satisfied of the merits of the deal.
- each local authority will need to address each of these commercial and legal issues from its own perspective and not view the issues in a collective manner. Where the deal is being or has been for practical purposes project managed by one authority on the behalf of several, this does not remove the need for each authority to satisfy themselves as to



its appropriateness for them. In near completed deals processes of due diligence are needed on behalf of authorities who have not been closely involved in the project.

- implications of individual authorities selling their interests.

Joint deals structured through a JV Co can be expected to be amicable initially and partners will have common or aligned goals. This may not remain the case and a local authority partner may wish to exit and another may wish to sell its shares. These issues need to be addressed and set out in the partnership agreement at the outset of the participation in the JV Co.

3.62 The size of the local authority shareholding in JV Co will be a key issue which must be considered at an early stage. Considerations include:

- the equity holding justified by the value of assets (whether cash or kind e.g. assets) it is contributing;
- the level of control required over the company; and
- possible dilution through future share issues.

3.63 As indicated previously there is now little or no impact of public or private sector classification or JV Co (assessed by levels of control) upon local authorities (other than the HM Treasury reserve powers (see paragraph 3.37)). If the exact percentage of the local authority shareholding is left open to negotiations with potential partners, consideration will be needed on how proposals for different levels of shareholding will be evaluated. **Figure 7** shows some different types of structures where there are two shareholders.

**Figure 7: Types of joint venture shareholding structure**

<b>Types of Structure % Shareholding Private Sector Partner: Local Authority</b>	<b>Comments</b>
50:50%	Both parties have an equal shareholding. With this type of structure it is usual for the parties to have equal management and voting rights. This means built-in potential for deadlock where no decision can be made as each shareholder takes an opposing view.
More than 50%: Less than 50%	Even though the private sector partner holds the majority of shares the local authority can still build in adequate protections through its voting rights at board and shareholder level (see paragraph 6.30 below).
Less than 50%: More than 50%	As a majority shareholder the local authority is

### **Types of shares**

- 3.64 A subscription for ordinary equity shares is the simplest and most common way to capitalise a joint venture. This subscription can be in the form of a capital or kind (assets, etc) consideration. However, UK law provides a flexible system in which various types of shares can be issued with different rights associated with them. Shares of the same type are referred to as a 'class'.
- 3.65 An example of this is preference shares, which may give, for example, priority over other ordinary shares for the payment of dividends. Other rights that may attach to shares include the number of directors that the shareholder has a right to appoint to the board or a right of veto or approval over certain matters to be decided by the shareholders.
- 3.66 Whether it is appropriate for each shareholder to subscribe for the same class of shares or for certain shareholders to have a different class of shares with specific rights attached will depend upon the particular circumstances. Different classes of shares with differentiated rights and restrictions can be used to protect the interests of the public sector body, particularly where it is a minority shareholder. The extent of control on JV Co exerted through such class rights may affect its classification in local government terms.

### **Managing the Joint Venture Company**

- 3.67 The local authority and private sector must decide how JV Co is to be managed. The shareholders' agreement and Articles of Association will need to be tailored accordingly.
- 3.68 The structure of JV Co will influence how it is to be managed. For example, a 50:50 joint venture is often deliberately structured so that both parties have equal representation on the board and equal voting rights. This structure has in-built potential for deadlock where no decision can be made if each party takes an opposing view. Where the shareholders hold unequal shareholdings, a majority shareholder will expect to have a final say on matters to be decided at the board, whilst a minority shareholder will need to consider what special rights it may need in order to protect its position.

### **Shareholders**

- 3.69 The shareholders will need to decide the degree of active involvement (the extent of governance) they wish to have in JV Co. They will need to protect the interests (and investment) of the shareholders while providing the necessary degree of autonomy for those responsible for managing JV Co.
- 3.70 A shareholder can be involved in JV Co in a number of ways: voting at general meeting; exercising rights of approval or rights of veto over those matters the shareholders have agreed to withdraw from the remit of the board; or through specific contractual provisions agreed between the shareholders and set out in a shareholders' agreement.
- 3.71 The local authority will need to consider:
- those matters (if any) to be withdrawn from the remit of board to be approved by the shareholders; and
  - those matters (if any) over which it wishes to have veto rights.

- 3.72 These should be kept to a minimum. However, if the local authority is a minority shareholder there are key issues which it will need to address.

***Board of directors***

- 3.73 Responsibility for the supervision and management of JV Co and its business lies with JV Co board of directors, except for those matters which UK Company law requires to be decided by shareholders or are specifically reserved for approval by the shareholders. The exceptions include, for example, the right of shareholders exercising 51% of the vote to remove a director.
- 3.74 A decision will need to be made as to whether the role of the board is to be:
- actively involved in the managerial decisions of the company; or
  - more strategic/supervisory.
- 3.75 The outcome of this decision will influence the composition and structure of the board. If the board is to have an active executive role, then it will need to include individuals with the appropriate skills base. If, however, the board is to have a supervisory role, reviewing overall strategy and key decisions, it will consist mainly of representatives of the shareholders. An executive management committee (see below) will need to be established to whom the supervisory board will delegate conduct for the day-to-day running of JV Co.
- 3.76 As part of the negotiations for establishing JV Co, the partners will need to decide:
- the number of directors each shareholder can appoint to the board, together with any particular voting rights;
  - whether the board can appoint additional directors;
  - whether, as a matter of best practice, the board should contain independent non-executive directors;
  - the matters to be decided by the board rather than delegated to the executive management;
  - the frequency of board meetings;
  - how board decisions are to be decided (including what represents a quorum);
  - whether a director can appoint an alternative director to vote in their absence; and
  - how the chair's role is to be fulfilled.
- 3.77 Ideally, the chair should be selected on the basis of executive managerial experience, knowledge of the business and associated market, leadership, and an appreciation of the shareholders' original motivations for starting the joint venture.

*Executive management committee*

- 3.78 If the role of the board is to be supervisory, then it will be important to establish an executive management committee. The extent of the committee or an executive manager's authority will need to be determined and guidelines prepared. It is important to note that the board of directors will still have legal and fiduciary responsibility for the management of JV Co, even though authority has been delegated from the board to an individual or committee.
- 3.79 JV Co should be structured so that the party with the best skills to undertake a particular management function does so, irrespective of the shareholder's actual equity investment. For example, management could be vested in the private sector shareholder under a management services contract entered into with JV Co.

*Directors' roles*

- 3.80 The parties will need to agree the number of directors they nominate to the board of JV Co. As directors they will be required to attend and vote at board meetings and are legally responsible for the management of JV Co. The local authority will need to consider early on who they will ask to serve as their directors.
- 3.81 The primary obligation of a director is to JV Co, and they should act in the best interest of JV Co. As JV Co is owned by its shareholders, acting in its best interests will have to be assessed by reference to the shareholders and their long-term interests as well as their short-term interests. Where JV Co is insolvent, a director must also consider the interest of creditors.
- 3.82 A director appointed by a shareholder (possibly a member or officer of the local authority shareholder) may find they feel a conflict between acting in the interests of JV Co or in the interests of the shareholder in circumstances where such interests are not the same. This may be particularly strong where the director is also an employee of the shareholder who has nominated them. It is therefore very important for directors of JV Co to understand to whom they owe a duty and the exact nature of that duty. This issue will need careful consideration for local government officers who are nominated as directors.
- 3.83 A director must:
- comply with duties imposed on directors by statute (e.g. Companies Act 1985);
  - carry out his/her duties with care and skill;
  - act in good faith in the best interest of JV Co (fiduciary duties);
  - act within the powers conferred on him/her by the memorandum and articles of association;
  - exercise independent judgement on behalf of JV Co (i.e. any restrictions entered into with a shareholder as to how to vote which would restrict a director's ability to vote would be a breach of duty);

- seek to avoid potential conflicts between JV Co and a director's interests or a duty owed to a third party; and
  - comply with his/her duty of confidentiality to JV Co.
- 3.84 The constitutional documents and shareholders' agreement can help alleviate the concerns for a director appointed by a shareholder by:
- reserving certain matters (particularly those where conflicts are likely to arise) to be decided by the shareholders only and not by the board;
  - imposing a restriction on a director from voting on any issue in which he/she has a conflicting interest; or
  - by expressly allowing a director to vote on a matter in which they have a conflicting interest, provided that the nature and extent of the director's interest has been fully declared to the board.
- 3.85 Directors should also be aware of their liabilities, both individually and for the body, and take out appropriate insurance. A company can take out such insurance for its directors but before doing so should take notice of the personal tax implications that may arise.
- 3.86 Officers and members may be indemnified by the local authorities against liabilities arising as a consequence of appointment to the board of a Company (see Local Authorities (Indemnities for Members and Officers) Order 2004 SI 2004 3082). Under this Order a local authority may indemnify an officer or member in relation to any act or failure to act by the member or officer in question, provided that act/omission arises from the duties or powers of that officer or member, in consequence of them carrying out a function which has been requested by the authority, or which is done in pursuance of the authority's purposes. As an alternative to providing an indemnity, the authority can provide insurance. Even if the act/omission in question was outside the authority/member/officer's powers, so long as the officer or member in question believed that the act/omission was within the relevant powers and it was reasonable for that member/officer to hold that belief at the time, the indemnity will be valid (provided the authority has powers to grant it).
- 3.87 An authority cannot indemnify an officer or member to the extent that their act/omission constitutes a criminal offence or is the result of that member/officer's fraud, deliberate wrongdoing or recklessness. However, subject to one condition, an indemnity may be provided in relation to the defence of any criminal proceedings against that member/officer or any civil liability which arises in consequence of an act or omission which constitutes a criminal offence. The condition mentioned above is that the indemnity/insurance cannot be provided unless it is subject to a term stipulating that, should a member/officer be found guilty of a criminal offence, or (in the case of Part 3 proceedings) it is found that the member/officer has failed to comply with the Code of Conduct, then the member/officer will reimburse the authority/insurer as the case may be (as a civil debt).

### **Corporate governance**

- 3.88 It may be important to put corporate governance arrangements in place to provide protection when JV Co is at least partly funded by the public purse. These should be established to minimise the risk of conflict of interest and give reassurance to key public sector stakeholders over the propriety of the corporate arrangements. Examples of such arrangements include non-executive steering groups, advisory councils, audit committees, remuneration committees, etc. Reference to the Combined Code on Corporate Governance (The Turnbull Report) should be made for further guidance on corporate governance. This can be found on the Institute of Chartered Accountants website (<http://www.icaew.co.uk>).

### **Dividend policy**

- 3.89 The shareholders will need to decide general policy for how any available profits of JV Co are to be distributed. The shareholders' agreement should include a provision setting out the principles of the dividend policy:
- a requirement to distribute no less than X % of the realised profits each financial year;
  - a requirement to distribute all profits in excess of working capital requirements as specified in an agreed budget or business plan;
  - a requirement that no profits are to be distributed until a certain event occurs; and
  - a dividend 'holiday' while JV Co gets established.

### **Business plan**

- 3.90 A comprehensive business plan must be written with input from both parties at the outset of the formation of JV Co. The business plan will need to be updated on a regular basis once JV Co is established. Where a company is established for LA trading, a business case must also be prepared before the company is established.

### **Minority shareholding**

- 3.91 A minority shareholder will not have as great an influence in the decisions of JV Co as a majority shareholder. Although the law of England and Wales protects certain rights of a minority shareholder through statute or common law, it is generally considered that they do not go far enough in relation to joint venture arrangements where the minority shareholder may be contributing an important skill or resource to the venture or matter of public policy may need to be protected.
- 3.92 Additional protection is therefore usually sought by a minority shareholder. The extent of such protection will depend upon the bargaining position of the joint venture partners and the actual percentage shareholding of the minority shareholder, e.g. a 40% shareholding should entitle the shareholder to greater influence than a 10% shareholding.

- 3.93 The types of additional protection that can be sought by shareholders, and of particular relevance to minority shareholders, are summarised in **Figure 8** below. Controls on sale of JV Co shares are an important way to secure protection.

<b>Figure 8: Forms of additional protection</b>	
<b>Type of Protection</b>	<b>Comment</b>
Board representation	A director on the board can ensure a shareholder is involved in the decisions of the board and is kept informed.
Approval and Veto Rights	A shareholder should seek a right of approval for certain issues where it holds a certain stipulated % of the shares or for very key issues a veto right (either at board or shareholder level) in relation to key matters or major decisions which have a fundamental impact upon the business or operations of JV Co. Examples include matters which affect the capital structure of JV Co or could dilute a shareholder's equity stake. A key area of concern will be contracts between JV Co and other major shareholders which are not at arm's length, thereby taking value out of JV Co.
Exit	Provisions that allow a shareholder to exit the JV Co and guard against 'lock in'.
Dividend Policy	A stated dividend policy to prevent money being locked into JV Co
Right to Information	Additional protection could be provided by a contractual provision in the shareholders' agreement for the right of access to certain information
Claims against Majority Party	A shareholder should ensure that the right of JV Co to claim against the majority party for breach by that party under any contract with JV Co is not blocked by the ability of the majority shareholder to outvote the minority shareholder.

- 3.94 A shareholder can include these protections either in the shareholders' agreement or in the Articles of Association. However, as the Articles of Association can be amended by shareholders with 75% of the voting rights, a minority shareholder may want to ensure required protection is included in the shareholders' agreement (which can only be amended with the agreement of all shareholders) or alternatively, the right could be attached to a distinct class of share.

### **Deadlock**

- 3.95 In a joint venture, deadlock can arise at board level (for example where opposing positions are taken by an equal number of directors) or at shareholder level (where shareholders fail to agree those matters which have been reserved to them). The shareholders' agreement can provide for deadlock disputes to be escalated to senior individuals in the shareholders' parent organisations (for example, to chief executives of the private sector partner and the local authority).



3.96 However, some disputes may result in an intractable deadlock where there is a fundamental breakdown in management and the ability to continue with the joint venture. It may be useful at the outset to include in the shareholders' agreement mechanisms for avoiding deadlock (e.g. a Chairman's casting vote or referring disputes to an expert) and the consequences of an intractable deadlock. The rationale for this approach being that the shareholders will know the consequences of failing to resolve a deadlock and that this knowledge may help disputing parties to focus their minds on trying to resolve the disputes. Types of provisions for when a deadlock becomes intractable include:

- voluntary winding up of JV Co; or
- compulsory sale of shares by an aggrieved party (subject to any pre-emption rights); or
- put and call option (if a minority shareholder).

3.97 Alternatively, the contractual documents may be silent as to the consequences of an intractable deadlock. The shareholders will then have to agree a procedure when it occurs rather than try to anticipate an appropriate procedure in advance.

### **Exit strategies**

3.98 Exit provisions are needed to enable shareholders to realise their investment in JV Co (and thereby extract value), and to protect their investment if JV Co or other shareholders fail to perform in accordance with the agreed objectives.

3.99 Agreeing provisions for shareholders to exit from JV Co is likely to be one of the most difficult issues to resolve. This stems from the difficulty in determining the value of shares held in JV Co where they have no readily established market value. It is important to ensure that the local authority avoids the situation where it is forced to buy shares at an inflated value. This is a complex area, but typical mechanisms for calculating the value of shares include:

- net present value of future earnings;
- underlying asset value, e.g. calculated on the basis of depreciated replacement costs or net book value;
- break-up value;
- the use of an expert valuer; and
- assignment of software licences etc.

3.100 It will be important to draft appropriate provisions in the shareholders' agreement (or Articles of Association) setting out the conditions for when and how shares in JV Co can be sold and JV Co wound up, taking account of the consequences of these actions. Before attempting to draft such provisions, the parties must be clear as to the underlying intention behind setting up JV Co, i.e. what are the objectives of the parties in setting up

JV Co? How are these objectives to be realised? The following questions will need to be considered:

- To what extent can JV Co exist without the founders' involvement?
- Is JV Co being set up for a specific task or duration, so that when completed or reached, JV Co will cease to operate?
- How are management deadlock or disputes to be resolved?
- In what situations would changes to the shareholders be required?
- Are there any situations where changes to the shareholders may be permitted?

3.101 In the case of multi-authority schemes these questions will need to be answered from the perspective of each public sector body. The overall position may be satisfactory but the interests of individual participants may differ.

3.102 There are two basic scenarios for a shareholder to exit JV Co:

- Voluntary – either voluntary sale of the holder's shares in JV Co or where all the shareholders consent to winding up JV Co.
- Compulsory – events which compulsorily give rise to (a) a sale of a holder's shares or (b) winding up of JV Co.

3.103 A sale of shares will alter the ownership structure of JV Co, but JV Co and its business will continue. Therefore, where a shareholder sells its shares in JV Co and exits the shareholders agreement, parties will need to consider:

- what will happen to any assets or shared assets contributed to JV Co by the outgoing shareholder;
- how a price for the shares will be determined;
- what process will be used for approval of new shareholders;
- what will happen to any loans provided to JV Co by the outgoing shareholder;
- how to deal with any guarantees or indemnities provided by the outgoing shareholder;
- the extent to which the outgoing shareholder should be bound by obligations of confidentiality or restrictive covenants;
- whether any outgoing shareholder should be given a licence to use any intellectual property rights owned by JV Co;
- what will happen to any staff who have been seconded to JV Co from the outgoing shareholder;

- what will happen to any subsidiary contracts between the outgoing shareholder and JV Co.

### *Voluntary sale of shares*

- 3.104 The voluntary sale of shares is likely to be a main way of extracting value from JV Co (dividend payments and licensing fees/royalty payments being the other main ways). The strategy for selling the shares and realising value should therefore be considered in detail when forming JV Co.
- 3.105 Shares can be sold to other existing shareholders or third parties in a variety of ways (either a sale of a block of shares or all shares held by one party), including a trade sale.
- 3.106 As JV Co has been set up by agreement of at least two parties for a specific purpose, it is important to have a degree of control other than the ability of the parties to sell their shares. It is usual to include in the Articles of Association (or shareholders' agreement) specific principles that may prevent a party from selling its shares or may restrict a party's ability to sell its shares to an unknown third party. **Figure 9** describes a number of different mechanisms which may be adopted to control how and when a shareholder sells its shares in JV Co.

**Figure 9: Disposal of shares**

<b>Mechanism</b>	<b>Explanation</b>	<b>Comments</b>
Lock-in period	Prohibition on a party from selling its shares for a specified period.	To ensure that an important partner stays involved and to incentivise the party to achieve the objectives of JV Co.
Consent of other shareholders not to be unreasonably withheld	Prohibition on a party from selling its shares without the consent of all other shareholders not to be unreasonably withheld.	Where the participation of the private sector party is considered critical for JV Co, this could be a compromise to a lock-in period. It is important to question whether a party who is refused consent to sell will still be willing to contribute to JV Co, or whether they will feel aggrieved; the mechanism is therefore sometimes linked to a winding up provision of JV Co if the sale of shares is refused.
Approval of Board	Any transfer to be subject to approval of JV Co Board.	This mechanism may favour a sale by a majority shareholder who has greater board representation than a minority shareholder.
Put and call options	Where a party may have an option to require the other party to buy or sell their shares. The option for a compulsory transfer could be exercisable at will or on a trigger event depending upon how the shareholders have structured the joint venture.	This option can enable a party to require the other party to sell or buy its shares. As these provisions may force an unwilling buyer/seller, they may not be appropriate for a joint venture. They may be a useful mechanism for minority shareholders to prevent a lock-in.

Figure 9: Disposal of shares (continued)

Mechanism	Explanation	Comments
Pre-emption rights	Any shares for sale must first be offered to the other shareholders in accordance with agreed procedures and a share valuation mechanism to prevent opportunistic pricing by the exiting party.	This standard provision is a useful mechanism for the remaining party to consolidate control (subject to being able to raise the cash for the shares and any classification consequences (See section above).
Intra-group transfers	Allows members to transfer shares to other companies within a group of companies.	A fairly standard mechanism. It is important to define carefully the parties who are in the 'group' e.g. is it a 'wholly owned subsidiary' or any subsidiary.
Piggy back	Variation to pre-emption rights mechanism which allows a party to sell its shares to a third party provided that if the remaining shareholders wish, the third-party buyer also buys the entire shareholding of the other shareholders.	This is a useful mechanism for a minority shareholder who may wish to sell out where its partner has found a buyer. The effect of this clause is that it is the sale of the entire JV Co to a third party. Consideration will need to be given to the status of any subsidiary contracts.
Drag along	Where a party (generally a majority shareholder) is permitted to sell its shares to a third party it can also force its joint venture partners to sell their shares to the same third party.	The rationale for this mechanism is that a business is far more saleable where it is a sale in its entirety or of a majority of shares sufficient to give the buyer effective control. The effect of this provision is that it is the sale of the entire JV Co to a third party.
Tag along	A minority shareholder can force a sale of its shares to a third party buyer of a majority shareholding at the same price.	This mechanism provides an exit route for a minority shareholder so that it does not find itself in a joint venture with a completely different joint venture partner. Tag along and drag along provisions usually go together. They need to be treated with caution in joint ventures focused on long-term partnership and not simply about investment and realisation of an investment.
'Russian roulette'	Halfway between a voluntary and compulsory exit, this mechanism allows a party wishing to exit a joint venture at any time to offer its shares for sale to the other party. If the other party rejects the offer to buy, it must offer its own shareholding to the original seller upon the same terms.	This mechanism can only be used where the parties are on an equal footing. It cannot work where one party is weaker in its ability to buy shares (e.g. because of funding constraints), as the party forcing the issue may take advantage of this to force a sale of shares by the other party. Given that this method makes it difficult to prove value for money, it does not seem appropriate to a public-private joint venture.

Figure 9: Disposal of shares (continued)

Mechanism	Explanation	Comments
'Texas shoot out'	A variant of Russian roulette where one party applies to buy the other party's shares. If this offer to buy is rejected, a counter offer for the purchase of the 'buyers' shares must be given at a higher offer. Then the parties may go to sealed bids with a sale to the highest bidder.	This is more akin to form of compulsory transfer. As with Russian roulette, a mechanism where the price paid for the shares is not open to scrutiny is unlikely to be appropriate to a public-private joint venture.

### *Voluntary winding up*

- 3.107 In some cases shareholders may all agree to exit the joint venture by winding up JV Co (shareholders' voluntary winding up). This may occur where for example the objectives of JV Co have been achieved or the underlying rationale for setting up JV Co no longer exists.
- 3.108 The shareholders' agreement may include detailed provisions stipulating a particular procedure to apply to the disposal or break up of JV Co's assets (for example, a compulsory auction of its assets) together with any ongoing provisions as to confidentiality or restrictive covenants which should continue following the winding up of the company. Local authorities may wish to consider specifically, and develop specific procedures to address, how contracts the company has with other public sector bodies should be catered for.

### *Compulsory sale of shares or winding up*

- 3.109 The shareholders need to agree whether there are circumstances or default events which may trigger:
- the right of one party to compel the other party (usually a defaulting party though not always) to sell its shares; or
  - JV Co to be wound up.

Figure 10 sets out a few examples of the type of trigger events which the shareholders may wish to consider. It is not intended to be a complete list.

Figure 10: Trigger events

Event	Consequence	Comments
Material default by one party	Right to compel the defaulting party to offer its shares for sale (usually to the non-defaulting party under pre-emption rights).	Default events include a material breach of the shareholders' agreement (usually a breach which is incapable of remedy) or possibly of any other agreement (such as subsidiary contracts) or breach by the private sector party to inject capital into JV Co.
Insolvency of a joint venture partner	Right to purchase insolvent party's shares through a 'call option.'	This default event will only apply to a private sector party. Definition of 'insolvency' to be carefully drafted and may need to include parent companies. The mechanism for valuing the share price will also need to be considered.
Change of statutory functions	Right to terminate the contract if the law is changed and a service provided by the company is no longer the remit of the public sector partner.	This default position will only apply to fundamental changes in law and where novation of the contract to another public body of equal standing cannot be achieved.
Change of control of a joint venture partner	Option to require the party which is subject to a change of control to sell its shares or buy the shares of the other party.	This default event will normally only apply to a private sector party. Need a sensible definition of 'change of control', this mechanism allows the party who has not changed control to determine whether or not to continue the joint venture, and if not, on its own terms. This could be used for situations where a council changes political control but this is extreme.
End of purpose	Right to compel JV Co's winding up.	Useful where a company has been set up for a specific purpose which has ended.
Invalid transfer of shares	Provisions which enable the transfer not to be effective and to provide for compulsory purchase of shares.	This is important to prevent a party from benefiting from acting outside the provisions set out in the shareholders' agreement or articles of association in relation to transferring shares.

- 3.110 In addition to a specified default event, it will always be open to a shareholder to apply for a court order compelling the winding up of JV Co on the grounds that this would be 'just and equitable' under the terms of the Insolvency Act 1986.

### Funding

- 3.111 In order to operate, and in particular to expand and reach the various stages of a commercial operation, JV Co will require sufficient funds. The expectation is that these funds should normally come from the private sector. The timing, amount and origin of these funds will depend on the operation, nature and structure of JV Co.

- 3.112 Funds for JV Co can be raised in a number of ways, at both initial funding stage and subsequent rounds of funding. These include:
- issue of shares (equity);
  - debt raising; and
  - grants.
- 3.113 Providers of funding differ in the risk/reward profiles that they are seeking from the investment. Those buying shares expect to take higher risks in return for higher returns on their investment. Banks, on the other hand, will not provide debt unless the risks are low, but expect a lower return. Grants providers do not require any financial returns, but grants are only available for certain activities and with conditions attached.
- 3.114 JV Co can raise funding by any combination of these three means, both when it is formed and in subsequent fund raising. However, at formation the risks are inherently greater as JV Co has no track record, and so funding at this stage will typically come from JV Co's founders.

#### *Issue of shares (equity)*

- 3.115 This is the selling of shares in order to raise funds. These shares can be of many classes (different types with different rights), and can include voting and non-voting shares. The principal sources of equity funds will primarily be from founding private sector partners:
- typically, equity funding will be provided by the founding partners in the early stages of JV Co's existence.
  - when additional shares are issued, it is important to consider the implications, particularly with respect to dilution of the local authority interest.

#### *Debt raising*

- 3.116 There are three main sources of debt funding for the company:
- loans from shareholder(s);
  - loans from commercial lenders (banks); and
  - issuing of bonds or other transferable loan stock.

Authorities may also give consideration to raising funding for projects through prudential borrowing.

- 3.117 In a similar fashion to equity funding, these different routes of raising loans often depend on the funding stage reached, the amount of money required and the expected risk/reward balance. Loans from existing shareholders are more likely in JV Co's early stages or at initial funding; loans from banks become more likely as JV Co grows; and the possibility of JV Co raising funds through bonds will only arise when JV Co has reached a very substantial size.



### *Loans from shareholder(s)*

- 3.118 It is often possible to agree that capital injection by the shareholder(s) is in the form of a loan rather than through the issue of shares. The advantages of including some shareholder loans rather than pure shareholder equity include:
- debt can be repaid even if there are little or no accounting profits (when no dividends are payable);
  - interest on the debt provides a predetermined flow of cash back to the shareholders; and
  - they can be more tax-efficient.

### *Loans from commercial lenders*

- 3.119 JV Co may want to arrange a loan from standard commercial lenders (e.g. banks). This is usually only possible when JV Co can offer security for the loan or has a track record of generating profits. If there is still considerable commercial risk, the lender may require a guarantee from JV Co's founding partners. In normal circumstances the local authority should avoid giving such guarantees.

### *Issuing of bonds or other transferable loan stock*

- 3.120 Corporate bonds can be issued which pay out a certain interest rate/return at a given time. The value of the bonds can be paid back using various payment profiles.

### *Tax issues*

- 3.121 JV Co and its advisers will need to consider numerous tax issues, concerning both direct and indirect taxation. JV Co should be set up and operated in a way which is tax efficient. This will be important both for the commercial viability of JV Co and for attracting private sector investment. Tax considerations, however, should not affect the aims and objectives of JV Co.

### *Assets*

- 3.122 The assets which the joint venture partners could contribute to JV Co include employees, buildings, equipment or land, finance or intangible assets, for example intellectual property rights. These assets will form an important part of the structure of the business and should be provided under separate contracts. The local authority will normally contribute assets in return for equity in JV Co, and it is therefore important that they are properly valued. Consideration should also be given to how the assets should be dealt with on exit from or termination of JV Co.
- 3.123 As with any transaction in the nature of a 'business sale', the joint venture partners may seek warranties from the other in relation to the assets contributed by them to ensure that they may be validly used in the joint venture. Furthermore, where one or other of the partners is to provide crucial information for the joint venture a warranty as to the accuracy of such information may be sought. A local authority may consider giving such warranties but only where it is reasonably certain as to the accuracy of the warranties and therefore they are unlikely to be breached and where it is better value for money to give them to eliminate significant uncertainties giving rise to contingencies and/or the

significant cost of a due diligence (verification) exercise by the private sector partner.

### ***Documentation***

3.124 This option will involve the following documentation:

- Memorandum and Articles of Association of JV Co;
- Shareholder or Joint Venture Agreement; and
- Any other ancillary contract documentation such as works or service contracts pursuant to which JV Co will discharge its objects.

### ***Memorandum and Articles of Association***

3.125 All companies incorporated in England and Wales have to have a Memorandum and Articles of Association. These are referred to as the constitutional documents of JV Co, and are lodged at Companies House. Standard forms can be provided which should be tailored to the requirements of the joint venture partners.

3.126 The Memorandum describes the object of JV Co and gives JV Co its powers. The Articles of Association are the company's internal rule book. The Articles can be amended from time to time by shareholders owning 75% of the voting rights.

### ***Shareholders' agreement (or Joint Venture agreement)***

3.127 A joint venture partner may express its intention to provide certain assets or funds to JV Co, but there will be no binding commitment to do so unless a shareholders' agreement is entered into. The shareholders' agreement is a contract and is governed by the ordinary rules of contract. Accordingly a shareholder (even a majority shareholder) cannot unilaterally amend the terms of the shareholders' agreement. Unlike the constitutional documents, the shareholder agreement is not a public document.

3.128 The local authority and its advisers should prepare either a summary of the key terms of the shareholders' agreement or a draft of the shareholders' agreement in any documents provided to potential partners. This is a key part of the local authority's consideration of how it believes its desired outcomes can be achieved. In discussions/negotiations with potential partners, however, these draft documents may change and the public sector body should be flexible in its approach while ensuring it secures its requirements.

3.129 The types of commitments which the local authority should seek from its joint venture partners should include:

- the initial subscriptions for equity of each joint venture party;
- an obligation of the parties to include any agreements to be entered into (e.g. any asset transfer agreement);
- an agreement as to the business of JV Co;

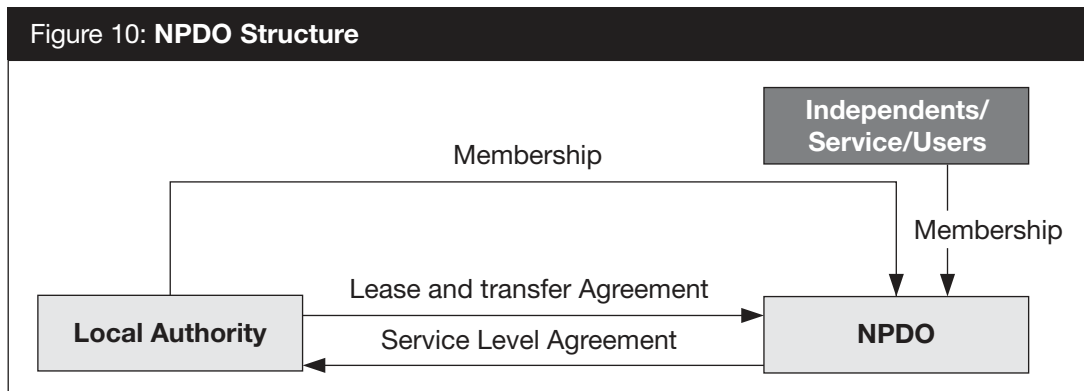
- each parties' intention for future funding commitments;
- procedures for managing JV Co and deadlock;
- dividend policy;
- exit provisions;
- any matters which are to be reserved for approval or veto by the shareholders;
- any non-compete provisions;
- obligations of confidentiality;
- obligations of transparency e.g. access to charging information of private sector partner under secondment agreements or as required for public sector auditing purposes;
- the requirement to prepare a business plan each year; and
- the governing law and jurisdiction.

3.130 Care must be taken in drafting the shareholders' agreement. If the parties wish JV Co to be classified to the private sector, it is important that control of JV Co is not passed back to the local authority through excessive and restrictive veto rights or other obligations included in the shareholder agreement.

### **Risk Transfer**

- 3.131 The joint venture company enables maximum risk transfer from the local authority to JV Co. However, to achieve the best value for money local authorities should only transfer those risks which are best managed by JV Co. Local authorities should be careful to assess the re-transfer of important risks through, for example, the giving of guarantees in relation to the performance of JV Co to third parties or the repayment of finance.
- 3.132 Where the local authority subscribes for share or loan capital then that capital will be at risk if JV Co were to become insolvent. Similar considerations arise in relation to tangible assets which the local authority may transfer to JV Co. A structure may be put in place to mitigate such risks such as leases of land, but such may inhibit JV Co raising debt finance.

## Part 2 – Non-profit Distributing Organisations (‘NPDO’)



### OVERVIEW

- 3.133 The Government supports a mixed economy for the delivery of public services and considers the not-for-profit sector to have an important role. The NPDO may also have a role as a participating partner rather than a direct provider of services.
- 3.134 Local authorities themselves, other public sector entities, voluntary organisations, charitable trusts, industrial and provident societies, co-operative societies can all be recognised as not-for-profit entities that form the complex matrix of not-for-profit service delivery in the UK.
- 3.135 The promotion of separate (often specific) purpose not-for-profit entities has always been a feature of UK local government and historically local government has been entrepreneurial. Early in the last century local authorities have created and run Municipal Banks and insurance businesses for this purpose. Whilst some Municipal Banks still exist in Scotland, these entities no longer exist in England. The creativity and scope of local government invention and activity has been progressively curtailed by controlling legislation and this became very apparent with the greater restrictions imposed in the 1980s. However, signs of re-emergence of creativity and the use of not-for-profit entities has emerged in the last decade.
- 3.136 Since 1990 there has been a growing trend for local authorities to use not-for-profit entities to operate leisure centres and other cultural services. The reasons for the use of these entities have been mixed. A principal driver has been the existence of fiscal advantages – both reduction in business rates and remission in VAT liabilities. Other reasons have been attributed to this development. These include the facilitation of the involvement of stakeholders in decision-making, incentivising employees to greater levels of productivity, and reduction in operational costs.

- 3.137 There is an apparent demand and pressure within society to re-examine the not-for-profit option alongside other options. Suggestions have emerged that in the development of service delivery partnerships, the option has frequently been overlooked. So can a community association NPDO provide a suitable vehicle for a service delivery partnership?
- 3.138 There is little doubt that in some circumstances the answer will be that they can play a key role in the formation and running of a service delivery partnership. However, before this option can be a serious contender as a main stay of service delivery partnerships, cultural, commercial, technical and legal barriers need to be overcome. The most apparent reasons for this are explained below.
- 3.139 The option that this chapter considers is using a non-profit distributing organisation as an operating vehicle. However, they can be used to co-ordinate client-side management partnerships. For example, a local authority has decided to outsource some of its education support services to a private sector body. The local community and education specialists could join with the local authority to participate in a not-for-profit vehicle to monitor performance and provide the client-side management on behalf of the community and the council. Using such a non-profit distributing vehicle allows for multiple outsourcing to be catered for and so could a mixed economy of in-house and outsourced services. Figure 10 illustrates the structure.

## **DESCRIPTION**

- 3.140 Non-profit distributing organisations (NPDOs) can provide efficient mechanisms for operating services. However, they do not feature as leading providers of services for many sectors of the economy. They tend, in the main, to figure as a vehicle sponsored by the local authority e.g. a housing association for a stock transfer or a 'leisure trust' for leisure services. They tend to be sector specific and often regulated.
- 3.141 They do not provide IT services, revenues and benefits, highway maintenance, waste collection and disposal for instance. Hence, where service/operating contracts are awarded in competition, commonly not-for-profit entities will not submit expressions of interest. Even if such bodies do express an interest, their lack of experience and/or comparative weak financial position may prove an insurmountable obstacle to their serious consideration.
- 3.142 NPDOs are commonly used in local government in three contexts:
- Regeneration and economic development programmes: in particular, as vehicles for delivery of projects at a local level;
  - Housing – in particular, housing associations, community associations and local housing companies;

- Leisure (including recreation, sports, arts, theatres, museums) – transfers of local authority sport centres to an NPDO are an increasingly popular Best Value option for local authorities, with beneficial tax and business rates treatment releasing resources for capital investment.

They could also be used as a vehicle for public public collaboration, effectively as the conduit through which the public public collaboration is undertaken (see Chapter 2).

- 3.143 The main forms of NPDO are companies limited by guarantee and industrial and provident societies. The term ‘trust’ is often used but, technically, it is inappropriate, as in a ‘legal trust’, the trustees are personally liable for the trust’s debts, even if the reason for its indebtedness is through no fault of its own.

### **Characteristics of Limited Companies**

- 3.144 A company is governed by its memorandum and articles of association (which set out the objects and powers of the company, the rules for holding general meetings of the members and board meetings of the directors, the rules for the introduction of new members, the rules for the appointment or election of directors, and the rules of company governance). It has a two-tier management structure:

- companies are managed by a board of directors and when the company is a charity, they would be ‘charity trustees’. The directors have ‘day-to-day’ control. In many companies the members and the board are one and the same, with directors retiring by rotation and either being re-elected or replaced by new elected directors;
- the members of the company who have residual control; they have the right to change the company’s memorandum and articles of association by a 75% majority (although any changes to the objects of a charitable company need the approval of the Charity Commissioners) and they have the right to remove a director by ordinary resolution.

- 3.145 The members of a company have limited liability. In a company limited by shares, the member’s liability is limited to the nominal value of the share (usually £1). Once the share has been fully paid for, the member does not have to make any further contribution to the debts of the company if it becomes insolvent.

- 3.146 In a company limited by guarantee (the normal vehicle for a charitable company), the member’s liability is limited to the extent of his guarantee. When he becomes a member, he signs a guarantee form (usually included in the membership application form), in which he agrees to pay £1 (typically) towards the debts of the company in the event of an insolvency.

- 3.147 The position of the directors from a personal liability viewpoint is a significant improvement on that of trustees of a trust. Since all contracts etc will be with the company (a separate legal entity), it is the company itself which is liable for its own debts. The directors are unlikely to bear any personal liability, save in exceptional circumstances (e.g. wrongful or fraudulent trading). Directors are still personally liable for breaches of trust.

### **Characteristics of an Industrial and Provident Society**

- 3.148 These are very common in the housing association movement, but relatively unusual in the traditional charity sector, although more than half of the leisure NPDOs are industrial and provident societies (IPSS). There are two types of IPS:
- a bona fide co-operative; or
  - a society set up for the benefit of the community ('bencomm').
- 3.149 An IPS is governed by its rules and registered with the Registrar of Friendly Societies (the Financial Services Authority). The principal legislative provisions are set out in the Industrial and Provident Societies Act 1965.
- 3.150 An IPS is a corporate body. The liability of members as shareholders is limited to the extent of their share. An IPS is governed by its committee (who are the equivalent to the board of directors of a company) who run the society on behalf of its members and its own internal rules. As with a company, the committee members are unlikely to bear personal liability save in exceptional circumstances which include fault on their part. The principal distinction between a company limited by guarantee and an industrial and provident society is that in the latter only equality of voting ('one member, one vote') is permitted whereas in the former weighted voting and class rights are permitted.
- 3.151 The members of a **bona fide co-operative** must have a common economic, social or cultural need or interest; the members must mutually benefit from participation in the business; control of the society must lie with the members; and any distribution of profit to the members must reflect the extent to which they have traded with the society or taken part in its business.
- 3.152 A **bencomm** must be run primarily for the benefit of people who are not members of the society, and in the interests of the community at large. Its rules must not allow its profits or assets to be distributed to the members. If it is dissolved, its profits or assets should be transferred to some other body with similar objects.
- 3.153 Many housing associations are established as IPSs, and the IPS form has been found appropriate in some other local authority contexts, such as leisure and home care.

### **Charitable status**

- 3.154 Having chosen an NPDO to be the delivery vehicle for a project, it is necessary to consider whether it will be charitable. To be charitable, an organization must have purposes which are exclusively charitable and it must be established for public benefit. There is no structure or legal form which is reserved solely for charities. In practice charities may be registered companies, trusts, or unincorporated associations.
- 3.155 A charity's purposes are its objects or aims which are usually set out in its governing document. At present there is no statutory definition of charity and the legal concept has been developed by the courts over several



centuries. The current law is based on the preamble to the *Charitable Uses Act 1601*. This Act did not contain a definition of charity but instead a list of the purposes considered charitable at that time. New purposes are considered to be charitable if they are analogues to one of the purposes listed in the preamble or to a purpose already considered charitable by analogy with it.

- 3.156 The courts have grouped charitable purposes into four divisions: the relief of poverty; the advancement of religion; the advancement of education; and other purposes beneficial to the public.<sup>22</sup>
- 3.157 Public benefit involves two elements. First, the purpose must be beneficial and not detrimental to the public. The first three heads of charitable purpose are assumed to be beneficial, but purposes within the fourth head must be proved to be beneficial. The second element concerns the size of the class intended to benefit. It has been established in case law that the section of the public receiving the benefit must be sufficient.
- 3.158 There is also some legislation relating to charities. Some sporting organisations and some organisations promoting recreation are charitable under the *Recreational Charities Act 1958*. In addition, the *Charities Acts* of 1992 and 1993 tightened up the regulation of charities. However, the current position is that a body of charity law, much of it very ancient in origin and honed in case law rather than modern statutes, is used to establish whether an organisation is legally charitable. If an organisation meets that test, then it can take advantage of valuable tax concessions.
- 3.159 If it is a company limited by guarantee, it has to be registered with the Charity Commission. Charity Commission registration is a guarantee of charitable status. An IPS is an exempt charity; that is exempt from registration with the Charity Commission. Exempt charities are usually exempt because they are subject to regulation by another regulator (e.g. in the case of an IPS the FSA). There is no 'guarantee' that a charitable IPS is, in fact, charitable. This is ultimately an issue for the court. However, a charitable IPS is entitled to make a claim to the Inland Revenue for charitable corporation tax relief.
- 3.160 It is possible for a charity to engage in ancillary trading activities; for example, a bar provided by a leisure NPDO only for those using the facilities and spectators is regarded as ancillary and, therefore, acceptable. There are also rules allowing a limited amount of 'mixed trading'. Taking the bar example, if its principal use is by participants and spectators, a limited use by members of the general public may not invalidate its status.
- 3.161 The advantages of charitable status include:
- tax relief (though not an absolute relief from all taxes). VAT is an issue and there is a risk of a liability in the event of trading.
  - national non-domestic rate relief for some activities, e.g. recreational.

<sup>22</sup> Income Tax Special Purpose Commissioners v Pemsell [1891] AC 531.

The Charity Commission decided in February 2005 that charities can deliver public services which public authorities have a statutory duty to provide. The decision concerned leisure trusts, Trafford Community Leisure Trust and Wigan Leisure and Culture Trust which were registered as charities. The decision changed the Charity Commission's previous approach that charities could not usually use charitable funds to pay for public services, which a public authority had a duty to provide, but could only supplement them.<sup>23</sup>

- 3.162 Charity law is currently in the course of modernisation. Most of the changes flow from a review published in September 2002 entitled 'Private Action, Public Benefit' and are contained in the Charities Bill which is expected to reach the statute book in 2006. The principle changes are explained in the following paragraphs.
- 3.163 ***New Statutory definition of charity*** Charity will have a new legal definition and charitable status would be subjected to a two-stage test. To be considered charitable, an organisation would need to demonstrate that its purposes, as set out in its constitution, fell within one or more of those in the new list of 12 charitable purposes, and also that it was established for the public benefit. The listed charitable purposes are:
- the prevention and relief of poverty;
  - the advancement of education;
  - the advancement of religion;
  - the advancement of health (including the prevention and relief of sickness, disease or of human suffering);
  - social and community advancement (including the care, support and protection of the aged, people with a disability, children and young people);
  - the advancement of science, culture, arts and heritage;
  - the advancement of amateur sport;
  - the promotion of human rights, conflict resolution and reconciliation;
  - the advancement of environmental protection and improvement;
  - the promotion of animal welfare;
  - the provision of social housing; and
  - other purposes beneficial to the community.

<sup>23</sup> The full decision can be found at the Charity Commissions website at <http://www.charitycommission.gov.uk> under 'Decisions of the Commissioners'.

- 3.164 These categories would include all the present areas of charity, widened in some cases, for example, the prevention as well as the relief of poverty. They would also widen the scope of what might be considered charitable. However, there would no longer be a presumption that charities for the relief of poverty or the advancement of religion or education are of public benefit. Therefore, for example, independent schools would have to show that they provide a public benefit. The inclusion of the final purpose, 'other purposes beneficial to the community' should mean that the law would remain flexible enough to include new charitable purposes in the future. Furthermore, the Government has stated that there will be no statutory definition of public benefit which should mean that the existing case law definition would remain (although the Charity Commission has issued guidance). In practice, therefore, notwithstanding the intended clarification of the law, it seems likely that the Courts would still be able to decide on what is charitable.
- 3.165 **Greater flexibility for charities:** Measures would be included to make merger, evolution and administration easier for charities. Charities would also be allowed to spend their permanent endowment (capital) where to do so would provide for a more effective means of fulfilling the purposes of the charity.
- 3.166 Other important changes will include:
- **New legal form for charities:** A new legal form will be available for charities, the Charitable Incorporated Organisation.
  - **Fundraising:** The Home Secretary would be given power to introduce statutory regulation of fundraising if he deems self-regulation to have failed.
  - **Auditor protection:** Auditors and independent examiners of charities would be given statutory protection from the risk of action for breach of confidence or defamation if they report to the Charity Commission abuse or significant breaches of charity law.
  - **Promotional ventures:** Companies would be required to make a specific statement about the return that will be made to charitable purposes from promotional ventures.
  - **Payment of trustees:** A trustee body would be given power to pay an individual trustee in limited circumstances.
  - **Personal liability of trustees:** Trustees would be able to apply for relief from personal liability for breach of trust where they have acted honestly and reasonably.
  - **Excepted and exempt charities:** It is intended that formerly excepted charities<sup>24</sup> with an income of £100,000 or more and some exempt charities<sup>25</sup> should be required to register.

24 For example, some religious charities, scouts and guides and armed forces groups.

25 For example, housing associations, universities and colleges.

- **Audit requirements:** The threshold for charities to have their accounts professionally audited would be raised from annual income of £1/4m to £1/2m.
- **Reforms to the Charity Commission:** There would be a package of reforms to the Charity Commission including establishing clear statutory strategic objectives setting out what it exists to achieve as regulator.
- **Tribunal:** An independent tribunal would be introduced to hear appeals against the legal decisions of the Charity Commission as registrar and regulator. It should be noted that the Government has not indicated that it intends to create a charities ombudsman as recommended by the Charity Commission.

### **Community Interest Companies<sup>26</sup>**

#### *What are they?*

- 3.167 CICs were introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004. They are companies limited by shares or by guarantee which are established to benefit the community (or a section of the community) and whose assets cannot be disposed of other than at full market value or in a way that benefits the community. In order to become a CIC a company must satisfy the Regulator of Community Interest Companies that it meets the relevant statutory criteria.
- 3.168 The CIC form was established primarily with a view to providing an easy-to-use purpose-built limited company form for social enterprises (businesses which trade with a primarily social, rather than commercial purpose). Initial indications are that many CICs will be focused on relatively small-scale delivery of public services at a local level, but the form can be used for a variety of community purposes and has already been adopted by some substantial established businesses.
- 3.169 To ensure that CICs use their assets and profits for the community interest each CICs has some special additional features:
- the memoranda and articles of CICs must at all times contain provisions prohibiting the transfer of its assets for less than market value (except where they are transferred for the benefit of the community – which includes transfer to a charity or another CIC);
  - if a CIC is limited by shares, it may choose to pay dividends on them, but dividends on any of its shares held by persons other than charities or CICs are subject to a statutory cap, and, except by way of dividends, shareholders cannot get back more from the company than they have paid the company for their shares;
  - CICs are required to make a ‘community interest statement’ setting out how its activities will benefit the community;

<sup>26</sup> Explanation fact sheets are available on CICs at the DTI website <http://www.dti.gov.uk/cics/>. More comprehensive guidance will be issued from time to time on CIC regulator’s website <http://www.cicregulator.gov.uk>

- CICs must produce an annual community interest report setting out how the company has benefited the community and consulted with its stakeholders; and
- complaints about CICs can be investigated by the Regulator, who has significant reserve powers to intervene in the running of CICs whose activities give serious cause for concern.

3.170 A CIC may have charitable objects, but even if it does so, it will not have charitable status or the tax benefits which come with it.

3.171 Protecting the assets in this way does not necessarily mean that the company could not be taken over or dissolved. In the event of insolvency of the CIC the normal insolvency procedures to protect creditors apply. In the event of a solvent winding up, members cannot receive more than the paid up value of their shares. In the event of a takeover, the new owners of a CIC will remain subject to the same regime.

3.172 CICs are able to make use of debt finance and are able to use its assets as security for loans in the usual way.

#### *Use by Local Authorities<sup>27</sup>*

3.173 Apart from the restrictions on the use of assets and the payment of dividends, the CIC form is almost as flexible as the 'ordinary' company forms limited by shares and limited by guarantee. The CIC form might be useful to local authorities who wish to:

- 'ring-fence' activities in a distinct corporate vehicle; and/or
- have a particular kind of relationship with outside business partners or wider stakeholder groups; and/or
- carry on activities on a more or less 'commercial' footing, but with an externally validated assurance of 'community benefit'.

or where:

- the objectives of the company are beneficial to the community and the access to those benefits will not be unduly restricted; and /or
- the corporate vehicle comprises diverse stakeholders/members/shareholders who need to be prevented from altering the status of the company.

The CIC form may be relevant to, for example:<sup>28</sup>

- health related and social services activities involving the community and voluntary sector;

<sup>27</sup> The CIC regulator keeps a list of registered CICs.

<sup>28</sup> From the list of companies maintained by the registrar it appears that there is local authority participation in CICs for local regeneration, local services for the elderly, providing activities for young adults with disabilities, promotion of social enterprise and offering rehabilitation services.

- bespoke rural or community transport enterprises;
  - leisure activities involving the community or other stakeholders but not involving a commercial partner;
  - educational and training activities involving the community; and
  - community based ‘regeneration’ activities (perhaps involving multi-public sector agencies).
- 3.174 It has also been suggested that the CIC form may be suitable for use in the context of a number of current initiatives relevant to local authorities, including local strategic partnerships, local area agreements, the transfer of publicly-held assets to community groups, and school companies
- 3.175 Whether the CIC designation will be relevant to PFI/PPP remains uncertain. As mentioned previously, certain local authorities are looking at ‘not for profits’ as an alternative to PFI/PPP structures. Instead of profits from the scheme being distributed to shareholders they are retained and reinvested and/or gift aided to charities. However, such PFI/PPP transactions usually involve ‘mainstream’ assets of the local authority e.g. schools and as such would not be appropriate for irrevocable transfers. The public benefit test may also not be satisfied. The designation would only really be relevant to PFI/PPP transactions involving assets which the local authority does not require to be returned or assets which are peripheral to ‘mainstream’ services. Joint Service Centres may be a possibility.
- 3.176 Depending upon the purpose for which the CIC is formed, local authorities will be able to rely on their usual company participation powers, well being, etc. to take an interest in the CIC. The designation may help to bring the company within powers in certain cases e.g. well being. However, even if designated as a CIC general local government law will still prevent delegation of functions to the CIC in the absence of express authority<sup>29</sup>.

### **Drivers**

- 3.177 The principal drivers for this option are regulatory:
- maximising revenue savings from NNDR relief (available to varying degrees for NPDOs which are charitable and NPDOs which are not charitable) and VAT;
  - other tax savings may be achieved if charitable status can be obtained;
  - significant local authority influence over service delivery (grant conditions and board representation);
  - may assist in raising small amounts of finance in less time and cost than PFI;

<sup>29</sup> Further information on CICs can be found at <http://www.cicregulator.gov.uk> and <http://www.dti.gov.uk/cics>

- can satisfy Best Value objectives (users/community on NPDO board);
- some risk transfer (operational).

3.178 The advantages of NPDOs may be realised as part of an umbrella structure, encompassing multi-services of the local authority, rather than a free-standing delivery vehicle. A charitable arm may be incorporated to enable the organisation to draw upon the advantages and the element of control afforded by the Charity Commission.

3.179 NPDOs can be used within hybrid group structures involving joint ventures with the private sector.

### **Disadvantages of NPDOs**

3.180 The principal disadvantages of this option include:

- the local authority often has to find capital resources/guarantees;
- discontinuity of service risk in event of failure or re-transfer to the local authority;
- additional management and support service costs;
- Charity Commissioners' tightened criteria for charitable status;
- the asset lock in the case of a CIC.

## **REGULATORY COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

3.181 The regulatory issues for an NPDO (whether an IPS or company limited by guarantee) are the same as for a joint venture company. The well-being power in section 2 of the Local Government Act 2000 is particularly relevant where a company for community benefit is formed.

3.182 Any services procured through an NPDO should be undertaken in accordance with the EU procurement rules unless the conditions in the Teckal and subsequent cases apply (see paragraph 2.68). The fact that the company is 'not for profit' will assist in bringing the arrangement within Teckal. Even where Part B services are involved, the principles in the Tel Austria will apply (see paragraph 2.71). Arrangements with NPDO's are sometimes structured as public service concessions (i.e. an opportunity to earn fees) but the principles in the Tel Austria case are equally applicable to such arrangements. Pure land disposals will not come within the EU procurement rules (unless the structure of such gives rise to a services contract or a public services concession). Where arrangements between a local authority and an NPDO relate only to grant aid, then again, such is not covered by the EU procurement rules (unless the effect of the arrangement is construed not as grant aid but rather a contract for services).



### **Commercial and Legal Issues**

- 3.183 The commercial and legal issues for an NPDO (whether an IPS or company limited by guarantee) are similar to those for a joint venture company.

### **Documentation**

- 3.184 This option will involve the following documentation:

- Memorandum and Articles of Association (if the NPDO is to be a company);
- Rules (if the NPDO is to be an industrial and provident society);
- a form of service/business transfer agreement containing the terms of transfer of the assets (including employees) to the NPDO;
- a service level agreement where the local authority requires, after transfer, the performance of services to a particular standard;
- where, as is likely, the disposal of land is concerned a form of lease(s) or transfer;
- sector specific documents including a grant or subsidy agreement for leisure transfers and nomination and other agreements for housing transfers; and
- registration with Charity Commission (if charitable status is sought) or CIC Regulator (if CIC status is sought).

### **Risk Transfer**

- 3.185 To the extent that the NPDO is capable of standing alone the same risks may be transferred to the NPDO as with a joint venture company. However, if subsidy or grant aid is required then unless this can be capped annually, there may be some risk transfer back to the local authority. Ultimately if the NPDO becomes insolvent then the local authority either:

- liquidates the NPDO and ceases to provide the service (where the service is discretionary);
- finds a person who wishes to acquire the NPDO and provide the service (unlikely); or
- takes back the service in-house (back to 'square one').

# Part 3 – Trading

## LEGAL FRAMEWORK

- 3.186 The *Local Authorities (Goods and Services) Act 1970* governs the way in which local authorities (LAs) are allowed to ‘trade’ with each other and other public bodies. It authorises LAs to enter into agreements with public bodies (which by definition includes LAs) for the provision by LAs to those bodies, of goods, materials and administrative, professional and technical services, for the use of vehicles, plant and apparatus, and for the carrying out of maintenance. There is also a power for the Secretary of State to designate by Order that any person(s) exercising functions of a public nature shall be a public body for the purposes of the Act. This is *public to public* trading.
- 3.187 The *Local Government Act 2003* provides power for the Secretary of State to make an order enabling best value authorities (with certain exceptions) to trade in any of their ordinary functions. The power to trade conferred by these provisions is only exercisable through a company within the meaning of Part 5 of the *Local Government and Housing Act 1989*. This is *public to private* trading.
- 3.188 The *Local Government Act 2003* provides wider powers to trade for all authorities where there is a strong performance on delivery and where this helps achieve Best Value in the delivery of public services. New powers for local authorities to trade have been introduced as part of a new package of freedoms and flexibilities following Comprehensive Performance Assessment (‘CPA’). The new powers are available to councils judged ‘fair’, ‘good’ and ‘excellent’ in the CPA. It is not available to councils judged ‘weak’ or ‘poor’ in the CPA<sup>30</sup>. Under section 95(4) of the Act, the power to trade must be exercised through a company.

## STATUTORY INSTRUMENTS

- 3.189 SI 2004/No1705 *The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2004* [as amended by SI 2004/2307 *Local Government (Best Value Authorities) (Power to Trade)(England) (Amendment) Order 2004* and SI 2004/2573 *Local Government (Best Value Authorities) (Power to Trade) (England)(Amendment No 2) Order 2004*] which came into force on 29 July 2004 authorises local authorities that have been categorised on the basis of their performance as ‘excellent’, ‘good’, or ‘fair’ to trade in any of their ordinary functions. This is subject to conditions requiring the approval of a business case, and the recovery of any costs, incurred in anything the local authority supplies to a company through which the trading power is exercised<sup>31</sup>.

<sup>30</sup> The Government is currently consulting on the approach to amend the CPA based freedoms following the change of the CPA regime to star-based categories for upper and single-tier authorities. The consultation paper is available on the DCLG website: <http://www.communities.gov.uk/index.asp?id=1163295>

<sup>31</sup> The Amendment Orders provide transitional arrangements in respect of certain fire and rescue authorities – allowing those authorities to continue trading in specified functions notwithstanding the repeal of the Fire Services Act 1947 by the Fire and Rescue Services Act 2004.

- 3.190 Under section 96 best value authorities are required to have regard to any guidance that may be issued about the exercise of their trading powers. Guidance on the trading powers was published on 28 July 2004. Guidance on the trading powers was published by ODPM on 28 July 2004. This is available at:

<http://www.communities.gov.uk/index.asp?id=1133773>

## TYPES OF TRADING

Paras 3.203 to 3.235 explores potential structural options available to local authorities seeking to implement their trading powers in the context of partnership working. If there is any perceived conflict between the advice in these paras and the ODPM published guidance then the guidance is the authoritative view.

### Classification of Trading

- 3.191 In order to determine what trading approaches may be relevant it is important that a distinction is made between activities involving one or more public bodies providing service for others as compared to trading. Local authorities have a long history of providing services jointly or in collaboration for one another, normally on a cost sharing basis, for example joint crematoria. In order to clarify what aspect of trading is being referred we have created 5 classifications, A to E and discussed trading as it applies to those categories.
- 3.192 These classifications are important as they underpin what understood by the term trading and in determining, for example, the fiscal incentives that exist to support various models and the choice of structures that may be employed.
- 3.193 For the purpose of this guidance we suggest that is convenient to classify trading under five categories:

**Category A** – collaboration between bodies for the better delivery of services, sharing of expertise or cost reduction.

**Category B** – trading for the profitable exploitation of assets, skills or location to provide income generation for the benefit of the initiating authority or authorities.

**Category C** – NHS and local authority joint working.

**Category D** – trading in partnership with a private sector partner.

**Category E** – traditional local authority trading or small scale trading to either dispose of surpluses or to reduce costs.

- 3.194 Owing to the broadness of the meaning of the word trading in colloquial use it is necessary to remove certain activities from scope. These are classified as Category E. These include: well known activities such as disposal of surplus library books or unneeded plants from nurseries; schools charging for music

lessons and for school meals. These areas are well understood and are not the focus of this advice. The following paragraphs focus on Category A and B activities and with an overview of Category C and D activities.

**Category A – collaboration between bodies for the better delivery of services, sharing of expertise or cost reduction**

3.195 Reference should be made to Chapter 2 where public to public collaboration is addressed in more detail. This section addresses the ‘trading’ elements of such collaboration. Suggested features of Category A activities are:

- no typical size or scope – can be large or small scale;
- no risk transfer out of the public sector;
- can be all or part of a service or function;
- can be marriage of convenience;
- EU procurement rules, unlikely to apply where no contracts for services are involved and the arrangements are of an administrative nature;
- normally structured either informally, through a joint committee and occasionally through a company; and
- tax and financial arrangements are relatively straightforward.

*Size and scope*

3.196 Examples of small scale and localised collaboration can be found extensively. For example, shared internal audit services between district councils. In procurement there has always been collaboration between authorities. A good example of such collaboration is the Yorkshire Purchasing Organisation (‘YPO’). YPO has a current turnover in excess of £500m. Again much of this existing activity stems from the use of Local Authority (Goods and Services) Act 1970 powers and involves local authorities working together for mutual benefit. It will be a matter of degree for local authorities to determine when the extent of their activities means that they need to rely upon the trading power contained in section 95 of the *Local Government Act 2003* and as a consequence need to adhere to the conditions and guidance attached to that power.

It is generally acknowledged that whilst there are many instances of collaboration the extent of joint working between authorities is not extensive. This issue was highlighted in the New Local Government Network’s publication *Crossing the Boundaries 2003*.

*Risk Transfer*

3.197 The activities that are carried out are at the public sector risk. Generally, there is an agreement to share costs in accordance with a formula. Where cost overruns occur, as they have in connection with computer consortia and health/social services joint working, this can create tensions between the parties but inevitably one public sector body or another picks up the cost.

- 3.198 In the relatively few examples that exist where there is joint service delivery risk, accountability can become opaque. For example, where two district councils have a joint refuse collection service, if a freighter injures anyone and there is a claim, as the vehicle is jointly operated then the claim will be against both local authorities. This is also a feature of joint social service and NHS services. Consequently an insurance protocol has been developed to agree how losses and risk is shared.

*Part or all of a function*

- 3.199 Commonly, the level of joint working is confined to part of a function. For example, there is collaboration across a number of county council trading standards services. Each service keeps its own officers but they agree to co-operate in areas of examination and share the results. Some authorities are beginning to combine the whole of the functions activity; there are examples of district councils in particular having a combined housing benefits service. Furthermore, several regional groupings of authorities for the performance of buildings control are being created.
- 3.200 These examples should not be seen as indicating that joint working of this nature is common, it remains the exception. Generally, it is more difficult to partner for the whole of a function rather than part of a function and collaboration also gets increasingly difficult as additional partners are added.

*Can be a marriage of convenience*

- 3.201 Occasionally local authorities work together because it is the only way of making progress. There are examples of two local authorities working together on waste disposal in order to obtain an adequate scale of waste to fuel the joint incinerator they commissioned. DEFRA is seeking to establish a framework of performance measures and incentives to encourage joint working between waste collection and disposal authorities in two tier local government areas.

*EU procurement rules*

- 3.202 Consideration will need to be given by collaborating local authorities to the potential application of the EU procurement rules to their collaboration. There is no express exemption from the EU procurement rules for public to public service provision. The issues which this raises are addressed in Chapter 2<sup>32</sup>.
- 3.203 Chapter 2 sets out the common structures for a public/public consortium. Their characteristics, advantages and disadvantages are summarised and the principal legal and financial issues that apply are identified.

**Category B – trading for the profitable exploitation of assets, skills or location to provide income generation for the benefit of the initiating authority or authorities**

- 3.204 This is not an activity that has been a common feature of local authority activity. Local Act powers exist in some areas allowing trading, for example, Birmingham provided a material testing service for the manufacturers in the

<sup>32</sup> Paragraphs 2.61 onwards.

West Midlands. On a larger scale, examples exist in airport, bus companies and local authority waste companies. In each of these instances, in the mid 1980s and early 1990s local authorities were required as a consequence of legislation to transfer what had been in-house activities to another business or a new limited company. These companies have had variable financial performance but a number have become very successful and some have created large capital receipts for the local authority on disposal of their share interests. For example, local authority shareholders in several airport companies have realised significant proceeds on the sale of a controlling interest in the airport.

3.205 This is where the new trading powers contained in the 2003 Act could have significant impact. New models will continue to emerge. One County Council has formed two companies and there are plans for a third. In the first instance, the wholly owned company has been formed to carry out direct labour activities for the council and joint venture subsidiary companies have been formed with two district councils. By removing unnecessary depots and standardising on best practice significant cost reductions have been achieved. The second company is providing professional property services and is forming strategic alliances with authorities in the north-east and north-west of England. The third company is being formed to offer back office services to other local authorities.

3.206 Suggested features of Category B activities are:

- emerging market but potentially can be large or small scale;
- involves risk taking and unless there is a partner, risk remains with public sector;
- can be all or part of a service or function;
- can allow excellent services to be offered to others;
- EU procurement rules will apply if work is undertaken for a public body;
- will be structured through a company but some scope for using limited liability partnerships for public to public service delivery;
- require good business case, careful tax and financial planning; and
- allow step change in service delivery methodologies.

*Emerging market but potentially can be large*

3.207 Local authorities are encouraged by auditors and legislation to act prudently and with full recognition of risks. Trading of this nature involves making an investment and diverting staff away from delivery of services for the authority into other activities. If losses arise or if service standards are not maintained the local authority is likely to be criticized. For this reason, it is likely that many local authorities will be cautious about using this power and it may be driven forward by a limited number of enthusiasts.



It is probable that growth will come from:

- Direct Service Operations seeking to expand their customer base;
- excellent services wishing to offer their services to others especially those that are poorly performing;
- exploitation of assets or intellectual property rights (the franchising model explained in Chapter 2 is one example of this); and/or
- services being provided where there is a failure in the market place either because of standards or price.

Growth may be held back if there is an absence of vision of how entrepreneurial opportunities could be exploited and the absence of precedent. In some instances, trading could be seen as a threat to existing businesses and may be controversial in some sectors.

***Involves risk taking and unless there is a partner risk remains with the public sector***

- 3.208 The essence of trading is taking risk, investing time and money to make money. Therefore, unless an arbitrage situation exists a local authority will need to spend to make money later. This is why the Trading Guidance states: *'Local authorities will need to be prudent, in particular, about putting Council Tax payers' money at risk. It is for this reason that the Order requires authorities to prepare a detailed business case before embarking on trading under these new powers, and to have the business case approved by the council before trading starts following a full discussion with the auditor. Local authorities remain bound by general administrative law, legal principles such as Wednesbury reasonableness, and fiduciary duties'*.
- 3.209 In some instances local authorities would be wise to consider having a private sector partner on board to help identify and exploit opportunities and take risk. The local authority adopting the partnering approach might receive less of the benefit but in many instances would be able to achieve a win win situation i.e. more focused resource, more income and limited trading risk. For instance, if an LEA has intellectual property in its education service, packaging that IPR and marketing it and seeking financial gain could, assuming the authority had a high enough CPA rating, be sold to other countries, individuals and other public bodies at a profit. It may not have the commercial expertise to do that but a private sector partner might.
- 3.210 Trading requires the identification of something that is saleable. Something that you have access to on a repeat basis at a cost that is competitive. It can be a commodity, it can be a service, and it can be the use of an asset or a combination of a range of things. It requires fresh thinking and a degree of original thought. Organisations that are not used to trading are likely to have a narrow vision on what to do and how to use the freedom to enhance the services on offer. Without an outside catalyst, it is likely that, initially, services offered will be based on support to other authorities and these could be all or part of a service or function.



***Can allow excellent services to be offered to others***

3.211 Within the private sector there is a belief that you always need to grow to improve. Excellence is not self supporting and needs stimulation and refreshment of challenge. Thus, under this hypothesis, excellent services that are provided by one authority should be offered to others.

3.212 This might mean:

- providing mentoring support to the other authority;
- taking over the whole of the support of the other authority;
- designing a how to do it methodology and providing a self help solution; and/or
- providing consultancy services.

Trading differs from collaboration in many ways but often it means responding to the needs of another organisation as they perceive it and not as the provider or seller does. The purchaser drives the transaction and effectively selects from a menu of choices that sellers have made available.

***EU procurement rules will apply if work is undertaken for another public body on a commercial basis***

3.213 If a local authority offers to undertake services on a commercial basis for another public body under the section 95 powers then it will be an economic operator and the purchasing body will be making a procurement decision. Teckal is unlikely to apply (see paragraph 2.68). Consequently, the award of that work to the trading company would, under this interpretation, need to have been dealt with in compliance with the EU procurement rules.

***Will be structured through a company but scope for using limited liability partnerships***

3.214 The power to trade is widely drawn but it is subject to restrictions, principally

- the power must be exercised through a company (within the meaning of Part V of the *Local Government and Housing Act 1989*);
- the trading must be function-related;
- the power cannot be used to provide services to anyone to whom there is a statutory obligation to provide them; and
- any company established for the purposes of carrying out trading under this section, in which a local authority has an interest, shall be subject to the rules about controlled, influenced, regulated and minority interest companies provided by Part V of the *Local Government and Housing Act 1989* and the *Local Authorities (Companies) Order 1995*. Details of the implications of Part V are set out earlier in Chapter 3<sup>33</sup>.

<sup>33</sup> Paragraph 3.37 onwards.

3.215 Definitions of company in Part V include:

- a company limited by shares;
- a company limited by guarantee and not having a share capital;
- an unlimited company; and
- a society registered or deemed to be registered under the Industrial and Provident Societies Act 1965.

3.216 Any of these forms may comprise a company for the purposes of section 95. However, it seems most likely that the company form taken will be a company limited by shares which provides more flexibility to trading companies, particularly with regard to distributions of profit and raising risk capital. The choice will have a fundamental impact on how people are employed, and the skills and numbers required.

3.217 Whilst trading has to be undertaken through a company, as defined above, when undertaken under section 95 powers, this does not apply for other forms of trading using other powers. For example, for larger trading enterprises the optimum arrangement from a fiscal perspective might be a combination of a company and a limited liability partnership. An illustration of such a structure can be found in Part 3 of Chapter 4.

*Require good business case, careful tax and financial planning*

3.218 Trading will need to be carefully assessed and business plans carefully established. The new trading entity will be fully exposed to commercial risks and the business case (the production and approval of a business case is a legal requirement) and its structure should be carefully considered if it is to secure the best arrangements for the authority, the new business, its staff (retained and transferred) and the finances for both organisations.

*Allow step change in service delivery methodologies*

3.219 Over a period of years authorities could specialise in what they do best and get other authorities to provide the services that they are less able to provide. Specialist services could be made available, say, across Europe and service delivery could be totally restructured. But this will require support, imagination and early successes and not significant failures.

**Category C – NHS and local authority joint working**

3.220 If trading were to involve services that were linked to NHS services the powers of joint working between local authorities and the NHS become relevant. NHS bodies generally have fewer freedoms than local authorities to create entities and to trade. However, the Secretary of State for Health does have powers to allow NHS bodies to participate in companies and has exercised this power in connection with Partnerships for Health and the NHS LIFT initiative. Health bodies also have powers to develop income generation

initiatives. We do not intend to develop those issues here. Details relating to the principal arrangements that have been used to facilitate joint social services and health working are set out in section 31 of the *Health Act 1999* ('the 1999 Act') and explained in Chapter 2.<sup>34</sup>

### **Category D – trading partnership with a private sector partner**

3.221 Some authorities may not have the capacity to develop trading as a significant part of their work. As an alternative an authority could choose to procure a partner to develop their trading ability. There are a number of ways this could be achieved including:

- procuring a strategic service partner and require that the partner includes business development within the remit of the partnership;
- appointing a business development partner to focus on developing income streams in defined areas;
- seek a business opportunity review of a range of activities to identify latent IPR with an exclusivity arrangement to have the opportunity to develop any business opportunities;
- if an authority had an exceptional methodology, there might be scope for franchising or concessions;
- if trading were to be based on expanded use of assets a strategic property partnership might be considered.

This arrangement could be structured through a joint venture company, partnering contract, limited liability partnership or outsourcing contract.

### **MODEL OPTIONS FOR TRADING**

3.222 The choice of option will depend on the precise circumstances of the situation and the local authority's performance. A full range of options exists. Options for trading and for services working with other services exist on a single authority or multi-authority basis.

<b>Organisational Involvement</b>	<b>Public Sector</b>	<b>Not-for-profit</b>	<b>Private sector</b>
Public sector consortium	✓	–	–
Joint venture	✓	✓	✓
Partnering contract	✓	✓	✓
Outsourcing	–	✓	✓
Concession or franchise	–	–	✓

<sup>34</sup> Paragraph 2.45 onwards.

Illustrations	
Structure	Description
Public sector consortium (see Chapter 2)	Consortia – where two or more Councils agree to pool resources and expertise, and share (some) functions. Again this can cover one function/service, a set, or the full range of functions and services. Trading can take place with other public sector bodies using the 1970 powers, it could form a company and trade with all comers, or it could form a composite arrangement consisting of a LLP and a company.
Joint Venture Part 1: Companies (See Part 1 Chapter 3)	Trading would be suitable in a joint venture structure whether this is part of a larger strategic partnership or if the arrangements were more specific on identified opportunities. The joint venture is likely to be with a private sector company but it could be with a charity/voluntary body/social enterprise sectors.
Joint Venture Part 2: Limited liability partnership (See Part 3 of Chapter 4)	Trading through a LLP would be suitable for trading with other public bodies where trading was not being carried out under the powers contained in section 95 of the 2003 Act. LLPs have a number of distinct fiscal advantages. A LLP could be a partnership between the authority and a private sector company or with a charity/voluntary body/social enterprise sectors.
Joint Venture Part 3: Not-for-Profit (See Part 2 of Chapter 3)	<p>It is intuitively contradictory to trade through a not for profit entity, however, given the wide definition of trading used there is no reason why Category A activities should not be linked to this type of structure.</p> <p>Where a council or a group of councils provide all or some services as a not-for-profit entity (constituted either as a company limited by guarantee, a charity or an Industrial and Provident Society) it would be able to trade. Trading can take place with other public sector bodies as long as the not-for-profit entity was designed as a public body under the Local Authority (Goods &amp; Services) Act 1970. It could form a company and trade with all comers, or it could form a composite arrangement consisting of a LLP and a company.</p>
Partnering contract (See Part 1 of Chapter 4)	Trading fits comfortably with strategic partnering – where the Council enters into an agreement with one or more private sector organisations to pool (some) resources and expertise, and share responsibility and decision-making to achieve common objectives. Strategic partnerships can be vertical (confined to a service or group of services) and/or horizontal (strategic management, operational management or the delivery of a range of services). The benefits of trading can be achieved either through a gain sharing agreement or with a project profit share.
Outsourcing (See Part 1 of Chapter 5)	Again trading can fit with outsourcing but it is likely that the benefits for the local authority will be limited. Outsourcing Chapter is delivered within a contractual framework by a private sector provider. The Council determines the specifications and retains only a contract management/client role for the services outsourced.
Concession (See Chapter 6)	Concession may be relevant as a model where the local authority wishes to exploit revenues from an asset. This may be a physical asset such as an airport or leisure attraction or intellectual property. There are currently few examples of the use of this model.

# CHAPTER 4

## Partnering Contracts and Legal Partnerships

### Part 1 – Partnering Contracts

#### GENERAL OVERVIEW

- 4.1 A partnering contract is a contract entered into between the local authority and a partner. The partner may be from the private, voluntary or public sector. Although this Chapter primarily addresses a partnering contract with a private sector partner, the principles and models will be equally applicable to a partnering contract with the voluntary or public sector. The partnering contract which builds on the experience and lessons of conventional outsourcing. In other words the nature of the contract envisages a collaborative role between the local authority and private sector partner in relation to the discharge of the private sector partner's obligations under the contract. Many authorities will find the partnering contract their preferred option as it is flexible and is able to provide a basis for a joined up approach without the overheads associated with a joint venture company.
- 4.2 The private sector partner's obligations will necessarily vary from contract to contract depending upon the extent of the support and/or service provision requested by the local authority. Such may be limited, amounting only to strategic advice or management or, alternatively, could be almost largely operational, but falling short of conventional outsourcing (e.g. contract where the private sector provider provides services under a contract without other means of monitoring or involvement of the local authority and/or other stakeholders). Whatever the extent of the service, the form of contract should be performance-based with payment to the private sector service provider being based on the achievement of performance standards and with inadequate performance resulting in deductions from the service fee payable by the local authority.
- 4.3 Following the principles of the Egan Report: *Rethinking Construction (1998)* the partnering contract<sup>35</sup> approach is seen as much less adversarial and more collaborative. Whilst the spirit is not yet there for written contracts to be dispensed with, the partnering contract exhibits certain characteristics which are innovative and include:

<sup>35</sup> The Treasury's Green Book provides a fuller description of a partnering contract.

- a less adversarial approach to contractual 'disputes' preferring a means of resolving disputes through a hierarchy of mediation;
- an ability to re-define the deliverables and costs as circumstances change over time;
- a 'team orientated' approach to contractual delivery;
- a collaborative approach to contract construction with the emphasis on resolving issues by reference to the spirit of commercial intention rather than the 'letter';
- gain and risk sharing; and
- an 'open book' approach to costs and profit.

4.4 Following the Egan Report, standard form partnering contracts have been published for works (for example the NEC Partnering Option, Option X12 produced by the New Engineering Contract Panel of the Institute of Civil Engineers (copies available from the ICE via its website or by ringing 0207 7665 2217). However, this option and the various sub-options are not confined to the narrow meaning of 'partnering contract'.

## **DESCRIPTION**

- 4.5 Whatever the structure of the 'partnership' this option involves the local authority selecting a private or voluntary sector partner to work to improve service delivery and to contribute at the strategic level to the authority.
- 4.6 The local authority will enter into a contract to achieve their objective. The contract may be directly with the private sector service provider or with a 'joint venture' intermediary. Unlike an outsourcing, the local authority (and indeed other stakeholders) will have an involvement in the delivery of the services either through a direct contractual involvement or an indirect monitoring involvement and a strategic relationship arrangement, such as a Strategic Partnership Board.
- 4.7 The contract for the delivery of the services may have provisions similar to those found in an outsourcing contract (such as provisions dealing with assets, employees etc.), but will embrace the principles of paragraph 4.3 above.
- 4.8 The extent of the local authority (and other stakeholders) involvement will depend upon the nature of the partnering structure put in place. A partnering contract may create a joint management arrangement, often called a partnership board.
- 4.9 A partnership board will probably have the following characteristics:
- a formal arrangement usually underpinning an outsourcing or insourcing transaction;

- the local authority and external service provider agree to representation on a partnership board to oversee and give strategic directions to the service(s) involved;
- it will usually meet on a quarterly basis and is often supplemented by a management board (of local authority client officers) acting on a more regular basis;
- a separate partnering agreement (in addition to the traditional service contract) will set down the parties' respective roles, relationships, and objectives and in a way that demonstrates commitment to the partnership.

4.10 The approach to the introduction of services into the partnering contract may be incremental rather than full. An incremental approach involves the local authority and the partner agreeing on a core set of services to be included within the partnering contract. There will then be a mechanism, probably by way of approvals of business cases, enabling the introduction of new services into the partnering contract.

4.11 Certain of the commercial and legal issues associated with a conventional outsourcing may also be relevant to this option.

### **Drivers**

4.12 The potential driver for this sub-option include:

- the local authority and other stakeholders have direct participation in the provision of the services (either through a joint venture company or other arrangement);
- partnering is in its nature more collaborative and less adversarial;
- the structure will involve the private and/or voluntary sector (and may involve other local authorities) and therefore will enable access to skills and other resources of the private sector;
- the private sector partner will gain financial reward by reference to standards of performance; and
- the local authority will gain reassurance in the arrangement from the openness of financial performance evidenced by an open-book approach.

### **Disadvantages**

4.13 The potential disadvantages of this sub-option include:

- the private sector service provider may have concerns over the board structure; and
- the mechanism is more complicated (and therefore potentially more costly) than conventional outsourcing. A management fee structure needs to be developed which adequately rewards success/failure.



### Risk Transfer

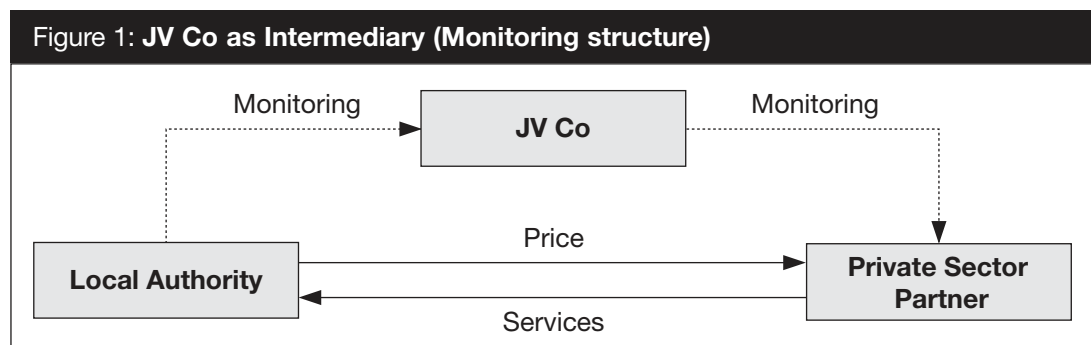
- 4.14 It is in the nature of the contractual arrangement that all risks of costs and performance may be passed ultimately to the private sector service provider. It is accepted practice that risk should be placed with the party best placed to manage that risk. It is a truism to state that risk transfer involves a value for money judgment and if all aspects of risk are transferred regardless of how it can be managed, excessive costs may result.

### LIMITED COMPANIES LINKED TO PARTNERING CONTRACTS

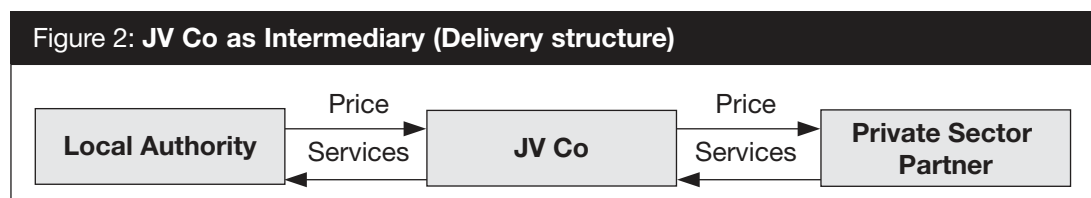
- 4.15 Using a partnering contract does not necessarily mean that a limited company might not be used to provide a separate legal personality to the contract.

### Using a JV Co as an intermediary for a partnering contract

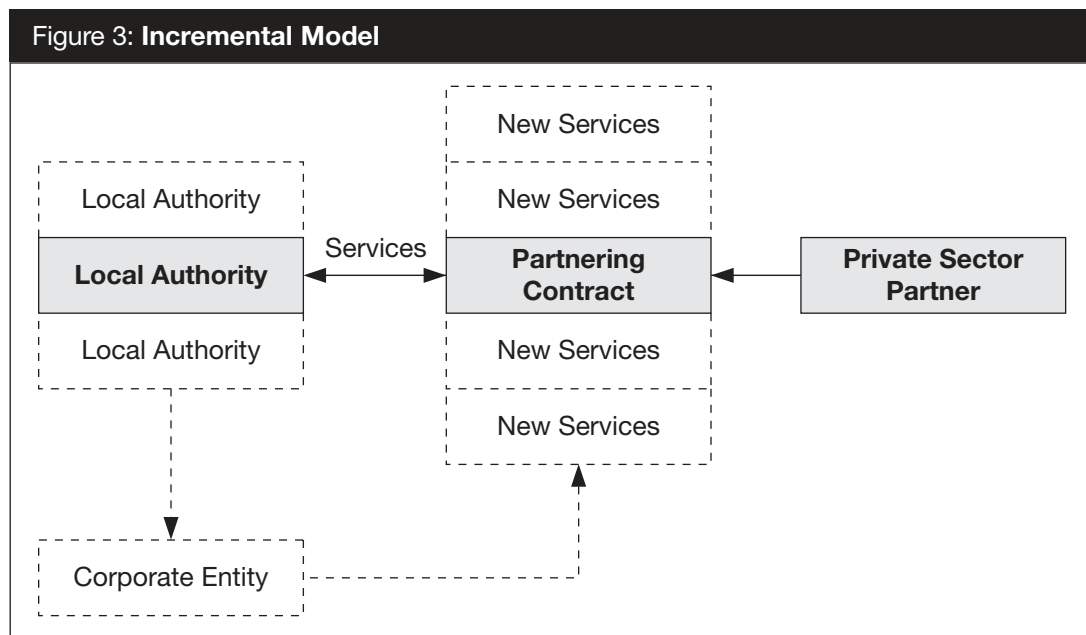
- 4.16 In the first model (see **Figure 1**) the JV Co monitors the performance of the private sector partner which it appoints to perform the services under the Partnering Contract. This structure is not dissimilar to the Partnership Board Structure referred to in paragraph 4.9. This is a structure that should be attractive to the private sector as it will give them control over the operation of activities and create a distance between its activities and the local authority.



- 4.17 In this second model (see **Figure 2**) the JV Co has a direct operating responsibility to the local authority but mitigates that responsibility by subcontracting the whole or substantially whole of the operations to the private sector operation. In this model JV Co will be controlled by the private sector partner. Either the shareholdings in JV Co will be commensurate with levels of investment or alternatively the local authority will take a nominal shareholding where little or no investment is envisaged by the local authority. In either case the shareholders agreement may contain minority protections for the local authority along the lines of those explained in Part 1 of Chapter 3. Many of the considerations raised in Part 1 of Chapter 3 in relation to joint venture companies will be equally applicable to this model.



## INCREMENTAL PARTNERSHIP



### Overview

- 4.18 Incremental partnering (see **Figure 3** for model) offers local authorities step-changes in service provision with low risk and without comprehensive, all-inclusive commitment. One of the greatest risks in the early years of a service delivery partnership is finding that the chosen partner does not live up to expectations, the relationship on both sides which took so long to cement is not developing, partners do not get on as well as originally hoped and, as a consequence, the partnership is unlikely to flourish.
- 4.19 If it is not possible to have a trial period of working together to see if the relationship blossoms, can the relationship be de-risked in any other way? Incremental partnering may be the answer, in some circumstances.
- 4.20 Many service delivery partnerships have been extremely large, complex deals entered into by a few large authorities. A number of these partnerships have been entered into with the private sector on the basis of substantial, long-term all-inclusive contracts. These are substantial contracts involving a public/private partnership whereby the public sector gained investment, business process re-engineering and significant risk transfer.
- 4.21 Undoubtedly, these large contracts have provided benefits for the local authorities who entered into them and other like-minded authorities may seek to follow their example. But for other authorities, the long-term commitment to a single partner for such a large proportion of essential services is seen as high risk. Many recognize the benefits of strategic partnering, but they do not have the confidence that they should go forward with a 'big bang' approach.
- 4.22 Unlike the 'big bang' public/private strategic partnerships, many public/public relationships are incremental. Effectively, these partnerships have adopted a low risk stage-by-stage approach, allowing confidence in the partnerships to be built up before moving to the next level. Can this common sense approach

to relationship building be applied to service delivery partnerships between the public and private sectors? Is it possible to capture the joint partnership benefits that come from a long-term strategic relationship in one that begins with a more limited scope?

- 4.23 Incremental partnering involves working with a partner or partners but without, initially, a long-term commitment to a partnership covering a range of core activities. Instead, it allows the local authority or the consortium of local authorities to build up confidence with a supplier partner or partners to work with them to develop a stage-by-stage approach to process re-engineering of their activities.
- 4.24 An incremental approach has also been followed by the DoH to introduce capital investment into the health and social care sector through the NHS LIFT project. The underlying principle in NHS LIFT is the appointment of a partner to form a joint venture company (LIFT Co) with public sector participants (generally PCTs and local authority(ies)). LIFT Co contracts to deliver identified and priced specimen projects and also to provide services to the public sector participants by way of working up potential new projects against that initial framework. LIFT Co has a period of exclusivity during which, it has the first right of refusal to deliver new projects. All new projects must be market-tested to demonstrate value for money pricing.<sup>36</sup> A similar model has been introduced by DfES (Building Schools for the Future or BSF) for investment in secondary schools.

### **Developing an Incremental Partnership**

- 4.25 In order to secure a service delivery partnership, it is necessary to establish a long-term relationship. The concept of working jointly in a harmonious relationship is common to both the large 'big bang' strategic partnerships and incremental partnerships. The challenge for authorities of incremental partnering is to provide the basis for a long-term commitment without the all-inclusive contracts that characterise some of the big strategic partnerships within local government.
- 4.26 The prerequisite for such an incremental partnering approach will be a comprehensive plan to modernize or process re-engineer a significant number of services. The authority will not need to have developed a detailed list of requirements for those services, but will have established a *prima facie* case for change. The need for the comprehensive plan arises as a consequence of the OJEU advertisement which requires the scope for the potential project to be set out openly and transparently.
- 4.27 A decision by an authority to use the incremental strategic partnering approach will result in the need for the authority to plan as extensively as they would have done for a 'big bang' approach. However, it does allow some of the work anticipated in the ODPM publication *Rethinking Service Delivery – From Vision to Outline Business Case (2003)* to be spread over a longer period. When an element of service is to be considered for inclusion within the partnership, then the planning requirements of the advice should be implemented.

<sup>36</sup> See Chapter 5 for more detail on NHS LIFT and BSF.

4.28 Assuming that all the necessary preparation and soft market testing has been properly carried out, the process might be as follows:

**Step 1** – Advertise comprehensive OJEU notice for contract partner(s).

Indicate the intent to enter into a medium-term contract (7-15 years) with one or more partners to modernise/process re-engineer the specified services. The breadth of the services to be sufficiently all-encompassing to cover all potential services to be included in the contract. OJEU notice to explain the incremental approach and, if a framework contract, as to how the framework arrangements will be implemented. The procedure is likely to be the negotiated or competitive dialogue procedure.



**Step 2** – Evaluate the economic standing, technical capacity and ability of bidders to undertake the project.

Where necessary, use ISOP to reach a shortlist of bidders.



**Step 3** – Produce tender documentation against which bids will be sought from bidders to become the authority's strategic partner(s) or if a framework or multi-contract model are of the authority's framework contractors or potential strategic partner.

The tender documentation will vary depending on the model to be adopted. Where the model is the single contract model, then the tender documentation will contain a detailed specification for the initial services, a payment mechanism and conditions of contract. The initial services will have been selected through a business planning process following this department's Rethinking Service Delivery series of advice.



**Step 4** – Selection of partner, framework contractors or potential strategic partner.

The selection will be undertaken by reference to published objective evaluation criteria.



**Step 5** – In the single contract model and following competitive dialogue or negotiation (depending upon whichever procedure is used), a strategic partner will be appointed and the contract awarded. The contract will include the initial services and a formula or conditions for the identification, working up, pricing and determining value for money and affordability of further packages of services.

In the framework contract or multi-contract model, the framework contractors or potential strategic partners will be appointed and entitled to packages of services by reference to pre-agreed terms and conditions (including price) or entitled to participate in a mini-competition.



**Step 6** – In the single contract model, new packages of services will be brought forward following a business planning process. The contract provisions covering new packages of services will include a sufficiently certain contractual arrangement to identify price and bring the services within the contract.

In a framework contract or multi-contract model, the authority will identify a package of services through a business planning process, work up the package with the framework contractor or potential strategic partner and then either award the contract to a framework contractor or strategic partner on the basis of pre-agreed terms and conditions or make such an appointment following a mini-competition.



**Step 7** – Repeat Step 6 for consecutive packages of work.

## **Advantages/Disadvantages to the Incremental Partnering Approach**

### *Advantages*

Advantages of the incremental partnering approach include:

- allows long-term partnering relationships to be nurtured;
- reduces the risk to the local authority and the provider;
- provides an ongoing incentive for all parties in the relationship to operate well together;
- if two or more partners are appointed, provides a mechanism for assessing the value for money of each batch of work;
- provides a mechanism of performance comparison, keeping each partner alert to potential improvements;
- can allow process re-engineering to take place faster than would otherwise be the case;
- can allow partners with differing skills and strengths to be included within the partnering family;
- may appeal to smaller organisations that do not have the capabilities to take on 'big bang' strategic partnerships; and
- possibly less costly to establish for all parties.

### *Disadvantages*

- may not provide the stimulus to step-change in every area;
- compared to 'big bang' strategic partnering, unlikely to leverage as much external investment and create economic advantage to a region;
- needs ongoing assessment and development of the outline business case by the authority as each phase of work is taken on board;

- may provide more ongoing uncertainty of direction and purpose; and
- the ability to award additional contracts diminishes over the life of the contract: i.e. all packages of work would need to end when the contract terminates.

### **Legal Considerations**

- 4.29 In legal terms, the challenge of incremental partnering is to find a model which is set up for the medium term (7-12 years), where a local authority (or authorities) work with a partner (or partners) to develop a stage-by-stage approach to process re-engineer their activities. The desire is for a model based on a long-term relationship with one or more private sector partners, but differs from the 'big bang' approach used for many of the existing PPP, strategic partnerships.
- 4.30 There are key legal considerations that need to be addressed by those authorities that are contemplating such a model. These are the impact of the EU procurement regime and the need for contractual certainty.
- 4.31 There are three likely models that may be used to categorise incremental partnerships:
- a single contract model;
  - framework agreement (as defined under the EU regime) – this may be single provider or multi-provider; and
  - multi-contract model.
- 4.32 These models are clarified in the section below; and it is acknowledged that other models exist. It is also possible, for example, merely to operate a separate tendering exercise for each package of services, once the needs are determined. Each package could be advertised, specified and negotiated separately, but this is not an incremental partnership.
- 4.33 For simplicity, it is assumed that a single authority is undertaking the contractual arrangement.

#### ***The Single Contract Model***

- 4.34 In this model, a legally binding contract is entered into following a procurement exercise. A single contract is awarded for the whole of the term; however that contract is divided into different phases. The term may be between 7-12 years as required. In order for such a contract not to be a framework agreement, the contractual terms and conditions must be certain at the time the contract is entered into (i.e. it must not be an agreement to agree).
- 4.35 The key disadvantages of this model from the perspective of the authority is that it needs to be clear about its potential total needs over the whole potential period before entering into the contract. From the perspective of the provider, there is a lack of long-term security as the contract is broken up into phases and may end after any phase. NHS LIFT and BSF follow this model.

### *Framework Agreement*

- 4.36 In this model, a single procurement exercise is commenced, but the arrangement takes the form of a framework. Unfortunately the term 'framework' is used to describe a variety of different contractual arrangements and there is little consistency in its use. The term has been applied to such diverse arrangements as approved lists (where there are no agreed contractual terms at the approved list stage) through to the single contract model as described above.
- 4.37 The area is one where the European Commission has felt it necessary to intervene in their use by certain government agencies. The Consolidated Directive<sup>37</sup> defines a 'framework agreement' as follows:
- 'an agreement between one or more contracting authorities and one or more economic operators, the purpose of which is to establish the terms governing contracts to be awarded during a given period, in particular with regard to price and, where appropriate, the quantity envisaged.'
- 4.38 The European Commission therefore envisages that a framework agreement will be based on a set of agreed terms and conditions and one of these is the price or pricing mechanism. Here however, the precise items or quantities are not agreed but are drawn down by the authority as needed. The draw down will be upon the agreed terms and conditions. As well as the contract terms, it also assumes that the prices for different items will also be agreed at the commencement of the agreement; and that these terms and conditions will apply if any order is placed by the authority. This is the type of model that may be familiar in the context of the regular or recurrent purchasing needs for goods (e.g. stationery or IT hardware). Every time the authority wants an item of stationery, it places an order for that stationery (at the pre-agreed price) and the quantity required is delivered. In this model a contract is let, following selection and evaluation, but the quantities are variable and conditional upon the placing of a particular order.
- 4.39 As described, it therefore shares the disadvantage of the single contract model (see section above) in that the authority needs to determine its potential needs over the length of the framework and the providers need to determine their prices or a manner for fixing those prices (e.g. cost plus) for the same period. If deemed a framework, the duration would be limited in time to a four-year period under the Consolidated Directive, (unless there are exceptional circumstances). The actual call off contracts could be longer i.e. a series of 5 year call off contracts could be entered into under a four year framework.
- 4.40 One variant under the Consolidated Directive (Article 32(4)) which was implemented in the UK from 31 January 2006 is a multi-provider model where mini-competitions are undertaken with those providers within the framework (a minimum of three, assuming three suitable providers may be found). This overcomes the pricing disadvantage but leaves the problem that the authority still needs to identify the (potential) totality of the service package it may required when the arrangement is first advertised.

<sup>37</sup> See below.



- 4.41 Even under the previous rules (pre-January 2006), one advantage of a framework model is that the authority is given control over the draw down of each element and the quantities it requires at any time. In a services contract, this model may be suitable for consulting services (e.g. BPR) where the precise volume of those services is not known, but can be priced (e.g. day rates may be agreed in advance).
- 4.42 Before advertising in OJEU, the authority would need to be clear on whether its preferred model was a single provider framework or a multi-provider framework. The former would share some similarities with the single contract model, the latter some with the multi-contract model.<sup>38</sup>

### *The Multi-Contract Model*

- 4.43 The multi-contract model seeks to overcome the disadvantage of the earlier two models, and provide a model where the authority may determine or change its needs for services over a number of years. In addition, the provider may adjust its prices and certain terms in line with market conditions. If this model can be used, it would normally have to be (at least) a dual provider model to preserve value for money comparisons between the partners.
- 4.44 This model assumes that an authority awards a series of different contracts at different times, to one or other of the providers. The nature of the services to be provided (and potentially certain terms) is agreed at the time of letting the contract. Selection of the partner(s) takes place at one stage, but award may take place several years later, but based on a set of core terms and conditions.
- 4.45 If this multi-contract model can be developed under the EU procurement regime and other constraints, it would (if classified as a framework agreement under the Consolidated Directive) only be permitted for a maximum of four years (save in exceptional circumstances). That contract period would include any extensions. Currently there is no express limit on duration, particularly if not classified as a framework, but a similar length is likely to be implied by any court to prevent competition being distorted.

### **An Example that combines these Models**

- 4.46 A local authority (ALA) seeks a strategic relationship with a private sector supplier (APSS) covering a wide range of services, initially ten identified services lines, for a period of up to 15 years.
- 4.47 Although it would be possible to let a contract for all the services, ALA wants to minimise its risk in the partnership by adopting an incremental approach to the relationship. From a period of soft market testing, it would appear that a number of the experienced private sector suppliers together with some potential new market entrants would also value an incremental approach.
- 4.48 It is important to understand the motivation of market suppliers in seeking a service delivery partnership with a local authority, together with the supplier's view of risk management. In order to maximise shareholder value, the private

<sup>38</sup> See further as detailed below on Framework Agreements and the Consolidated Directive.

company wants to optimise three things, size of contracted services, period of relationship and hence total value of the relationship and rate of profitability. It is the third of these requirements that is of greatest importance to the supplier. The disaster scenario for a supplier is to be locked into a large long-term relationship that is only marginally profitable, or worse still loss making, with a client/public authority partner that sees no value in helping to ensure profitability.

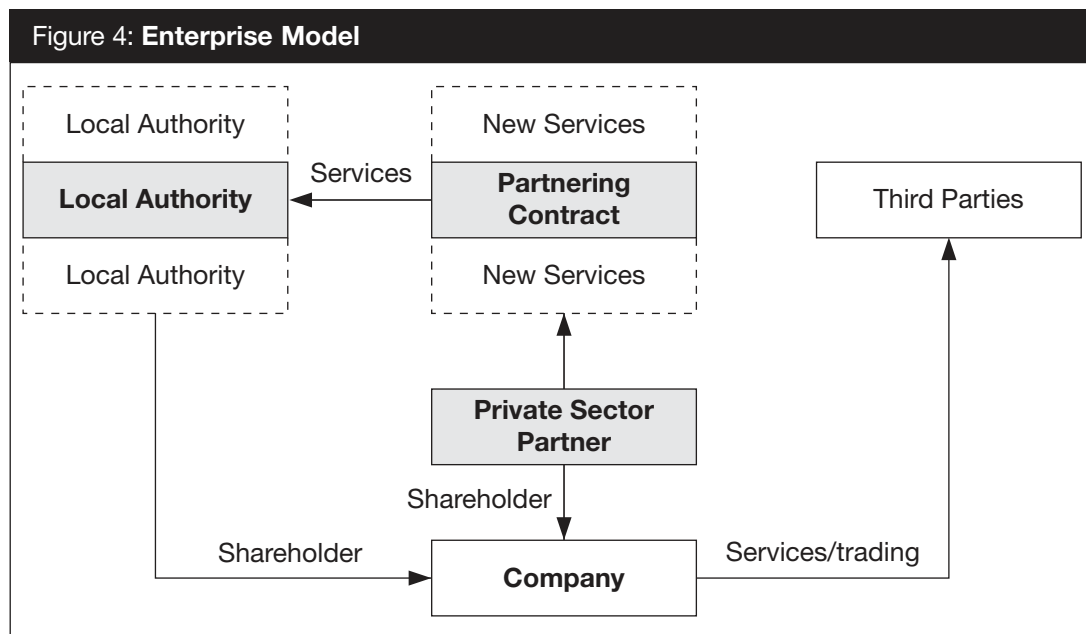
- 4.49 From the local authority standpoint, the strategic relationship will only develop successfully if its private sector partner is able to recognize and accommodate the changing needs of local government without exploiting its contractual position.
- 4.50 In other words, as in any true partnership, there has to be mutual understanding of each partner's needs and a genuine 'give and take' approach to the developing relationship. These subtle parts of the relationship cannot be built into a legal agreement and will only be tested over time. Hence the attraction of an incremental partnership to both sides of the agreement where both sides go into the relationship knowing that it will only grow to its full potential if the real essence of partnership exists between the parties.
- 4.51 So, in the example of ALA that is seeking a ten service line relationship with APSS, the service lines would be grouped into four categories:
1. those that will benefit from simultaneous re-engineering;
  2. those that are project based, e.g. the establishment of a customer contact centre;
  3. those that can be started later in the relationship; and
  4. those that are optional to the relationship.
- 4.52 The procurement process would require comprehensive bids on categories 1 to 3. The chosen supplier would receive contractual certainty for categories 1 and 2. With regard to the services in category 3, it would be recognised by both parties that they would only be implemented if both parties confirmed their commitment at an agreed future date, the price having been agreed through the original bid process. It would be possible for either party to withdraw their agreement to progress the relationship beyond category 2 if they felt the partnership was failing to deliver its strategic objectives.
- 4.53 Category 4 services, which were not specified in detail or priced in the initial procurement, would be put out to tender at the appropriate time, with no certainty of commitment to the initial partner but with a clear advantage to the existing supplier if the partnership relationship was progressing well.
- 4.54 This approach ensures that there is an incentive for both parties in making the relationship work. If either party feels unhappy about developing the partnership, then it can call a halt to the relationship's growth. Risk to both sides from an unsatisfactory partnership is contained and the upside of a good relationship is available.

### New Authorities

- 4.55 The model could also be set up to enable new local authorities (or indeed other public bodies) to join the arrangement as well as (or instead of new services). The process for this through business cases will be the same as for new services. However, as mentioned below, it is important to frame the OJEU sufficiently widely to embrace all of the potential services and local authorities (or other public bodies). Furthermore some of the problems can be alleviated by the use of Central Purchasing Bodies.

### Enterprise Model

- 4.56 The business cases may extend beyond the provision of services to providing services to others (local authorities or indeed other private sector bodies and third parties). Where this occurs the partnering model could be said to have developed into an enterprise model with the local authority making use of its trading powers. See **Figure 4** for model.



## REGULATORY ISSUES

### Powers

- 4.57 There are unlikely to be any issues with regard to powers to enter into their contract. The contract will be covered either by incidental powers possessed by local authorities and/or the confirmatory power in Section 1 of the Local Government (Contracts) Act 1997. If the contract is for a period of five years or more it will be capable of certification under the Local Government (Contracts) Act 1997 and the private sector partner will be able to take advantage of agreed Relevant Discharge Terms.

### Capital Expenditure

- 4.58 Until 2004 it was always contemplated that capital funding for a partnering contract would be through finance raised by the private sector partner. This was due to the constraints which the then controls over borrowing placed on local authorities. However, the prudential framework for capital investment has opened up increased opportunities for local authorities through being

able to access significantly cheaper funding provided such is affordable and prudent. Appendix 1 contains more detail on the prudential framework.

## **EU Procurement Rules**

### ***Negotiated Procedure***<sup>39</sup>

- 4.59 Thus far local authorities have tended to use the negotiated procedure for partnering contracts. The negotiated procedure is the procedure where the local authority negotiates the terms of the contract with one or more tenderers of its choice. Local authorities have historically justified the use of this procedure on the grounds of one or more of the ‘exceptional cases’.<sup>40</sup> It has sometimes been difficult to bring partnering contracts (or other PPP contracts) within one of these ‘exceptional cases’. As a consequence the Consolidated Directive contains another procedure for complex contracts, the competitive dialogue procedure.

### ***Consolidated Directive***

- 4.60 The need for a simplified legal framework adapted to modern procurement methods and best practice culminated in the publication of the new public procurement directive in the Official Journal of the European Union (OJEU) on 30 April 2004. The relevant directive which applies to works, supplies and services procured by, amongst others, local authorities is Directive 2004/18/EC of the European Parliament and the Council of 31 March 2004 on the Coordination of Procedures for the award of Public Works Contracts, Public Supply Contracts and Public Service Contracts (the Consolidated Directive) (OJ L34, 30/04/2004 P114). Provisions of the new Directive were transposed into UK legislation on 31 January 2006 by Regulations made under section 2 (2) of the European Commissions Act 1972 (the Public Contracts Regulations 2006).

### ***Competitive Dialogue Procedure***<sup>41</sup>

- 4.61 Many of the parties consulted before the adoption of the Consolidated Directive made the point that the procurement of complex arrangements was facilitated by the input of tenderers during the procurement process and that this was not always possible under the existing public procurement directives. In fact, the point was frequently made that the existing procedures and, in particular, the restrictive conditions under which the competitive negotiated procedure was available actively discouraged use of the PPP model and, in some cases at least, led to the rules being ignored. The new procedure, the ‘competitive dialogue’, was introduced into the Consolidated Directive to respond to these concerns.
- 4.62 The competitive dialogue does not replace any of the existing procedures (i.e. the open, restricted and negotiated procedures), but is an additional procedure which will be available to contracting authorities for the procurement of ‘particularly complex contracts’ where use of the open or restricted procedure will not allow the award of the contract. The Consolidated Directive considers a contract to be ‘particularly complex’ where the contracting authority:

39 More detail on the application of the EU procurement rules generally can be found in the ODPM Publication *Rethinking Service Delivery From OBC to Contract Signing*. The OGC website also contains guidance.

40 See Article 30 of the Consolidated Directive or Regulation 13 of the Public Contracts Regulations 2006.

41 See Article 29 of the Consolidated Directive or Regulation 18 of the Public Contracts Regulations 2006.

- is not objectively able to define the technical means capable of satisfying its needs or objectives; and/or
- is not objectively able to specify the legal and/or financial make-up of a project.

4.63 A recital to the Consolidated Directive provides some examples as to when use of the competitive dialogue may be appropriate. These include:

- the implementation of important integrated transport infrastructure projects;
- large computer networks; or
- projects involving complex and structured financing.

Competitive dialogue can be used with the most economically advantageous award criteria and this must be stated in the contract notice or accompanying descriptive document. The local authorities' needs must also be stated in one of these documents. The potential to use the competitive dialogue procedure should be considered before use of the negotiated procedure with prior publication of a contract notice.

4.64 In the case of particularly complex contracts, local authorities may be well aware of their needs but not know in advance what is the best technical, legal or financial solution for satisfying those needs. The authorities may also want to allow innovative solutions or may be unable, objectively, to assess what the market has on offer. A competitive dialogue procedure between local authorities and suppliers is therefore necessary to identify the solution or solutions that best meet their needs.

4.65 The procedure for the competitive dialogue can be divided into three parts: the selection phase, the dialogue phase and the award phase. The specific procedural rules governing these phases are set out in the Consolidated Directive and are as follows:

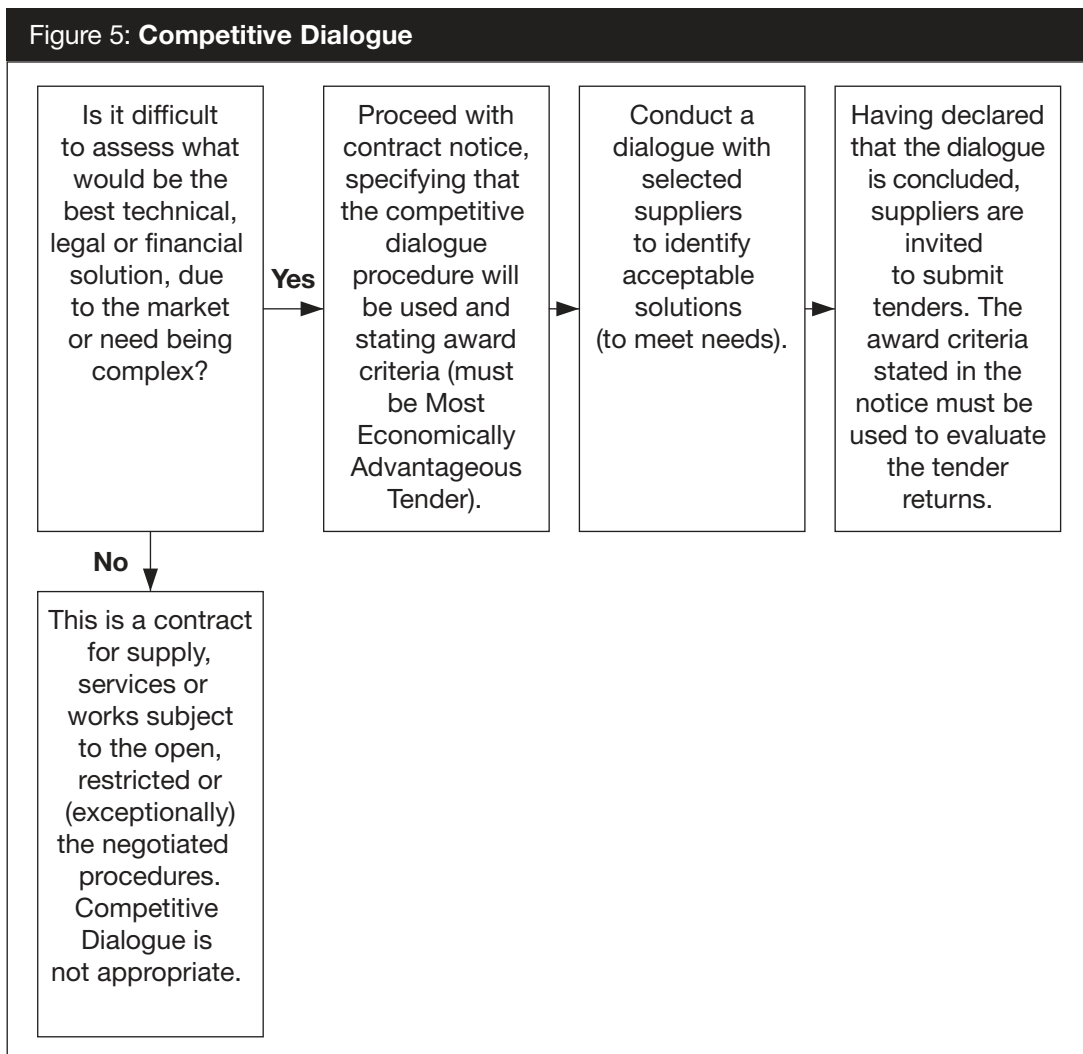
- the contracting authority publishes a contract notice and sets out its needs and requirements in that notice and/or in an additional 'descriptive document' obtainable from the contracting authority;
- following a selection (pre-qualification) process in accordance with the normal rules on selection, the contracting authority must select at least three candidates to participate in its dialogue. If there are not enough candidates meeting the contracting authority's selection criteria, the contracting authority may proceed by inviting only those candidates with the required capabilities to join in the dialogue. In any event, the number of candidates invited to participate in the dialogue must be sufficient so as to ensure genuine competition;
- the contracting authority then opens the dialogue with the selected candidates with the aim of identifying and defining the means best suited to satisfying its needs. During the dialogue the contracting authority can discuss 'all aspects of the contract' with the participants;

- two particular obligations are imposed on the contracting authority by the Consolidated Directive in respect of its conduct of the dialogue. First, during the dialogue the contracting authority must ensure that it treats candidates equally and in particular, that it does not provide information to candidates in a discriminatory manner, giving one or more candidates an advantage over the others. Secondly, the contracting authority may not disclose proposed solutions or confidential information provided by a candidate taking part in the dialogue without that candidate's agreement;
- the procedure may take place in successive stages with the number of solutions and participants reduced as the dialogue progresses. Any reduction of participants during the dialogue must be made with reference to the pre-determined award criteria. An iterative process is already common place in the procurement of projects. However, the contracting authority must specify in the contract notice or the descriptive document that it intends to reduce the field in this way. A similar obligation is introduced by the Directive in respect of the competitive negotiated procedure;
- the dialogue continues until the contracting authority is able to identify the solution or solutions capable of meeting its requirements;
- the contracting authority then declares the dialogue concluded and requests participants to submit final tenders. The tenders of individual participants will be based on the outcome of their individual negotiations with the contracting authority and should contain 'all the elements required and necessary for the performance of the project';
- tenders will be assessed on the basis of the pre-stated award criteria and must be awarded to the most economically advantageous tender. Again, the participant who has submitted the best tender may be asked 'to clarify aspects of the tender or confirm commitments contained in the tender, provided this does not have the effect of modifying substantial aspects of the tender or of the call for tender and does not risk distorting competition or causing discrimination'.
- the contracting authority can require participants to clarify, specify and fine-tune their tenders. However, none of this can have the effect of changing the basic features of the tender or the call for tender, because this would be likely to distort competition or have a discrimination effect;
- the key point is that there is an absence of post tender negotiations which is the route traditionally favoured by the competitive negotiated procedure.

4.66 Authorities may (but are not compelled to) specify payments to participants in the dialogue. It is for the purchaser to determine whether payment is appropriate and, if so, how much on a case by case basis.

4.67 Rules governing the competitive dialogue procedure are illustrated in **Figure 5**.





- 4.68 Many of the basic provisions in the Consolidated Directive remain the same as in the previous Directives. However new provisions have been added to take into account modern procurement methods and developments in best practice. These include explicit provisions on Framework agreements.
- 4.69 The Consolidated Directive seeks to clarify the extent to which social and environmental issues can be considered. In essence, the Commission's interpretative communications of 2001 concerning environmental and social issues have been reflected in the Consolidated Directive along with more recent and relevant European Court of Justice case law.

#### *Framework Agreements*<sup>42</sup>

- 4.70 Framework agreements are used in the case of repetitive purchases to choose suppliers who, when the time comes, will be able to meet the purchaser's needs. Frameworks may be used in conjunction with any procedure. Framework agreements may be relevant for the procurement of Partnering Contracts depending on the structure adopted. Incremental partnerships in particular can either be structured as a framework contract or framework agreement. To be structured as the former, the terms of the contract must be sufficiently

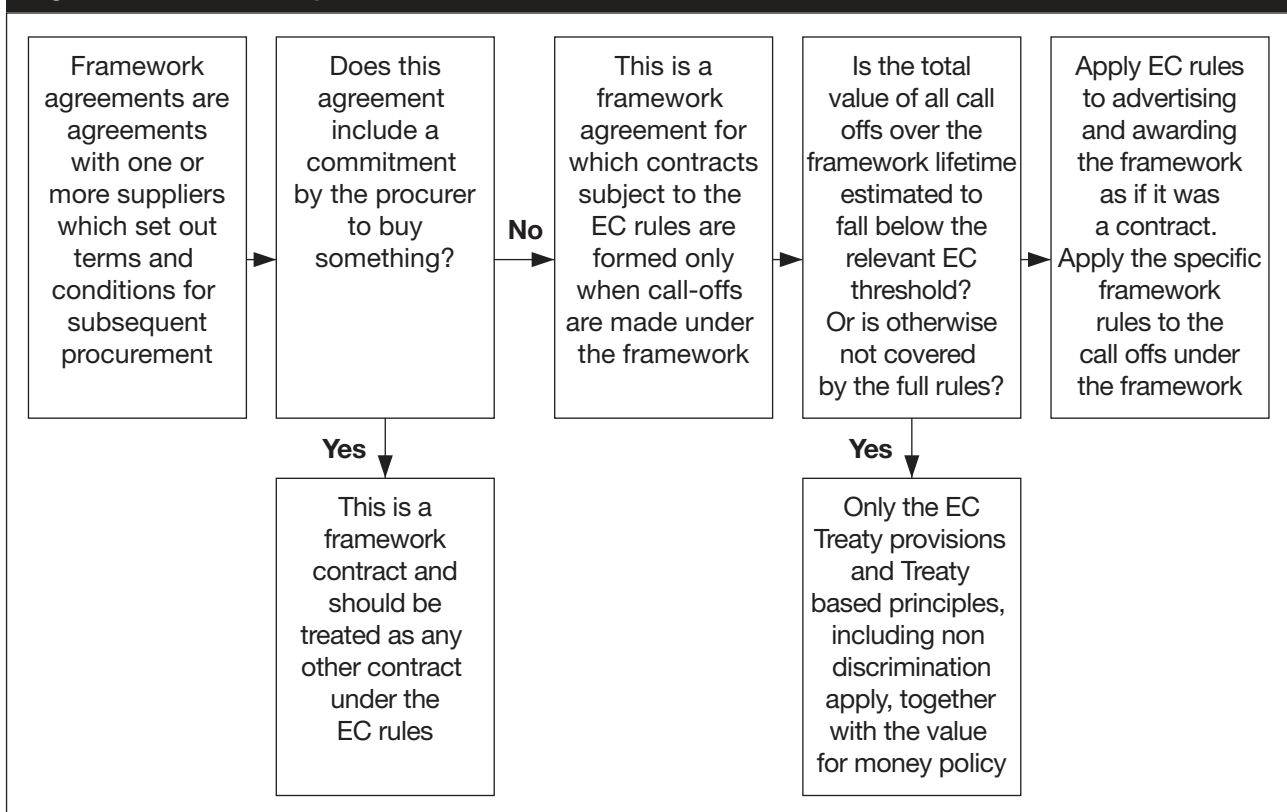
<sup>42</sup> See Article 32 of the Consolidated Directive.



certain for there to be a binding contract. In other words, the procedure for production of business cases must be sufficiently mechanical on formulae to be a binding contract and enforceable.

- 4.71 Framework agreements in the context of the Consolidated Directive are agreements to agree. They set out terms applicable to contracts formed at the call off stage. If the framework establishes rights and obligations by, for example, guaranteeing a volume of work to a supplier, it is not a framework agreement as defined by the Consolidated Directive. In respect of Partnering Contracts, where there is insufficient certainty over the terms and conditions and the arrangement is merely a 'call down', then such will be a framework agreement.
- 4.72 Provision for framework agreements in the Consolidated Directive is very similar to established UK practice but there are some important differences. Framework duration is limited to four years unless, exceptionally, a longer term can be justified, in particular, by the subject matter of the framework agreement. The contract notice must state the planned duration of the framework. Where there is only one framework supplier, work may be awarded directly provided the terms of the framework agreement are applicable.
- 4.73 Where a single appointment has not been made, the minimum number of framework providers is three or the number passing the selection criteria if less than three. The original framework terms and conditions can be used to award work if sufficiently specific. Where there is a need to refine or supplement however, a further mini competition will be necessary involving all those companies on the framework who are capable of providing the goods or services.
- 4.74 Those capable of supplying must be consulted in writing. Bid periods must be reasonable, taking account of the particular circumstances and the award must be based on the criteria used in setting up the framework agreement. Call offs can extend beyond the life of the framework agreement subject to a test of reasonableness. For example, the duration of such call offs should be consistent with the trend established throughout the life of the framework.
- 4.75 Rules governing frameworks are illustrated in **Figure 6**. Guidance on framework agreements is available at the OGC website: <http://www.ogc.gov.uk>

Figure 6: Framework Agreements



### *Specifying Sustainability Requirements*

- 4.76 Relevant environmental and social requirements may be specified in selecting a partner for a partnering contract, but must be defined sufficiently precisely to allow bidders to understand the requirement and to allow award of the contract. Production process standards and eco label criteria can be referenced but alternatives which demonstrate equivalence must be considered. The Consolidated Directive enables environmental and social conditions relating to the performance of the contract to be specified provided they are compatible with Community Law.

### *Sheltered Workshops*

- 4.77 When identified in the contract notice, relevant provisions in contracts may be limited to sheltered workshops, employing mostly disabled people unable to gain normal employment. It will be necessary to ensure that any amended description covers relevant organisations in other Member States to avoid discrimination against them.

## **COMMERCIAL AND LEGAL ISSUES**

- 4.78 The Partnering Contract will need to address similar commercial issues to those commonly found in an outsourcing contract (see Chapter 5 paragraph 5.27 onwards).

4.79 The following are the principal commercial risk issues where the model introduces JV Co as an intermediary:

- the structure enables the JV Co to manage its risk effectively. Whatever obligations it enters can be passed directly onto the private sector partner.
- it is unlikely that the JV Co will have significant levels of profit or loss and the structure will lead itself to managing this outcome.
- there are not likely to be any insurmountable corporation tax or VAT issues, but each situation needs review.
- the JV Co might have few direct costs other than those needed to manage the contract and the Board. It might wish to look to outsource them, or look to the local authority to provide its basic operational needs.
- the reward mechanisms would involve:
  - service payments from the local authority to the JV Co; and
  - service payments from JV Co to the private sector provider.

(If there were to be a three-party contract the local authority could pay the private sector provider directly).

- the elements of the service payments would include:
  - standing elements for performance of tasks;
  - incentive/penalty payments to address key performance targets;
  - incentive/penalty payments would be mirrored in the contracts between the local authority/JV Co and JV Co/private sector partner; and
  - risks of financial stress owing to mismatch seem unlikely.

A fixed payment might be made to the JV Co each month effecting the payment to the private sector provider. The private sector provider might provide a statement of performance to the JV Co which, after validation, would then be sent to the local authority, who then refund the JV Co. This process might continue each month throughout the contract.

4.80 The implications for local authority employees as a consequence of the partnering arrangements are:

- employees presently employed by the local authority would be transferred under TUPE to the private sector provider or seconded or potentially given the right to choose between these two options (further reference to employee issues can be found in the ODPM Publication *Employment and Partnerships – Technical Notes* (ODPM 2003 updated by DCLG 2006);

- the private sector provider would need to abide by the Workforce Code of Practice (3/2003) and the Cabinet Office code (2005) and enable the authority to comply with its obligations under Best Value;
- the ability to retain existing pension rights will be dependent upon whether the local authority is willing to support a proposal whereby a private sector provider can put forward a broadly comparable pension scheme or whether the option of continued membership of the local government pension scheme is a condition of the contractual arrangements. In this instance, the private sector provider will have needed to have arranged for a bond to be put in place in respect of its commitment to the pension fund or for cash resources for the same amount to be put aside. In some instances, local authorities themselves have provided the bond;
- if the JV Co intermediary model is employed comparatively few employees will be directly employed by JV Co.

### **Documentation**

4.81 Documents required for this sub-option are:

- Partnering Contract between local authority and partner (or JV Co where appropriate)
- Memorandum and Articles of Association (local authority and private sector provider – where there is an intermediary company or a trading company);
- Shareholders' Agreement (local authority and private sector provider – where there is an intermediary company or a trading company);
- Sub-contract (JV Co and private sector provider – where there is an intermediary or a trading company);
- Terms of reference of Partnership Board (where appropriate).

## Part 2 – Legal Partnerships

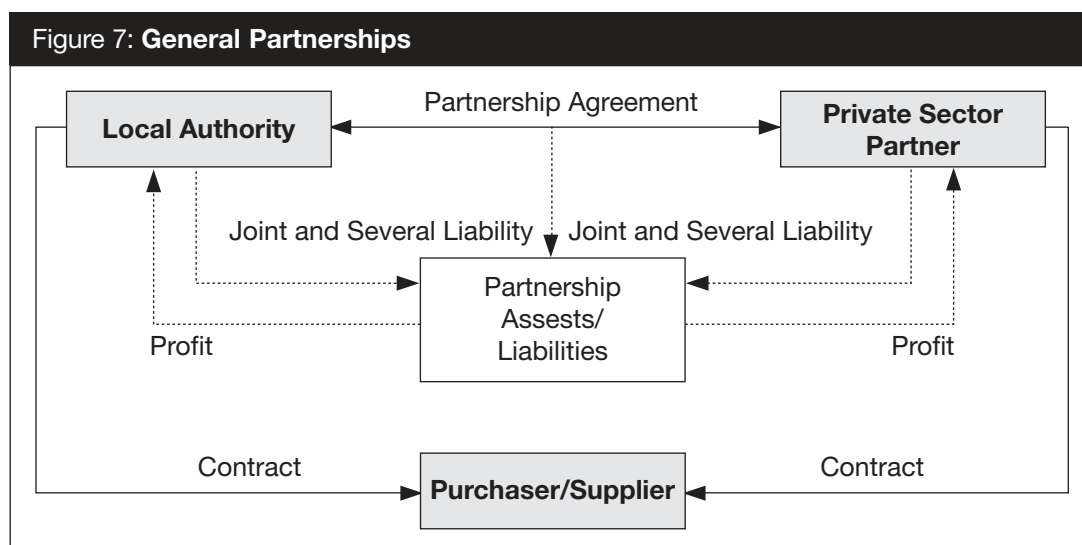
### OVERVIEW

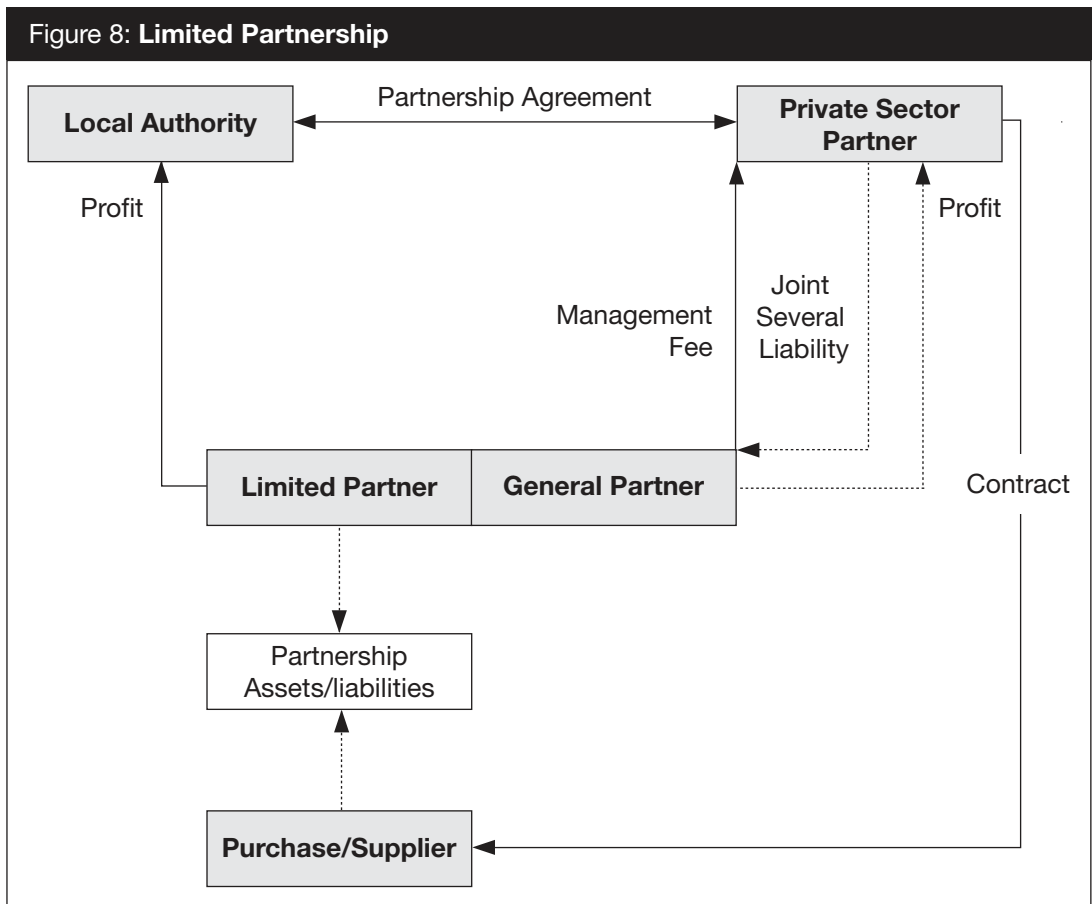
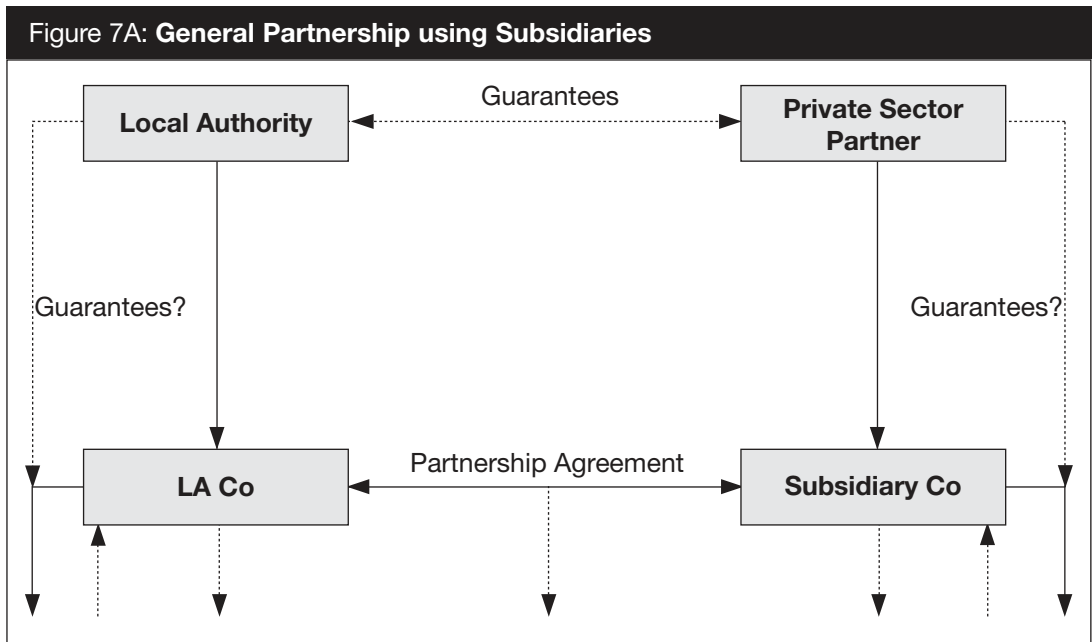
- 4.82 ‘Partnerships’ here mean legal partnerships rather than the more general relationship (contractual or otherwise) in the nature of a ‘collaboration’ to achieve common goals or objectives as in the more general use of the term, such as in ‘Service Delivery Partnerships’.
- 4.83 A partnership is defined as ‘the relationship which subsists between persons carrying on a business in common with a view to profit’. It is not a legal entity in itself (but see limited liability partnerships). The basic rules of partnership law provide that the partners share directly in the profits or losses of the common business in the proportions in which they put up the capital (or in whatever other proportions they agree between themselves). The actions of each partner, in relation to the common business, bind each of the other partners and each partner has unlimited liability for debts and obligations of the partnership incurred, while he is a partner. Legal partnerships are regulated by the Partnerships Act 1890.
- 4.84 Whilst the Partnerships Act 1890 regulates unlimited partnerships, the Limited Partnership Act 1907 permits limited partnerships in certain circumstances (limited partnerships should be distinguished from Limited Liability Partnerships formed under the Limited Liability Partnership Act 2000). Limited partnerships permit the existence of a limited partner(s) (a sleeping partner) provided such do not participate in the management of the partnership and provided the management is undertaken by a general partner with unlimited liability. For tax reasons limited partnerships have become a favoured investment vehicle. Such are ‘tax transparent’. The tax liability falls on the partners by reference to their share of the partnership profits, hence the attraction for local authorities.
- 4.85 Until recently, it was a widely held view that local authorities may not have powers to enter into legal partnerships because of:
- the lack of an express power to do so;
  - the suggestion that ‘profit’ must necessarily involve ‘trading’; and
  - the likelihood that a local authority would be acting unreasonably by assuming joint liability for a partner’s actions.

That said, whilst general partnerships may be hard to justify, local authorities have made the occasional use of a limited partnership under the Limited Partnership Act 1907 (principally for investment in economic regeneration schemes) and the corporate framework for limited liability partnerships (as set out in the Limited Liability Partnership Act 2000) may be attractive for some projects (other than where trading powers under section 95 of the 2003 Act are being used). A legal partnership is an arrangement where two or more persons come together to fulfil a business arrangement with a view to profit. Consequently, there will be many ‘partnership’ arrangements that

local government may consider that will not satisfy that fundamental condition. Local authorities will need to take their own advice as to whether each situation before them is such as to allow the legal partnership option to be considered.

- 4.86 Whilst being much simpler and flexible in structure, for reasons of uncertainty over powers and unlimited liability, general partnerships are unlikely to be attractive vehicles for local authority strategic partnerships. If a local authority were to contemplate a partnership then it is likely that such would be undertaken through a wholly-owned special purpose company to enable 'ring fencing' of potential liabilities, were such to be commercially achievable without guarantees being given in respect of its subsidiary company by the local authority.
- 4.87 Although the limited liability may be superficially attractive, the 'sleeping partner' role of the limited partner is likely to be less attractive (other than perhaps where the local authority is investing say in economic regeneration). Although the local authority should be able to have its influence in such a model as a member or shareholder of the company formed to be the general partner.
- 4.88 **Figure 7** illustrates general partnership, **Figure 7A** a general partnership using subsidiaries (highlighting the issue of guarantees from the 'parent' which will underpin the structure) and **Figure 8** a limited partnership.





**DESCRIPTION**

4.89 A true partnership between a local authority and a third party would arise where they agree to carry on a business with a view to profit, for example, where a local authority agrees with the third party to exploit an income-producing asset. In which case both the local authority and the third party



would share the profits from the venture (equally unless otherwise agreed) but also the losses. Each of the partners would also suffer unlimited liability for the venture such that if any of the partners failed to discharge any liabilities to third parties, then the other(s) will be responsible for the whole. There is no obligation on a creditor to pursue either or both partners; it is a matter for the creditor which he pursues and for the contributing partner to recover from the other(s). As a local authority will not have limited liability and will have joint and several liability, legal advice must be taken before contemplating a general partnership.

- 4.90 Limited partnerships are identical to general partnerships except that such may have one or more limited partners (i.e. a partner(s) with limited liability). However, limited partners must not participate in the management of the partnership, that being the responsibility of the general partner who, as a consequence, will have unlimited liability. However, this is often mitigated by using a limited company as the general partner.
- 4.91 As partnerships generally have tax advantages (partnerships are 'tax transparent' in that the partners rather than the partnership are taxed – compare that with a company where the company is liable to corporation tax and the shareholder to corporation/income tax). Limited partnerships have recently become the preferential vehicle for investment funds. The fund manager will act as the general partner with the investor(s) as the limited partner(s). It is understood that one or two local authorities have adopted such structures to manage investment funds (using the then economic development powers) but they have been used little, if at all, elsewhere.

### **Drivers**

- 4.92 The potential drivers for partnerships include:
- relatively simple formation procedures. No formal requirements, although a written partnership agreement between the partners is desirable; no other constitutional documents required and there are no registration requirements.
  - management is by agreement and flexible arrangements can be set out in the partnership agreement. There are no formal 'boards' or other management structure as in a company.
  - the partnership can be simply dissolved by agreement with reserves and assets being distributed in accordance with the partnership agreement and if applicable, with creditors looking to all partners to satisfy outstanding liabilities.
  - profits can be distributed by agreement.
  - there are little or no formalities to be complied with during the existence of the partnership, e.g. there are no requirements to prepare and file accounts.
  - the formation, management and administration of a partnership incurs little cost.

- tax efficiency, in that partnerships are tax transparent, i.e. tax liability falls on the partners and not on the ‘partnership’ (i.e. the local authority partner is taxed and remains in the tax position of a local authority).
- limited liability for the limited partner in a limited partnership and for all partners in a limited liability partnership.

### **Disadvantages**

4.93 The principal disadvantages for partnerships arise out of their unincorporated nature (save obviously in the case of corporate limited liability partnerships – see below paragraph 4.100):

- the unlimited liability occurring to each partner (other than to the limited partner in a limited partnership and each partner in a limited liability partnership);
- the absence of an entity to enter into contracts, raise finance, grant security, etc;
- anything done (purchase, sale, borrowing) has to be done either through one or all of the partners;
- interests in a partnership are not easily transferred (when compared to shares in a company for example);
- the partnership is unable to grant a floating charge over its assets as security to facilitate borrowing;
- relevant activities of the partnership will be ‘on balance sheet’ of the partnership; and
- the local authority is not able to use a partnership to raise finance ‘off balance sheet’.

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

4.94 The power to enter into partnerships can be found in Section 2 of the Local Government Act 2000, assuming the purpose for entering to the partnership is either for the social, economic or environmental well being of the local authority’s inhabitants.

4.95 As a partnership is not a legal entity, any capital expenditure will have to be undertaken by one or more of the partners. It is ‘transparent’ for the purposes of the local authority capital finance rules and therefore the issue for the local authority partner will be the extent to which it may have promised financial assistance. Until 2004 it was always contemplated that capital funding for a partnership would be through finance raised by the private sector partner. This was due to the constraints which the then controls over borrowing placed on local authorities. However, the prudential framework for capital investment has opened up increased opportunities for local authorities through being

able to access significantly cheaper funding provided such is affordable and prudent. Appendix 1 contains more detail on the prudential framework.

### **Commercial and Legal Issues**

4.96 The local authorities will need to address the following strategic issues in a written partnership agreement with the private sector partner:

- the duration of the partnership;
- the purpose of the partnership and the business plan;
- each partner's respective contributions to the partnership and whether any extra funding will be required and if so, will this be raised by all partners or particular partners;
- the apportionment of profit and losses between the partners and the extent of reserves to be accumulated;
- the extent of each partner's authority to bind the partnership to third parties;
- the internal management arrangements for the partnership;
- the significant decisions which will require unanimity;
- arrangements in the case of deadlock between partners;
- grounds for expulsion of partners from the partnership and compensation provisions;
- exit strategies for the partners; and
- grounds for dissolution of partnership.

### **Documentation**

4.97 The principal documentation required for a partnership is the partnership agreement. The partnership agreement is capable of covering the whole of the relationship between the partners due to the simplicity of the legal structure of the partnership.

4.98 The activities of the partnership require other ancillary documentation such as a development agreement and lease(s) where for example the partnership involves the development of land and/or buildings.

### **Risk Transfer**

4.99 As partners do not possess limited liability there are certain to be risks retained by the local authority. The liabilities of a partnership are joint and several. This means that local authorities could become liable for debts over and above those specific to the local authority's own activities. These can be mitigated by forming a subsidiary company to be the partner although commercial reality might cause doubt to be raised whether the other partner and/or third partner would accept such a limitation without seeking guarantees.

## Part 3 – Limited Liability Partnerships

### OVERVIEW

- 4.100 The Limited Liability Partnership Act 2000 ('the 2000 Act') introduced a new form of corporate business association, namely the Limited Liability Partnership ('LLP') heralded by DTI as 'the first fundamental innovation in corporate design in the 20th century' in adding to 'the choice of legal organisations available to businesses in Great Britain'. The LLP creates a hybrid model, drawing upon the flexibility of the traditional partnership and the safeguards of limited liability.
- 4.101 In particular, the 2000 Act seeks to forge together the three general principles of company and partnership law and practice, limited liability, corporate personality and partnership flexibility.

### DESCRIPTION

- 4.102 The LLP is a partnership in that there still must be a 'relationship which subsists between persons carrying on a business in common with a view to profit'. An LLP therefore cannot be used for non-profit making activities although in theory it could be used as a non-profit distributing organization. Therefore it will be difficult to justify the use of an LLP for pure public/public collaboration where there is no element of trading.
- 4.103 The principal characteristics of an LLP are:
- **limited liability:** since creditors will only have access to the assets of the business, financial and other information must be filed regularly on the public record by analogy with the information filed by limited liability companies in the UK.
  - **corporate personality:** unlike general or even limited partnerships the LLP is a body corporate in its own right and will carry on for its own account the relevant business or professional practice. Its members have no personal liability for the acts of the LLP except as provided by the Act and the Regulations passed under it. Members may have personal liability in circumstances where, under the general law, they have been in breach of duties owed on their own account to customers or clients of the LLP (and also in the same way as they would be for companies, e.g. insolvent trading). The LLP can therefore contract, sue and be sued, borrow and give security for borrowing.
  - **partnership flexibility:** the members of an LLP will generally be free to organise their business on any basis which they agree amongst themselves, subject to the provisions at section 7 of the Act which apply in default of an agreement between the members. LLPs are not required to publish the detail of their internal arrangements (unlike companies where the Articles of Association must be filed with the Registrar of Companies and are open to public inspection). However, as with a company, the Accounts

must be audited and sent to the Registrar of Companies under the Companies Act 1985. The LLP is also largely subject to the same insolvency regime as companies.

The 2000 Act is relatively short, allowing for much detail relating to LLPs to be set out in regulations.

4.104 The 2000 Act provides that for a limited liability partnership to be incorporated:

- there must be two or more persons (which may include local authorities) who intend to carry on business for profit and become members of the LLP on incorporation. At least two of these members must be ‘designated members’ responsible for various things including informing the registrar of changes to details of members, keeping accounting records and signing accounts;
- none of them must be a person who is not eligible to be a member of a LLP (Part III of the Limited Liability Partnership Regulations 2001 applies the Company Directors Disqualification Act 1986 and the Companies Act 1985 to LLPs);
- they must have signed an incorporation document which complies with regulations; and
- the incorporation document and a statement, in a form approved by the Registrar for Companies, signed by either a solicitor engaged in the formation of a limited liability partnership or a subscriber to the incorporation document.

4.105 Under the 2000 Act, any legal person may be a member of an LLP and, in theory, may be available as an alternative structure for public/private joint ventures involving local authorities. A local authority is eligible to be party to a LLP as mentioned above and has the necessary powers to utilise this partnership vehicle.

### **Drivers and Advantages**

4.106 The potential drivers for this sub-option are the same as for partnerships generally (save that the formation, filing and accounts requirements are similar to companies), with the following additional points:

- limited liability for the partners;
- corporate personality; and
- fiscal advantages in that the partners, as opposed to the entity are taxed (giving distinct fiscal benefits to the local authority partner)

### **Disadvantages**

4.107 The principal disadvantages for partnerships largely stem from the absence of limited liability and corporate personality. Therefore the disadvantages are largely inapplicable to the LLP (save perhaps for the relative lack of ease in transferring membership in an LLP when compared to shares in a company).

However, there are certain inherent difficulties with LLPs as follows:

- the formalities associated with forming an LLP, filing of documentation and the preparation of accounts are similar to companies;
- LLPs are therefore relatively more costly to form and operate than general partnerships but less so than companies;
- they are a comparatively new vehicle for public/private joint ventures and there is little practical experience;
- they raise the same member/officer conflict of interest issues as companies that is, interests of LLP against interests of the local authority; and
- they are not available for authorities to use directly as a vehicle for the exercise of Section 95 of the Local Government Act 2003 trading powers (but see Figure 9).

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

- 4.108 LLPs raise the same regulatory issues as general partnerships. However, currently they are outside the remit of Part 5 of the Local Government and Housing Act 1989 (although the current impact of such is really only the propriety rules). Until 2004 it was always contemplated that capital funding for a LLP would be through finance raised by the LLP or the private sector partner. This was due to the constraints which the then controls over borrowing placed on local authorities. However, the Prudential Framework for capital investment has opened up increased opportunities for local authorities through being able to access significantly cheaper funding provided such is affordable and prudent. Appendix 1 contains more detail on the Prudential Framework.

### **Commercial and Legal Issues**

- 4.109 The commercial and legal issues for an LLP are largely the same as for general partnerships and in addition certain joint venture (as opposed to company constitutional) issues in Part 1 of Chapter 3 may also be relevant.

### **Documentation**

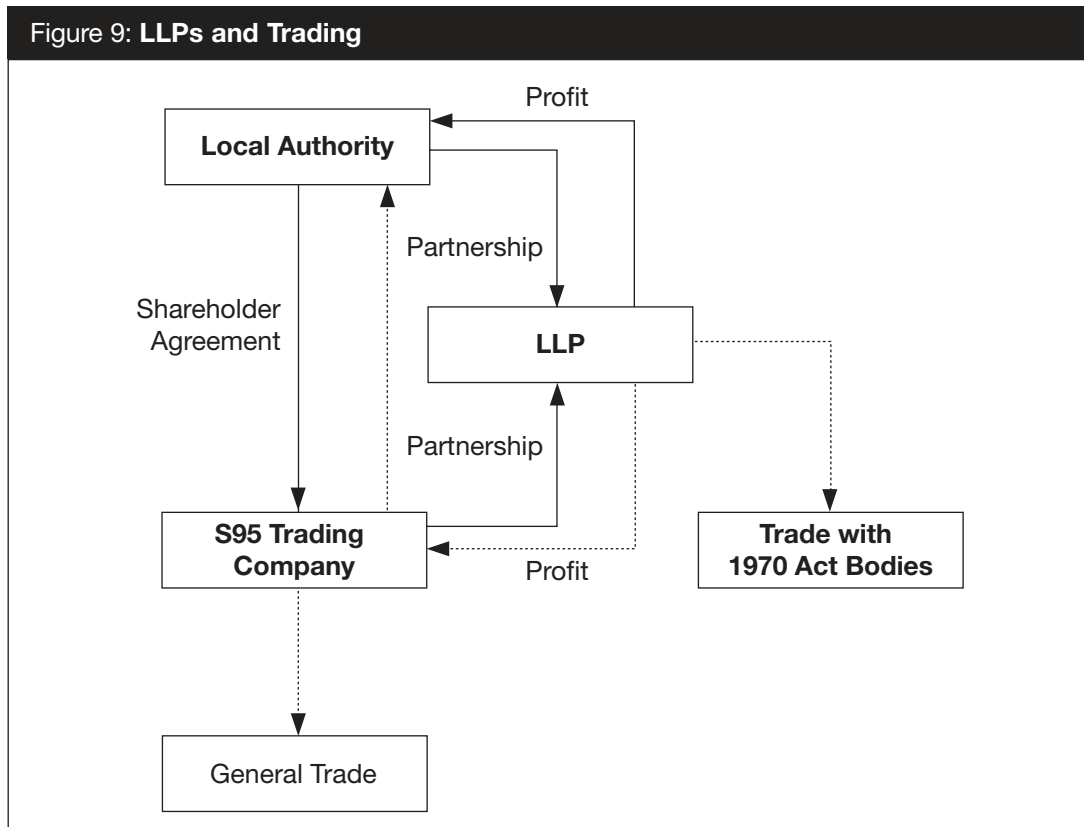
- 4.110 The documentation required for an LLP is the same as for a general partnership save for certain documents required to be filed on formation.

### **Risk Transfer**

- 4.111 Risk transfer in an LLP is similar to a joint venture company due to the LLP having corporate personality and limited liability.

### LLPs and Trading

- 4.112 As mentioned in Part 3 of Chapter 3 a local authority can only trade using the trading powers under section 95 of the 2003 Act through a company. However, it is possible to follow this requirement whilst utilising LLP for tax efficiency so long as the trading is not through the LLP, (see **Figure 9**).



### COMPARISON BETWEEN LIMITED LIABILITY PARTNERSHIPS, LIMITED PARTNERSHIPS AND LIMITED COMPANIES

- 4.113 **Figure 10** addresses the comparative treatments of Limited Companies, Limited Liability Partnerships and Limited Partnerships.



Figure 10: Comparative Table

	Limited Company	Limited Liability Partnership	Limited Partnership
<b>Running the business:</b>	A corporate body	A corporate body	A group of individuals with a common goal
<b>Administration</b>	<p>All limited companies must reflect their limited status in invoices and registration although they need not trade in that name.</p> <p>A company can have a single shareholder. However, it must have at least two people as director and the company secretary. The company must have an objects clause and must have a registered office.</p> <p>The maximum number of shareholders will be determined by the number of available shares/securities.</p>	<p>All LLPs must have a business name that ends with 'Limited liability partnership' or 'LLP' to indicate the entity's status. The name must be registered and the status must be shown on all documents.</p> <p>At least two persons/bodies are required to form a LLP. A LLP has unlimited capacity regarding objects. There must be a lawful business, a view to profit and a registered office.</p> <p>There is no maximum number of members within a LLP.</p>	<p>In a 'traditional' limited partnership there must be at least one 'general' partner who manages the business and bears unlimited liability. The other 'limited' partners' liabilities will be restricted to their capital; such partners may not take part in the management of the business or bind the firm.</p> <p>As with a normal partnership, although not compulsory, there should be a written partnership agreement. The Partnership Act sets out default terms that apply in the absence of exemptions.</p>

Figure 10: Comparative Table (continued)

	Limited Company	Limited Liability Partnership	Limited Partnership
<b>Key roles:</b>	<p>Directors (who need not be shareholders) have specific duties and responsibilities with regard to the company.</p> <p>Company Secretary required.</p> <p>The Board of Directors can bind the company.</p>	<p>No directors but concept of 'designated members' for certain matters.</p> <p>No Company Secretary required.</p> <p>Any member can bind the LLP, unless he had no authority and the third party knows this.</p>	<p>A senior partner will typically be appointed and nominated to deal with matters. The partnership agreement will often nominate partners to specific roles, and will quantify their percentage holdings.</p> <p>Any partner can bind the partnership, unless he had no authority and the third party knows this.</p>
<b>Decision-making:</b>	<p>Process heavily regulated. Generally, 50% or 75% majority shareholders can take major decision.</p>	<p>There is flexibility to determine in the agreement the rights to be afforded to different members and the extent to which partnership law is to be applied. If no agreement is in place, default provisions may be applied that require unanimous agreement from members.</p>	<p>There is flexibility to determine in the agreement the rights to be afforded to different members and the extent to which partnership law is to be applied. If no agreement is in place, default provisions may be applied that require unanimous agreement from members.</p>
<b>Employee issues:</b>	<p>Greater flexibility in staff reward options, such as share schemes and approved company pension schemes.</p>	<p>No option for share reward schemes.</p>	<p>No option for share reward schemes.</p>

Figure 10: **Comparative Table** (continued)

	<b>Limited Company</b>	<b>Limited Liability Partnership</b>	<b>Limited Partnership</b>
<b>Liability:</b>	Offers long-term protection from creditors (including banks). Shareholders' liability normally restricted to the amount, if any, paid on their shares.	The LLP itself is liable for the full extent of its assets, whilst the liability of the members is restricted to their member's contribution plus the amounts of any personal guarantee.	All partners are jointly and severally liable to for all of the partnership debts, in proportion of their partnership share. The liability of limited partners is restricted to their capital.
<b>BUT...</b>	Protection may be limited if personal negligence is concerned, if personal guarantees are given, or if directors trade insolvently.  Many lenders may require personal guarantees from company directors in respect of the company's obligation.	Protection may be limited if personal negligence is concerned, if personal guarantees are given, or if the LLP trades insolvently.  Provisions for funds to be clawed back apply under the Insolvency Act, where a member or members take out drawings leading to the LLP becoming insolvent.	If limited partners participate in management of the business, they are liable for all debts arising in that period.
<b>Membership:</b>	Shareholders own shares or securities in the company. Different classes of share give shareholders varying rights.	Members are entitled to profits and/or capital in accordance with a formal agreement.	Members are entitled to profits and/or capital in accordance with the partnership agreement.

Figure 10: Comparative Table (continued)

	<b>Limited Company</b>	<b>Limited Liability Partnership</b>	<b>Limited Partnership</b>
<b>Reporting requirements:</b>	<p>Companies must satisfy:</p> <ul style="list-style-type: none"> <li>• Companies Act requirements including Articles and Memorandum of Association. Forms 10 and 12 – statutory declaration.</li> <li>• Directors' Report required.</li> <li>• Presentation to General Meeting.</li> <li>• Potential audit requirements, subject to exemptions.</li> <li>• Public disclosure issue.</li> <li>• Full impact of employment legislation on all people working in the business.</li> <li>• CTSA tax return to the Inland Revenue.</li> </ul>	<p>LLPs have similar reporting obligations to companies:</p> <ul style="list-style-type: none"> <li>• Incorporation document in form approved by Registrar of Companies. A statement of compliance.</li> <li>• No Directors' Report.</li> <li>• No General Meeting but details to members.</li> <li>• Subject to same audit exemptions as a company.</li> <li>• Information distributed only to members of the LLP.</li> <li>• Partnership tax return to Inland Revenue.</li> </ul>	<p>There are no formal reporting requirements. Accounts are only available to full existing partners.</p> <p>Full accounts and disclosure required to Inland Revenue on Partnership Tax Return</p>
<b>Status:</b>	Greater commercial status and substance.	Good commercial status and substance.	Potentially less commercial status and substance.
<b>Taxation:</b>	A separate entity for taxation purposes.	Transparent entity for taxation purposes. Members in the LLP are taxed separately on their 'share' of income/gains from the partnership.	Transparent entity for taxation purposes. Members are taxed separately on their 'share' of income/gains from the partnership.

Figure 10: **Comparative Table** (continued)

	<b>Limited Company</b>	<b>Limited Liability Partnership</b>	<b>Limited Partnership</b>
<b>Tax rates:</b>	Profits taxable at corporation tax rates, depending on other levels of income.	Individual members currently (2005) pay income tax at an effective rate of 40% on income in higher rate band.	Individual partners currently (2005) pay income tax at an effective rate of 40% on their share of income in higher rate band.
<b>BUT...</b>	<p>Corporate shareholders do not generally pay corporation tax on dividends received from other UK companies.</p> <p>Corporation tax rates may vary if the company is 'associated' with other companies. The definition of association is wide.</p>	Corporate members currently pay tax at rates, depending on other levels of income and the number of any associated companies.	Corporate members currently pay tax at rates, depending on other levels of income and the number of any associated companies.

Figure 10: Comparative Table (continued)

	Limited Company	Limited Liability Partnership	Limited Partnership
<b>Retention:</b>	<p>Profit retention at a low corporate rate can be beneficial where owners only wish to withdraw part of the profits.</p> <p>Flexibility on retention and payout of profits, including option to reward individual shareholder directors via dividend and/or salary.</p>	<p>Each member pays income tax (or corporation tax for a corporate member) at their marginal rate even if profits are not withdrawn from the business.</p> <p>Flexibility on retention and payout of profits, including ability to vary profit entitlement.</p>	<p>Each partner pays income tax (or corporation tax for a corporate partner) at their marginal rate even if profits are not withdrawn from the business.</p> <p>Flexibility on retention and payout of profits, including ability to vary profit entitlement.</p>
<b>BUT...</b>	<p>In practice, companies used where there is an intention to retain profits in the long term in order to obtain lower tax rates.</p> <p>Additional tax cost of extracting profits from the company:</p> <ul style="list-style-type: none"> <li>• A double tax charge can arise on asset disposals where the company makes a gain and pays corporation tax, effectively increasing the value of the shares and the potential gain on a disposal by the shareholders.</li> <li>• Company profits will be subject to corporation tax and, when distributed, will be subject to income tax in the hands of the shareholder.</li> <li>• 19% Dividend tax can apply for small companies.</li> </ul>	<p>In practice, many LLPs likely to pay out profits as they arise, subject to working capital requirements.</p> <p>There are no double tax charges for corporate members of an LLP; income and gains are taxed in the company only as the LLP is transparent.</p>	<p>In practice, many partnerships likely to pay out profits as they arise, subject to working capital requirements.</p> <p>There are no double tax charges for corporate members of an LP; income and gains are taxed in the company only as the LP is transparent.</p>

**Figure 10: Comparative Table (continued)**

	<b>Limited Company</b>	<b>Limited Liability Partnership</b>	<b>Limited Partnership</b>
<b>Losses: relief by shareholders/members/partners</b>	A shareholder cannot get income tax relief for any corporate losses except in limited circumstances on a disposal of the shares. There is no special relief for losses in early years of trading.	<p>An individual member may be able to use trading losses against other personal income and/or capital gains. In addition, they have specific relief available for losses in early years of a business.</p> <p>Corporate members are treated as having incurred the trading loss themselves so may avail themselves of the usual corporate loss reliefs.</p> <p>In all cases, loss relief is limited to the amount of member's contribution less amounts withdrawn (plus, potentially, retained profits). If losses are restricted, they can be carried forward and can potentially be used later.</p>	<p>A partner may be able to use trading losses against other personal income and/or capital gains. In addition, they have specific relief available for losses in early years of a business.</p> <p>Corporate members are treated as having incurred the trading loss themselves so may avail themselves of the usual corporate loss reliefs.</p> <p>In all cases, loss relief is limited to the amount of capital contributed plus retained profit.</p>



Figure 10: Comparative Table (continued)

	Limited Company	Limited Liability Partnership	Limited Partnership
<b>Group relief:</b>	A company can be a part of a corporate group and can take advantage of various reliefs and tax advantages.	<p>A LLP cannot be a member of a group for tax purposes so cannot take advantage of group reliefs.</p> <p>However, corporate members are entitled to trading losses of the LLP, including losses for group relief purposes, but only up to the amount of the capital contributed.</p> <p>An LLP can break the group for stamp duty and stamp duty land tax purposes.</p>	<p>No equivalent concept. Partnerships cannot become members of groups.</p> <p>However, corporate members are entitled to trading losses of the partnership, including losses for group relief purposes, but for limited partners only up to the amount of the capital contributed.</p> <p>It may be possible to claim stamp duty and stamp duty land tax group relief on transfers to and from LPs where the partners are corporate bodies in a stamp duty group.</p>
<b>Stamp taxes:</b>	<p>Shares in a company are stock or marketable securities for stamp duty purposes. If duty is due on a transfer of shares, it will be payable at 0.5%. Stamp duty reserve tax will also apply to agreements to transfer shares.</p> <p>Transfers of land to and from the Company will be subject to stamp duty land tax.</p>	<p>A transfer of an interest in a LLP is subject to stamp duty. Since Finance Act 2004, stamp duty land tax will also be applicable.</p> <p>Transfers of land to and from the LLP are subject to stamp duty or stamp duty land tax, depending on the circumstances and timing.</p> <p>There is a tightly drawn exemption from stamp duty and stamp duty land tax for transfers of property to the LLP made 'in connection with the incorporation'.</p>	<p>A transfer of an interest in a LP and transfers to and from the LP are subject to stamp duty. Since Finance Act 2004, stamp duty land tax will also be applicable.</p> <p>Transfers of land to and from the LP are subject to stamp duty or stamp duty land tax depending on the circumstances and timing.</p>

Figure 10: Comparative Table (continued)

	<b>Limited Company</b>	<b>Limited Liability Partnership</b>	<b>Limited Partnership</b>
<b>National Insurance</b>	Employers NI contributions due on salary costs	No employers NI on a member's earnings	No employers NI on partners earnings.
<b>Taper relief for individuals</b>	<p>Potentially available on shares.</p> <p>Business Asset Taper relief is generally available only on shares in trading companies.</p>	<p>Likely to accrue more easily and quicker than Limited Company.</p> <p>Business Asset Taper Relief is only available for assets used for trading activities, and is specifically not available for investments by members in investment or property investment LLPs. However, Business Asset Taper Relief is available in respect of gains on property held by a property investment LLP where that property is let to a qualifying trader.</p>	<p>Likely to accrue more easily and quicker than Limited Company.</p> <p>Business Asset Taper relief is only available for assets used for trading activities.</p>
<b>Interest on borrowings by shareholder/partner</b>	Potential income tax relief for acquiring shares and making loans subject to conditions	More straightforward relief for capital contributions	More straightforward relief for capital contributions
<b>VAT:</b>	<p>Company is separate entity for VAT purposes and liable for VAT registration, subject to normal rules.</p> <p>Company may be able to join a VAT group, subject to normal conditions.</p>	<p>LLP is separate entity for VAT purposes and liable for VAT registration, subject to normal rules.</p> <p>LLP may be able to join a VAT group with other companies, subject to normal conditions relating to control.</p>	<p>Partnership is separate entity for VAT purposes and liable for VAT registration, subject to normal rules.</p>

Figure 10: Comparative Table (continued)

	Limited Company	Limited Liability Partnership	Limited Partnership
<b>Anti-avoidance:</b>		Specific rules apply to investment and property LLPs, especially where owned by a tax exempt body.	
<b>Profit extraction:</b>	'Veil of incorporation' limits scope	Potentially more flexible: equity participation offered but without the restrictions of shares: flexible reward strategies	Potentially more flexible: equity participation offered but without the restrictions of shares: flexible reward strategies
<b>Dividends:</b>	Family members can also extract funds as shareholders via dividend payments (although you should be careful not to create a settlement under Part XV ICTA 1988).  This may have 19% dividend tax implications for small companies.	N/a	N/a
<b>Pensions:</b>	Directors/employees pay pension contributions by reference to amounts extracted as salary and not dividends.  A company can set up a company pension scheme.	Partners pay pension contributions by reference to earnings.  A LLP cannot set up a corporate pension scheme for members.	Partners pay pension contributions by reference to earnings.

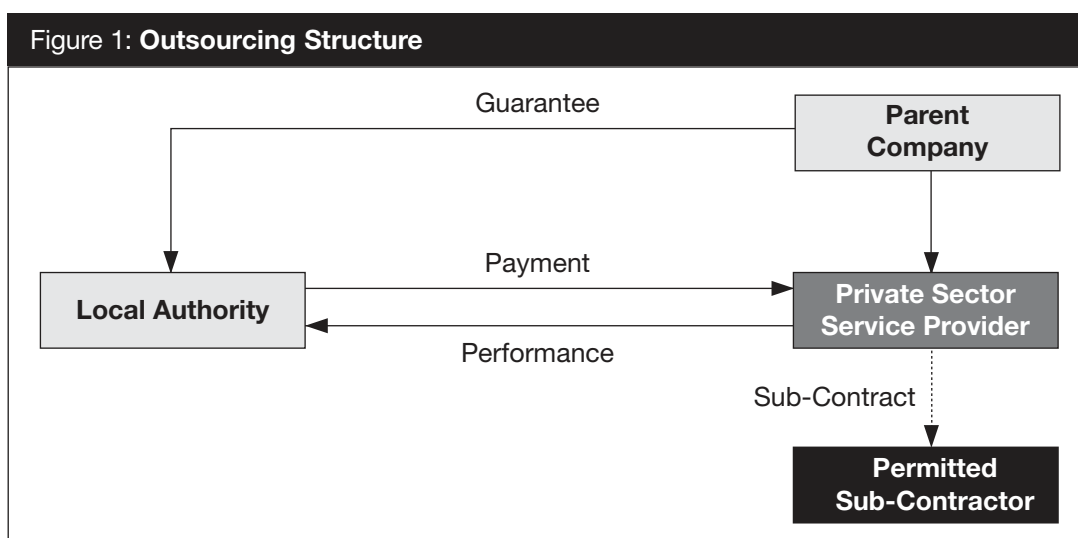
# CHAPTER 5

## Outsourcing

### Part 1 – Service outsourcing

#### OVERVIEW

- 5.1 In an outsourcing the local authority will contract with a private or voluntary service provider to provide certain services in place of the local authority. This type of contract generally involves a total transfer of the service provision to the service provider. The nature of the local authority requirements for service provision may be either input-based (i.e. a contract which specifies a detailed methodology – such as a CCT-style contract) or output-based (i.e. a contract where the desired outputs are specified with the methodology for achieving the outputs at the discretion of the service provider). The recent tendency has been towards output specifications.
- 5.2 The outsourcing of services will necessarily be undertaken where there is an abundance of private (or voluntary) sector providers and likely to be where the private (or voluntary) sector can provide the services more economically and efficiently through the use of economies of scale.
- 5.3 The in-house team will usually be precluded from bidding.
- 5.4 The service provider will secure access to, or acquire, whatever assets from the local authority are required (including employees who will be transferred to the service provider in accordance with the TUPE rules) to provide the services. There is, therefore, likely to be business transfer element to the contract.
- 5.5 The service provider will be required contractually to provide the services to certain standards and to meet certain targets. The service provider will be paid a service fee which will be adjusted upwards (incentives) or downwards (deductions) as a consequence of whether the standards and/or targets have been achieved.
- 5.6 The service provider will be required to comply with the ODPM Code of Practice on Workforce matters (3/2003) and the Cabinet Office Code (2005), and to enable the authority to meet its Best Value obligations in that regard.
- 5.7 The local authority will retain a client role with a limited number of staff. This is not say that the client-side management is not important and the resources available need to be such to ensure that the contract is delivered but not at a level that prevents the efficient operation of the contract.



## DESCRIPTION

- 5.8 This option involves the local authority selecting probably a private sector contractor (there is potential for voluntary sector service providers in certain sectors such as housing and social services) to enter into a contract to exclusively provide a service(s) to the local authority.
- 5.9 The local authority will enter into an outsourcing contract with the private sector service provider. The contract will have various elements but will largely fall into two sections, one dealing with the transfer of or granting a right to use existing assets (including employees) necessary to provide the service and the other relating to the standards of the provision of the service(s) to the local authority. Any additional investment in assets required to meet improvements to the services(s) will be provided by the private sector as part of the contract.
- 5.10 The assets which a local authority may need to transfer or grant a right to use to a private sector service provider in an outsourcing include buildings, equipment, employees, intangible assets such as contractual rights, software licences and intellectual property rights. These assets need to be properly valued to ensure that their value is reflected in the service fee to be paid by the local authority to the private sector provider.
- 5.11 As with any transaction in the nature of a 'business sale' the private sector provider may seek warranties from the local authority in relation to the assets transferred or to be used in connection with the outsourcing. In particular the private sector partner will wish to be certain that the local authority can transfer or grant the right to use the assets and that the assets do not come with either patent or latent liabilities. As a consequence, warranties may be sought in relation to:
- Buildings: title; absence of encumbrances (other than those disclosed) and claims, disputes and litigation (particularly environmental), confirmation of terms of leases, levels of rent and service charges, assignability and absence of breaches of covenants;

- Equipment: title, absence of retention of title clauses or other encumbrances, confirmation of terms of leases (rentals, payments, assignability and absence of breach of covenants; disputes and litigation) and confirmation of terms of service contracts;
- intellectual property rights: title, absence of encumbrances, confirmation of rights to and terms of use, compatibility of legacy (existing) equipment, compliance with any regulatory requirements and absence of disputes and litigation;
- existing contracts: confirmation of existing terms, absence of breaches of contract, assignability, duration (and absence of early termination provisions), and absence of disputes and litigation; and
- employees: confirmation of numbers to transfer under TUPE, terms and conditions of employees (salaries and other benefits), absence of claims, disputes and litigation, compliance with TUPE legislation, pension rights and payments into pension fund.

5.12 Furthermore, the local authority may have information in its possession which is crucial to pricing by the private sector partner, including aspects of present performance (such as rent collection or housing benefit determination), regularity of claims (such as tenant disrepair actions) and third-party income (such as numbers and types of customers in a leisure facility). To the extent that such information is incapable of independent verification by the private sector service provider (or only at a significant cost) warranties as to the accuracy of such information may be sought.

5.13 Whether and to the extent that the local authority gives warranties will vary from contract to contract depending circumstances. A local authority may consider giving such warranties where:

- it is reasonably certain as to the accuracy of the warranties and therefore they are unlikely to be in breach;
- such will yield better value for money for the local authority by giving greater competitive pricing arising from the elimination of significant circumstances surrounding an aspect of the 'undertaking' which would otherwise give rise to contingencies in the service fee; and
- the costs of a due diligence (verification) exercise by the private sector service provider may give rise to a significant cost reflected in the service fee.

5.14 Warranties are representations or promises as to certain statements of fact. A breach of warranty will give rise to a claim by the private sector service provider against the local authority in respect of losses incurred by it as a consequence of the warranty that it has relied upon as being accurate. The private sector service provider should be required to mitigate such losses and 'caps' and the liability of the local authority should be considered (covering quantum and extent of loss, such as consequential loss). The local authority may also wish to set a definitive amount for claims to avoid excessive small claims.

- 5.15 As the warranties are general representations or promises as to certain statements of fact any matter which the local authority perceives will put it in breach of the warranty will need to be disclosed against the specific warranty by the local authority to the private sector service provider (disclosing information against a warranty as opposed to changing the wording of the warranty is the conventional approach to ensure certainty). The extent of such 'disclosure' by the local authority should be sufficient for the private sector service provider to understand the nature of what is being disclosed and if price sensitive, to reflect in its pricing (indeed the private sector service provider may seek a warranty as to the accuracy of the disclosures).
- 5.16 Were the arrangement to be entered into by the local authority to stop after a transfer i.e. the local authority had taken the decision to cease to provide a discretionary service (e.g. housing or leisure), then the contract would largely reflect only the foregoing (with specific provisions to meet specific sector arrangements, for example, homeless nomination rights in a housing stock transfer). However, where the outsourcing also involves the provision of an ongoing service to the local authority then further contractual provisions relating to the provision of that service will be necessary.
- 5.17 The provisions of the contract relating to the services(s) will document the agreed commercial terms between the local authority and private sector service provider in relation to the required service provision. The service(s) will be provided for the duration of the contract by reference to a specification of the services to be provided (such will likely be an output specification). The output specification may require investment (e.g. in IT equipment) by the private sector service provider, either expressly as a specific output or as a necessary pre-requisite to the private sector service provider attaining the necessary standards of service in the output specification.
- 5.18 The private sector service provider will be entitled to payment for the service(s) provided by it. Payment will reflect the successful competitive bid by the private sector service provider. They in turn will reflect its anticipated costs and returns over the contract period, having taken into account the increased efficiencies which the private sector services provider believes it can achieve on contract (through economies of scale, improved organisation, investment in technology, etc).
- 5.19 However, the private sector service provider should not automatically receive full payment of its service fee. Payment should be by reference to the achievement of certain outputs being standards of service delivery. Full payment should be dependent upon full achievement of service delivery standards. Inadequate performance should result in a deduction from the service fee. It is therefore important that the standards of performance are objectively measurable by the parties to the contract (and potentially by a third party in the case of dispute) so far as possible. Performance standards should not contain any elements that are subjective to the local authority. Finally, deductions should be proportionate to the failure in service performance. Persistent service performance failure should result in termination of the contract.



- 5.20 The contract should reflect the local authority's duty of Best Value. The 4ps guidance on Best Value contained in 'The Standardisation of Local Authority PFI Contracts'<sup>43</sup> (November 2001 updated 2005) is also generally applicable to other long-term contracts such as outsourcing contracts. The local authority should give consideration to the desired Best Value outputs prior to seeking tenders from selected service providers. Such outputs should include step-changes in service improvements and achievable savings over the contract term. In seeking to achieve Best Value local authorities should also give consideration to the use of benchmarking of performance against comparator groups, the use of the customer satisfaction surveys, the input of the private sector service provider into local authority annual Best Value performance plans and the role of the private sector service provider in the local authority's Best Value Review process. The local authority should also insert contractual provisions to ensure that the private sector service provider does everything that is necessary to assist the local authority in discharging its statutory duties in relation to Best Value and to provide clarity on measuring efficiency gains for the Annual Efficiency Statements.
- 5.21 There are also likely to be ancillary issues to be addressed such as any leases of buildings to be granted and any parent company guarantees to be given by the parent company of the private sector service provider.

### **Drivers**

- 5.22 The following are the principal drivers for this option:
- the competitive nature should ensure most economic price for required quality of service;
  - the successful bidder provides necessary investment in service as part of annual contract payment by the council;
  - shortcomings in current service (e.g. management weaknesses, procedural failings, lack of staff training/development, poor customer relationships) should be addressed;
  - a mature market exists in respect of a number of local authority activities thus providing experienced providers of local authority services;
  - where the local authority approaches the arrangement from a partnership perspective, then both parties should get the best out of it.

### **Disadvantages**

The following are the principal disadvantages of this option:

- will not work well (and unlikely to attract major players) if the local authority adopts confrontational 'us and them' stance;
- authorities need to develop skills and competences for managing partnering contracts;

<sup>43</sup> Available on HM Treasury and 4ps websites.

- the local authority needs to be realistic and honest in performance targets etc especially where service is already perceived as failing/poor; the market response may be little or nil otherwise;
- service failure by the private sector provider presents major difficulties especially in relation to transferring to a new provider and contractual liabilities;
- Audit Commission evidence that shortcomings in service delivery not improved by outsourcing the problem; and
- the contract may not be flexible enough to adapt to unforeseen change especially for longer term contracts (over 7 years say).

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

- 5.23 Local authorities will need to verify that the arrangements proposed by them fall within existing powers. Powers for local authorities to contract for the provision of services are generally now sufficiently wide to encompass the majority, if not all, outsourcing arrangements contemplated by local authorities. Apart from sector specific express powers, other powers include Part 1 Local Government Act 2000 (well-being), Section 111 Local Government Act 1972 and Section 1 Local Government (Contracts) Act 1997. Local authorities should also be conscious of any restrictions on the exercise of their powers such as the requirement for ministerial consents and/or restrictions on trading by the local authority that remain following regulations under Section 95 Local Government Act 2003.
- 5.24 If, as is likely, the contract is for services for a period of five years or more, it will be capable of certification under the Local Government (Contracts) Act 1997 and the private sector will be able to take advantage of agreed Relevant Discharge Terms.
- 5.25 As the procurement by the local authority will involve the provision of services the local authority will be obliged to comply with the EU procurement rules.
- 5.26 The incurring of capital expenditure by the private sector service provider will not impact on the local authority to the extent that the local authority does not agree to provide any financial assistance.

### **Commercial and Legal Issues**

- 5.27 The outsourcing contract will need to address the following commercial and legal issues in relation to any transfer of assets and service provision:
- the identity of the assets to be transferred to the private sector service provider, buildings (probably involving the grant or assignment of a lease), equipment (particularly IT equipment), intellectual property, existing contracts (having undertaken enquiries to ascertain those contracts which relate to the outsourced services), employees (particularly the extent of the employees within the relevant undertaking and their terms and conditions);

- the extent of any consents required to deal with assets such as to assign software licences and assign or novate existing contracts and any measures to deal with any retained contractual rights (e.g. a trust arrangement where the existing contract covers more than the outsourced services);
- the extent of any indemnities given in relation to the assets (for example in relation to outstanding liabilities owed to transferring employees);
- the extent of any ‘caps’ on warranty liabilities and whether there will be any ‘de minimis’ amounts on claims;
- the extent of any disclosures against warranties;
- the duration of the contract;
- the extent of the services to be provided (the output specification);
- the standard of the service provision (the output specification);
- the payment and performance mechanism relating payment to performance;
- any future changes to the service(s) whether due to the requirements of the local authority or changes in law;
- restrictions or prohibitions on sub-contracting and assignments;
- any circumstances or events which may release the private sector service provider from performance;
- any circumstances or events which may release the private sector service provider from performance and result in compensation (for example local authority breach(s) of contract);
- the extent of indemnities to be given by the private sector service provider and local authority;
- the extent of required insurances;
- ‘hand back’ provisions relating to expiry or termination of the contract (such that the local authority is able to either take back the service provision in-house or retender the service provision, minimising unforeseen liabilities to the local authority; in particular those such as onerous contracts, employee numbers and ‘over beneficial’ contracts of employment, and inadequately maintained assets);
- provisions enabling the discharge of the local authority’s Best Value duty, including compliance with the obligations in the Code of Practice Workforce Matters (ODPM Circular 3/2003) and Cabinet Office Code (2005);

- provisions for the resolution of disputes;
- grounds for termination of the contract by the local authority, for example for insolvency of the private sector service provider, exceeding threshold for persistent inadequate performance, material and persistent breach of contract and by the private sector service provider for non-payment of the service fee;
- the extent of consequential adjustments between the local authority and private sector service provider's obligations; and
- the extent of any parent company guarantees required in respect of the discharge of the private sector service provider's obligations.

### **Documentation**

5.28 The option will involve an outsourcing contract between the local authority and private sector service provider encompassing ancillary documents such as:

- output specification; and
- payment and performance mechanism.

Other ancillary contracts may be required such as:

- property lease; and
- parent company guarantee.

### **Risk Transfer**

5.30 The outsourcing contract can be constituted so as to transfer the entire risk of service provision to the agreed standards to the private sector service provider. (see ODPM publication *Risk Management – Technical Notes* (ODPM 2004)).

5.31 However, the local authority may retain specific risks associated with the contract particularly in relation to:

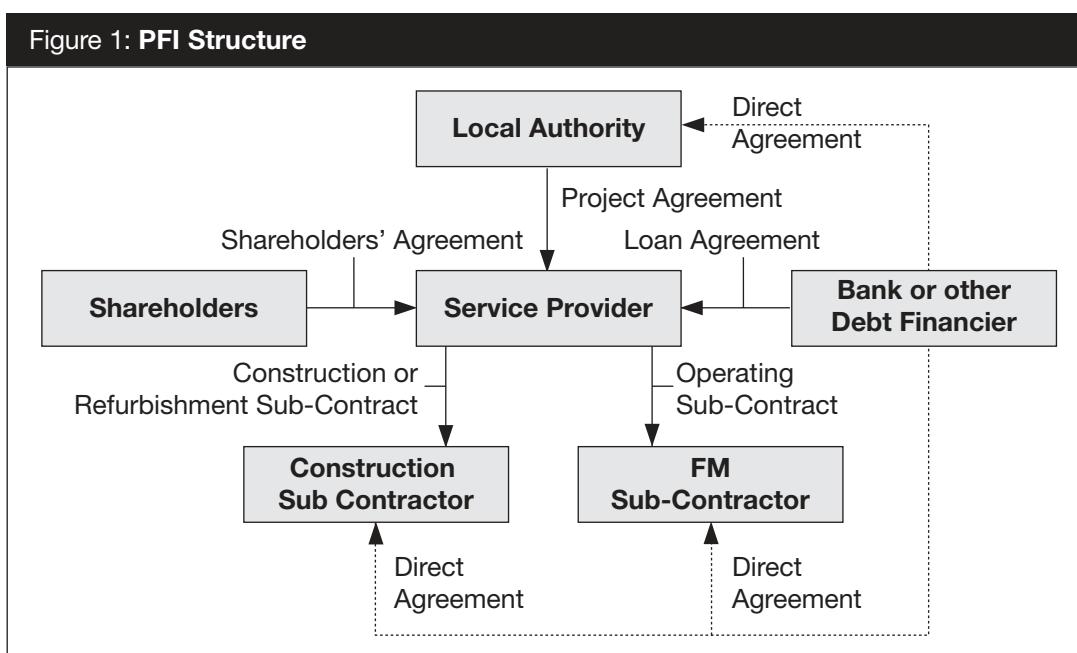
- any warranties which it may give;
- any specific risks retained by it e.g. sector specific changes in law; and
- any changes to the service that it may require.

## Part 2 – Capital Outsourcing

### Part 2A Private Finance Initiative

#### OVERVIEW

- 5.32 In this model, a local authority (either by itself or with one or more other local or public authorities) procures investment and services in relation to asset(s). The usual structure involves a design, build, finance and operate contract with a private sector service provider (the service provider) for a concession period of between 25-30 years. The service provider is usually a special purpose company set up especially for the project.
- 5.33 The local authority sets out its requirements in relation to the investment and the provision of services by reference to its desired specified outputs. The service provider is responsible for designing and procuring the works, services and private finance to achieve the local authority's desired outputs.
- 5.34 Payment to the service provider does not start until the services have commenced in relation to the asset(s). Payment to the service provider is dependent upon the performance of the asset and services when measured against the local authority's specified outputs.
- 5.35 Private finance for the investment typically derives from debt finance (traditional bank or sometimes bond finance, repayable over the term of the loan) and equity finance (traditional finance provided by shareholders in a company in return for shares, with returns being paid to the shareholders from available company profits) provided to the service provider. Finance is usually provided in a ratio of debt:equity of 90:10.
- 5.36 The Service Provider usually procures the works and services to meet the local authority's specified outputs from sub-contractors (usually from a construction or refurbishment contractor and a FM or operating contractor). **Figure 1** illustrates a typical PFI structure.



- 5.37 In July 2003, HM Treasury published the results of its review of the use of the PFI by Government, *PFI: Meeting the Investment Challenge*<sup>44</sup>. The review sets down far-reaching recommendations for the future use of the PFI and in particular in relation to IT projects and projects with a value of less than £20m.

## DESCRIPTION

- 5.38 The local authority will follow the EU procurement procedure to appoint a contractor to provide services in relation to an asset(s) to be provided or refurbished by the service provider. See *Rethinking Service Delivery – From Outline Business Case to Contract Signing* (ODPM 2003, technical addendum by DCLG 2006). An explanation of the new Competitive Dialogue procedure under the Consolidated Directive is contained in Chapter 4 paragraphs 4.60 onwards).
- 5.39 Once appointed, the service provider will enter into a contract (the Project Agreement) with the local authority under which the service provider will agree to design and undertake works and deliver services to meet the required outputs of the local authority. The services and outputs will be in relation to the asset(s) and services contained in the output specification referred to in the Project Agreement. In return for the provision of the services and the asset(s) being available for use, the service provider will be paid a fee or unitary charge to cover the cost of works, services, finance and returns to the shareholders of the service provider.
- 5.40 The Project Agreement will state which risks in the project are to be transferred to the service provider, those risks which are to be retained by the local authority and those risks to be shared between the contractor and the local authority. Standard guidance relating to the allocation of risks in PFI contracts generally is contained in the HM Treasury publication, *Standardisation of PFI Contracts – Version 3* (HMT Guidance).<sup>45</sup>

<sup>44</sup> Copy available on HM Treasury's website.

<sup>45</sup> Available on HM Treasury's website.

- 5.41 The HMT Guidance covers (and contains specimen drafting on) risks associated with, amongst other things:
- the duration of the contract;
  - provisions in relation to the works to achieve the local authority's accommodation requirements;
  - service commencement (and payment commencement) and supervening delays;
  - availability of the asset and service requirements (and the payment and performance mechanism);
  - lifecycle and routine maintenance;
  - changes in service;
  - changes in law;
  - price variations (including indexation, benchmarking and market testing);
  - termination and compensation on termination for the service provider and the financier;
  - loss, damage and liabilities (including insurance); and
  - provisions enabling the financier to 'step-in' on default and termination.

The overriding principle of the HMT Guidance is to allocate risks by reference to which party is best placed to manage them.

- 5.42 As a consequence, therefore, all risks associated with the provision or refurbishment of the asset will be at the risk of the service provider; more particularly, deductions will be made from the unitary charge in relation to inadequate performance measured against the requirements of the local authority's output specification.
- 5.43 Other risks such as those deriving from changes to the services required by the local authority or changes in law which are specific to or discriminatory against the services in the PFI project, or PFI projects generally, will be the responsibility of the local authority.
- 5.44 Other risks such as those which are not value for money to transfer or defined risks deriving from causes beyond the control of the local authority or service provider will be shared.
- 5.45 The risk allocation principles are also extended to the payment of compensation on termination of the Project Agreement.



- 5.46 Where termination is due to a default of the local authority, then the service provider is entitled to be paid the amount of any debt outstanding, all costs associated with termination and the anticipated returns due to the service provider's shareholders.
- 5.47 Where termination is due to the default of the service provider, then the local authority (subject to prior security rights of the debt financier) is entitled to sell the benefit of the Project Agreement (i.e. the cash flows from the unitary charge paid by it). The proceeds from the sale are to be paid to the service provider in discharge of all liability to pay compensation. Quite clearly such proceeds may or may not cover all outstanding debt and equity.
- 5.48 Where termination is due neither to the default of the local authority nor the service provider (for example, due to a force majeure event, such as war), then the compensation payable will be 'neutral'. This means that the Service Provider will be paid sufficient to cover outstanding debt, the return of shareholders' funds and the costs of termination, but not the anticipated return on shareholders' funds.
- 5.49 There are certain sector specific issues associated with local authority PFI contracts, i.e. issues that arise solely or predominantly in relation to local authorities and not other areas of government such as NHS Trusts and government departments.
- 5.50 As a consequence, the Public Private Partnerships Programme (4ps) have produced a supplement to the OGC Guidance: *The Standardisation of Local Authority PFI Contracts* (November 2001 updated 2005).<sup>46</sup> This Guidance covers:
- the reconciliation of a long-term PFI contract and the local authority's Best Value duty of making arrangements to secure a continuous improvement in their services;
  - the balance between enforcement of statutory duties and contractual terms; and
  - sector specific issues relating to termination (particularly the calculation of Relevant Discharge Terms as permitted by the Local Government (Contracts) Act 1997).
- 5.51 The service provider will normally (but not always) be a special purpose company set up by a consortium of investors (and contractors) appointed by the local authority to undertake a project. The investors will finance the service provider through equity contributions in return for shares in the service provider. For tax efficiency reasons, the 'equity' is often subscribed for by way of loan debt, subordinated in priority to the main debt finance provided by the banks (usually called junior or sub-debt).
- 5.52 The risks in a PFI project are such that the investors will seek to 'ring fence' the project or the project will be 'stand alone' in that no guarantees of performance will be given from the investors or contractors to the local

<sup>46</sup> Available on HM Treasury's and 4ps websites.

authority. The local authority's legal remedies for its part will be largely confined to deductions from the unitary charge and termination. The investors will enter into a Shareholders Agreement to confirm their investments and regulate their relationship.

- 5.53 Occasionally the service provider will be an entity of substance. This could be where the contractor is a single organisation and the project is either small in capital expenditure terms or the value of the contract. Another example may be where the contractor determines that it is able to satisfactorily manage the risks (e.g. a housing association in a social housing PFI project may agree to be the service provider).
- 5.54 The service provider will sub-contract the works and services to respectively a construction (or refurbishment) contractor and a FM (or operating) contractor. Essentially the service provider will 'back off' the risks in the Project Agreement to the sub-contractors. This will be done in return for, in relation to the construction contractor, the construction contract price and, in relation to the FM contractor, the annual service fee (which will reflect deductions made by the local authority to the unitary charge due to inadequate performance).
- 5.55 The debt finance (provided either from banks or through the issue of bonds, the latter being generally viable only where the capital expenditure is in excess of £50 million) is provided to the Service Provider on traditional project finance terms. The Service Provider will enter into a loan or credit agreement which will contain the terms on which the finance will be advanced.
- 5.56 As the Service Provider will not own any assets or property (other than perhaps a lease) the financier's principal source of security for the monies advanced will be control over the cash flows from the local authority to the Service Provider. An important element of this will be to prevent the local authority terminating the Project Agreement or any sub-contractor terminating a sub-contract without the financier being given the opportunity to 'step-in' to rescue the project. The financier will achieve this position through so-called Direct Agreements with those parties. The local authority will also enter into parallel Direct Agreements with sub-contractors to be able to 'step-in' were the Project Agreement to be terminated.

### **Drivers**

- 5.57 The potential drivers for PFI model include:
- obtaining specific ring fenced subsidy for the local authority;
  - allowing the local authority to concentrate on mainstream service provision (e.g. education) whilst 'delegating' to the private sector the expertise and responsibility for providing and maintaining the facilities for the service (e.g. buildings);
  - transferring the risk of the cost of provision and of lifecycle and routine maintenance of the facilities throughout the life of the contract;

- maximising revenue from surplus capacity in the facilities (e.g. third party income from events held in schools);
- benefiting from the commercial acumen of the investors and debt provider in controlling the costs of the construction and FM contractors; and
- TUPE applying to the transfer of staff to the FM contractor.

### **Disadvantages**

5.58 The principal disadvantages of the PFT model include:

- local authorities will require revenue support from central government to fund the unitary charge payable to the Service Provider;
- the amount of revenue support available is limited and there is a detailed approval procedure to navigate (approval of Outline Business Case etc) to obtain the necessary approvals;
- the local authority is required to part with possession of the facilities for the contract period (subject to the local authority having continued use);
- the project financing structure is a complex one (and therefore time consuming and costly) involving many legal documents whether for a small (£20m) or large (£100m) local authority project;
- employees will be transferred to FM contractor, although employee-friendly secondment models are being developed;
- the traditional PFI structure is too inflexible to enable a succession of projects to be undertaken;
- it is used merely as a funding mechanism rather than a partnering arrangement;
- VFM is ever more important for efficiency and for CPA and such models need to be stringently tested to an appropriate public sector comparator;
- it involves risk apportionment rather than risk sharing; and
- rather inflexible to secure the Best Value duty of continuous improvement.

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

5.59 The powers to enter into PFI contracts are well established and Section 1 Local Government (Contracts) Act 1997 contains a confirmatory power.

5.60 Furthermore, a PFI contract (and indeed a contract providing finance in relation to a PFI contract) is capable of certification under the Local Government (Contracts) Act 1997 and therefore the Service Provider will have the protection of Relevant Discharge Terms in the unlikely event of the transaction being found to be ultra vires.

- 5.61 As works and services will be provided to the local authority then the appointment of the Service Provider must be in accordance with EU procurement rules.
- 5.62 Although there no longer is any statutory requirement to comply with off-balance sheet accounting tests, Government policy is that to approve a Final Business Case for the local authority to enter into a PFI contract, the local authority generally, must demonstrate that the risk apportionment takes the PFI project off balance sheet for the local authority.

### **Commercial and Legal issues**

- 5.63 To summarise, the roles, risks and rewards of the parties are as follows:

The local authority:

- procures the consortium of investors, contractors and financiers to undertake the project (in accordance with EU procurement rules);
- enters into a Project Agreement with the Service Provider for the delivery of the project;
- manages the change process and staff transfers as required;
- provides an output specification for the project; and
- ensures the delivery of the asset(s) and services by invoking payment deductions if necessary.

The shareholders:

- create and manage the special purpose company which is the Service Provider;
- provide equity capital (or loan debt subordinated to the main debt finance) to the Service Provider;
- procure the sub-contractors and the debt financier to discharge the Service Provider's obligations under the Project Agreement; and
- manage the project to achieve and protect expected returns on equity capital by minimising payment deductions and other liabilities.

The Service Provider:

- provides (by the use of sub-contractors) the detailed proposals of the project solution (design);
- manages (through sub-contractors) the delivery of the project whilst minimising payment deductions;

- delivers (by the use of sub-contractors) the services to the local authority to satisfy the output specification;
- provides (by the use of sub-contractors) the works comprising the asset to satisfy the output specification;
- procures debt finance for the project; and
- enters into the Project Agreement, financing documents and sub-contracts.

The financier:

- provides debt finance to the Service Provider;
- manages the financier's risk (by the use of technical experts) to ensure the payment of interest (including the financier's margin or profit) and the repayment of principal of the debt advanced;
- enters into the financing documents with the Service Provider; and
- takes security for the debt advanced to ensure that it can take the benefit of cash flows in the Project Agreement, prevents the local authority or other sub-contractors from terminating their contracts, prevents the disposal of project assets, prevents any other lender or creditor from obtaining priority in claims against the Service Provider and protects the Service Provider from incurring payment deductions and other unexpected liabilities.

The sub-contractors:

- provide the works and/or services to discharge the Service Provider's obligations under the Project Agreement;
- seek to protect their profit comprised within the service fee; and
- seek caps on the potential liabilities to the Service Provider.

5.64 The HMT Guidance seeks to allocate the commercial and legal risks in a PFI project so that the risks are managed by the party best placed to do so. The allocation of these risks will impact upon the risks and rewards of the parties set out above. The HMT Guidance and the Local Authority Guidance has been developed in consultation with the private sector and therefore should be adhered to in full by local authorities save for exceptional circumstances as may be specified in other sector-specific guidance.

5.65 Other project-specific commercial issues (not covered by the HMT Guidance) will need to be agreed on a project-by-project basis, with the local authority being assured that the allocation of risk between the parties represents the best value for money and maximizes efficient use of resources.

## Documentation

5.66 This option will involve the following documentation:

- Project Agreement between the local authority and the Service Provider which will contain:
  - output specification;
  - payment mechanism;
  - transfer of assets (if any);
  - treatment of employees; and
  - provisions reflecting HMT Guidance and Local Authority Guidance.
- Memorandum and Articles of Association of the Service Provider and a Shareholders' Agreement between the consortium members who are investors in the project.
- Loan or Credit Agreement between the Service Provider and financier relating to the provision of finance to the project.
- Construction sub-contract between the Service Provider and construction sub-contractor in relation to the works.
- Operating or FM sub-contract between the Service Provider and the FM or operating sub-contractor in relation to the services.
- Security documentation in favour of the financier comprising:
  - Direct Agreements with the local authority protecting the financier against termination and permitting the financier to 'step-in' or take control.
  - Direct Agreements with each of the sub-contractors containing duty of care warranties and protecting the financier against termination and permitting the financier to 'step-in' or take control.
  - Guarantees in favour of the financier from parent companies of sub-contractors.
  - Debenture (fixed and floating charge) from the Service Provider in favour of the financier assigning all rights to cash flows under the Project Agreement and prohibiting disposal of the Service Provider's assets.
- Direct Agreements from the sub-contractors in favour of the local authority containing duty of care warranties and permitting the local authority to 'step-in' or take control on termination of the Project Agreement.

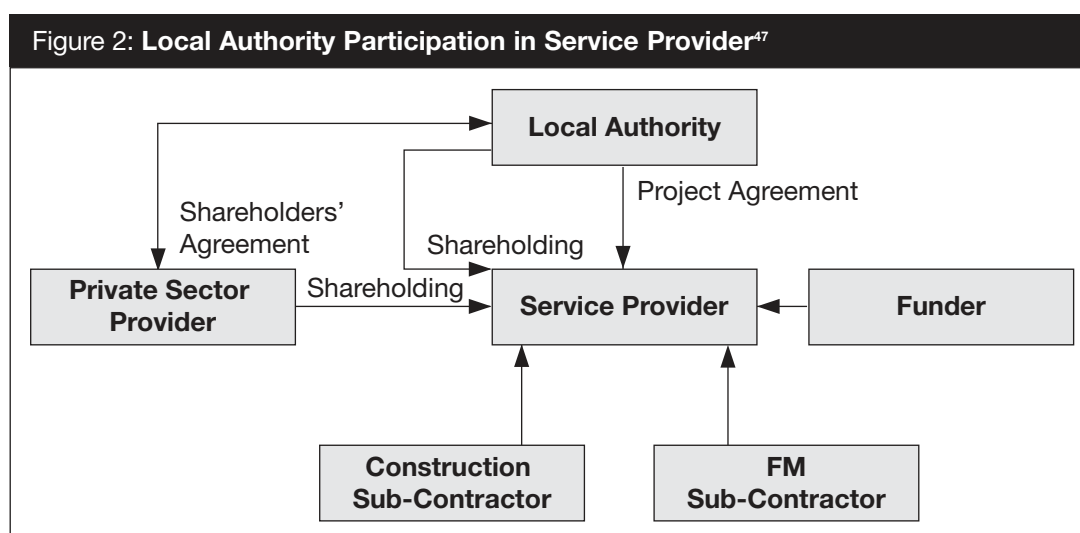
### Risk Transfer

- 5.67 This option will result in the allocation of risks between the parties on the basis of which party is best placed to manage the risk. Risks associated with the design, build, finance and operation of the project will be borne by the private sector. Risks associated with changes to the service by the local authority or specific or discriminatory changes in law will be borne by the local authority. Risks which do not represent good value for money (e.g. the risk of incurring all capital expenditure arising from all general changes in law) or are beyond the control of the parties (e.g. fire, flood, accidental damage etc) will be shared.
- 5.68 In order to gain approval for the Final Business Case the risks transferred by the local authority will have to be such as to demonstrate that the assets being supplied under the arrangement are 'off balance sheet'.

## Part 2B PFI Local Authority Participation in Service Provider

### OVERVIEW

- 5.69 In this sub-option the local authority subscribes for share or loan capital in the Service Provider. **Figure 2** illustrates the structure. Local authorities may perceive this approach as providing a closer involvement with the operation of the service and can achieve enhanced value for money. However, this approach will commonly be more expensive to procure, dissipates private sector risk and similar advantages can be secured through contract negotiations.



<sup>47</sup> This Figure 2 is an adaptation of the Figure 1 in this chapter. To allow focus to be given to the local authority the additional detail is not repeated here.



## **DESCRIPTION**

- 5.70 The description of the structure is broadly the same as that applicable to PFI generally. However, the local authority subscribes for share or loan capital in the Service Provider. Whether the local authority subscribes for share or loan capital will, to a degree, depend upon how the investment in the Service Provider is structured generally.
- 5.71 The subscription for share capital will mean that the local authority subscribes for true 'equity' and is thus wholly subordinated in receiving its returns, being purely paid dividends from available profit.
- 5.72 The subscription for loan capital on the other hand will mean that the local authority is paid periodic interest (as opposed to dividends declared when profits are available) which will enable the local authority to prove in any insolvency of the Service Provider as either a secured (albeit subordinated in priority to the debt finance provided by the banks) or unsecured creditor. The payment of interest may also be more tax efficient in that interest is deductible for corporation tax purposes. However, whether a payment of interest or a dividend on shares, such payment will be subordinated to the payment of interest and repayment of principal on the debt finance. As such, therefore, local authorities may well find the return on their investment 'locked up' until the financial ratios of net cash flows against debt service are reasonably high, which is often several years into the contract.
- 5.73 Since the Local Government Act 2003 there is no reason for the local authority to restrict its shareholding to below 20% except for propriety issues. However, commercial considerations will dictate a controlling interest for the private sector partner.

### **Drivers**

- 5.74 Additional drivers (to those applying to PFI generally) for the local authority subscribing for share or loan capital in the Service Provider are:
- the local authority seeking to obtain a return on its investment rather than merely taking available grant funding; and
  - the local authority seeking to have representation on the Board of the Service Provider so as to have a 'presence' when decisions are made. However, such a presence may well be more illusionary than real.

### **Disadvantages**

- 5.75 The proposed disadvantages (in addition to those applying to PFI generally) for the local authority subscribing for share or loan capital in the Service Provider are:
- increased negotiations with the investor and financier to structure the local authority participation such that a 'conflict' does not arise between the local authority as the 'purchaser' of the services from the Service Provider and as investor in the Service Provider and therefore also the 'seller' of services;

- the investment in the Service Provider necessarily involves a re-transfer of risk to the local authority; and
- the nature and effect of the participation by the local authority in the Service Provider may be (depending upon the extent of influence) such as to impact on the accounting treatment of the PFI transaction when the substance as opposed to the form of the transaction is examined.

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

- 5.76 The power to subscribe for share or loan capital in the Service Provider can be found in Section 2 of the Local Government Act 2000 (assuming one or other of Section 2 (1) objects is present). The fact that the local authority has no strategy under Section 4 of the 2000 Act does not preclude the exercise of the power under Section 2. If, as a matter of fact, the subscription for share or loan capital constitutes financial assistance then the subscription for share or loan capital will fall within Section 2(4)(b) of the 2000 Act (it is also likely that such would also fall within Section 2(4)(a)).
- 5.77 The power under Section 2 if exercised would not conflict with the Local Authorities Companies Order 1995. The payment of dividends on shares would only fall within the restriction under Section 3 if the exercise constituted a disguised form of raising money, which is unlikely.
- 5.78 A local authority charged or empowered to perform a particular task may make use of a company to carry out that task or some aspect of it provided it does not delegate to the Service Provider its discretionary decision-making functions.
- 5.79 As to the certification of the subscription of share or loan capital and the entry into the Shareholders Agreement under the Local Government (Contracts) Act 1997:
- certification requirements include the necessity for a statement that the contract is to be a contract falling within Section 4(3) or (4) of the 1997 Act (see Section 2(2)(c));
  - neither the actual subscription of shares or loan capital nor the Shareholders Agreement would fall within Section 4(3) as they would not be agreements for the making available of services;
  - the subscription for share or loan capital and the Shareholder Agreement may fall within Section 4(4) as:
    - it will be a contract entered into in connection with a contract falling within Section 4(3) (the Project Agreement); and
    - it will be entered into with another person, the co-investor(s), who in connection with that contract will provide a form of finance to a party to the Contract other than the local authority, namely the Service Provider.

### **Commercial and Legal Issues**

- 5.80 The additional role, risk and rewards for this option (in addition to those commercial issues relevant to PFI generally) are:
- the local authority as an equity provider will involve a retransfer of risk to the local authority in the case of inadequate performance and deductions from the unitary charge impacting upon equity. As such therefore, there may be a reluctance on the part of the local authority to levy significant deductions;
  - the local authority will need to protect its minority interest by:
    - being issued with a distinct class of shares entitling the holder to appoint an agreed number of directors to the Board representing that class;
    - seeking veto rights in relation to proposed changes to the articles taking away its representation on the board, any right to a dividend and other rights;
    - the Service Provider having a dividend policy;
    - having an exit route preventing ‘lock-in’ (e.g. having a ‘put option’);
    - having rights to information; and
    - ensuring that a co-investor (if also a sub-contractor) cannot veto actions against that sub-contractor.
- 5.81 However, as the Articles of Association can be amended by shareholders with 75% of the voting rights, the local authority may wish to ensure that the required protection is included in the Shareholder Agreement.
- 5.82 Conversely the other shareholder may wish to seek specific protections in relation to compensation on termination (particularly where a local authority default is involved).
- 5.83 Generally the commercial and legal issues associated with a joint venture company will also be relevant here.

### **Documentation**

- 5.84 The documentation will be the same as for PFI generally, save that, of course, the local authority will be a party to the Shareholders Agreement in respect of the Service Provider.

### **Risk Transfer**

- 5.85 The risk transfer profile should be the same as for PFI save that care should be taken by the local authority to ensure that its subscription for share or loan capital does not adversely impact on the accounting treatment.

## Part 3 – Capital Investment Strategic Partnership

### OVERVIEW

- 5.86 The investment in strategic infrastructure has developed from the standard ‘stand alone’ PFI structure into an incremental strategic partnering structure. This structure has been adopted by first, the DH in relation to health and social care and, secondly, DfES in relation to secondary schools (the Building Schools for the Future or ‘BSF’ programme).

### DESCRIPTION

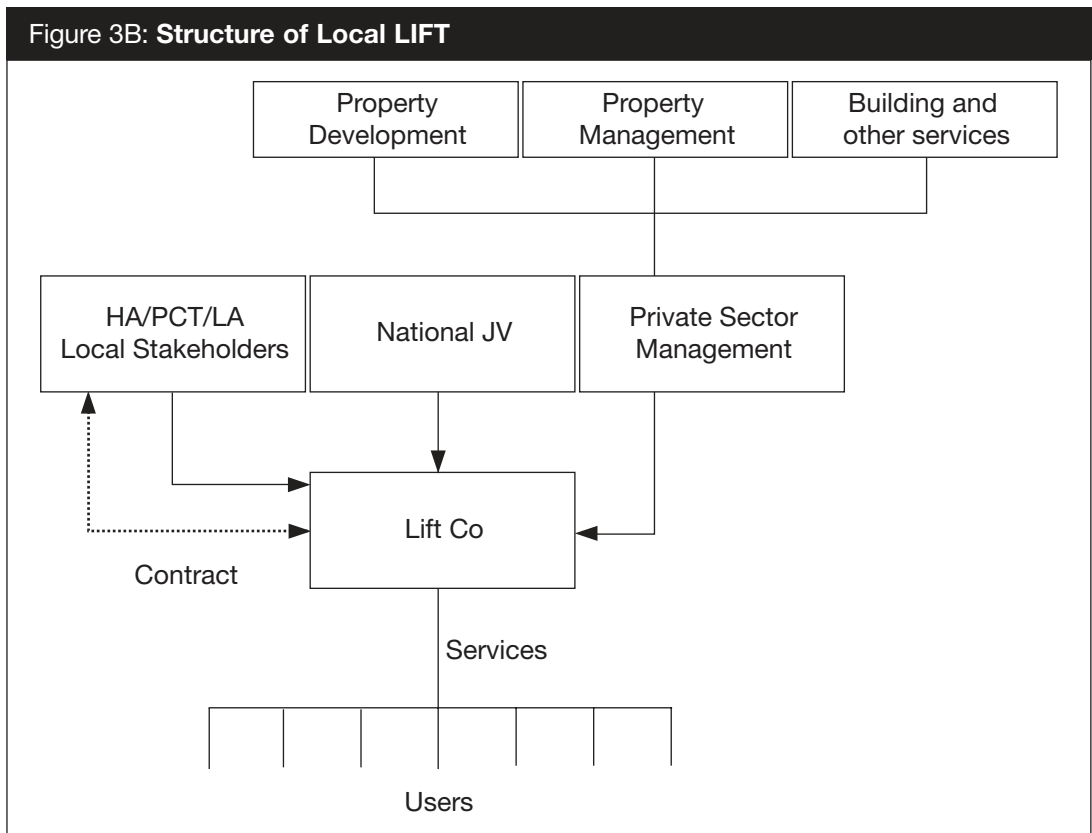
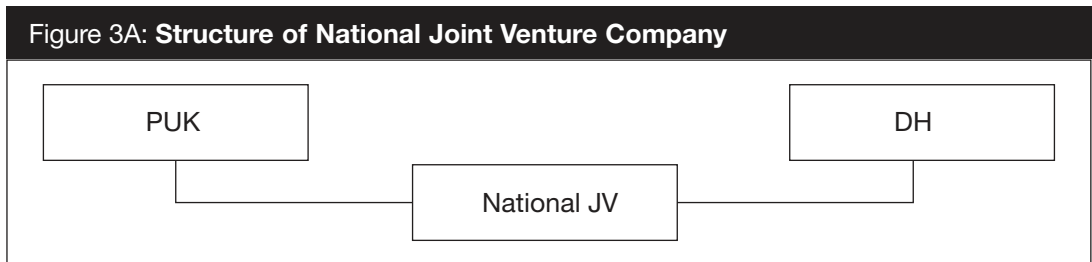
#### NHS LIFT<sup>48</sup>

##### *Structure*

- 5.87 **Figures 3A and 3B** provide an overview of the structure of the NHS LIFT initiative. At the national level a joint venture has been established between the Department of Health (DH) and Partnerships UK plc (PUK).
- 5.88 The national joint venture established by the DH and PUK has as its purpose:
- enabling investment in the local health economy, principally local primary health care facilities and services, to meet NHS Plan targets;
  - supporting the stakeholders in the local health economy in identifying, and reaching agreement with, a private sector partner; and
  - investing, alongside local stakeholders, in the LIFT for the locality, established with the private sector partner to deliver the facilities and services.
- 5.89 The local health economies which bring forward schemes under NHS LIFT are based on existing Health Authority boundaries. They have an integrated and co-ordinated health service strategy for the area and its population, and identified service requirements (and related facilities requirements) to be met under the proposed LIFT scheme. A competitive procurement process is run to identify a private sector partner to join in the LIFT. The opportunity is to become the long-term partner to deliver investment and services to cover the care needs of the locality’s whole population, over the life of a long agreement.
- 5.90 The agreement entered into with the private sector partner establishes the LIFT for the locality as a joint venture between:
- the local health stakeholders;
  - the national joint venture; and
  - the private sector partner.

<sup>48</sup> There are various useful publications on NHS LIFT on the Partnerships for Health website: [www.partnershipsforhealth.co.uk/publications.php](http://www.partnershipsforhealth.co.uk/publications.php). Some of the material in this section is extracted from those publications.

5.91 The LIFT is responsible, not only for managing and implementing agreed investments and services, but also for planning future estate and services requirements to meet the local health economy's needs and developing opportunities identified by the private sector partner.



5.92 Many local authorities have identified a requirement for improved social care services and facilities, with many existing facilities no longer being fit for their purpose or satisfying National Care Standards and models of care. New projects for residential and day-care and nursing care supported housing are being developed to offer better choice, integration and quality of life for vulnerable groups such as the elderly, children, the disabled and people with learning difficulties. Local authorities considering such objectives have looked or are looking at options for involvement in NHS LIFT. A majority of local authorities have already decided to become contracting authorities for local LIFT schemes, with OJEU notices going out which include their name.

5.93 NHS LIFT is an additional procurement tool for local government and health service provision, alongside the Private Finance Initiative (PFI), Health Act Section 31 pooling arrangements, joint venture arrangements and traditional procurement. It is already apparent that NHS LIFT will have a far reaching impact on future joint working arrangements between health sector bodies and local government.<sup>49</sup>

*How Does LIFT Differ From Other Procurement Models?*

5.94 LIFT is based on an incremental strategic partnership. LIFT is fundamentally about engaging a partner to deliver a stream of accommodation and related services through a supply chain, established following a competitive procurement exercise. This is different from either a conventional procurement or a PFI project, which is usually concerned with the delivery of a single facility (or a group of identified buildings) with an initial construction phase together with on-going related services. NHS LIFT has the potential to meet ongoing accommodation needs and is designed to be a flexible procurement tool which can be adapted (within the parameters of the original OJEU) to meet evolving local needs over a period of time.

5.95 LIFT combines elements of other procurement models. LIFT builds on aspects of other procurement models such as

- PFI – LIFT is a long term partnership for serviced accommodation supplied on a no service, no fee basis (note – unlike PFI, ‘soft services’ are not assumed to be included as ‘standard’ under LIFT Lease Plus arrangements – see below);
- Joint Venture Companies – LIFT uses a joint venture company limited by shares as a partnership vehicle;
- Land development – LIFT involves asset and property management planning for more efficient service delivery;
- Strategic Partnering – LIFT is about selecting a partner to deliver a range of projects and services over a long period of time; and
- Public Public Partnerships – LIFT provides a means of facilitating public/public partnerships and strategic investment planning between public and voluntary agencies involved in health or health related functions.

5.96 All NHS LIFT schemes are being delivered through a common approach, developed by Partnerships for Health (PfH). PfH is a national joint venture company established by the central bodies involved in promoting the LIFT initiative, namely, the Department of Health (DH) and Partnerships UK (PUK). PfH works with local health and social care economies to plan and manage procurement, through competition, of private sector joint venture partners for local LIFT schemes.

<sup>49</sup> 4Ps have produced various publications on Local Authorities and NHS LIFT which can be found on the 4Ps website [www.4ps.gov.uk](http://www.4ps.gov.uk)

- 5.97 Local LIFTs (LIFT Cos) are joint venture companies in which the private sector partner will work with health authorities and Primary Care Trusts (PCTs) local authorities and other stakeholders in the local health and social care economy (for example GPs, dentists, voluntary sector bodies and others) to deliver property-related investment, services and facilities to end users over a 20-25 year period. Local LIFT Cos are established with the majority of shares held by the private sector (60%) and the remainder being split between Partnerships for Health and the public sector participants (20%-20%). LIFT Co will manage and implement not only services and requirements identified for the purposes of the initial procurement competition (i.e. when the LIFT partner was selected) but will also be responsible for helping to plan future estate services to meet the needs of the local health and social care economy for at least a generation. LIFT Co may discharge its obligations to deliver developments itself or through a special purposes company(s) wholly owned by it.

#### *The Potential Benefits of LIFT to Local Government*

- 5.98 Integrating service provision between health and local government – LIFT offers an opportunity for local authorities and health providers to join forces to plan strategically for their accommodation needs and to deliver integrated health and health related services to users.
- 5.99 The saving of bid costs – One major attraction of LIFT is that it enables both the private and public sector to limit the majority of expenditure on procurement costs to the initial procurement exercise.
- 5.100 Attracting bidders and VFM bids – Smaller PFI schemes (with a capital value of less than £20m) are common in local government. An HM Treasury publication of July 2003<sup>50</sup> mentions the fact that PFI is unlikely to deliver value for money where the costs of pursuing PFI are disproportionate to the value of the project. LIFT could be used for such smaller health and social care projects.

#### *The Structure of NHS LIFT*

- 5.101 The Strategic Partnering Context – One of the principal characteristics of the LIFT structure is its strategic partnering dimension. This is exemplified by the stakeholders in a local health and social care community establishing a non-statutory Strategic Partnering Board (SPB). The SPB will be the forum where agreement concerning the local health and social care needs and requirements for local services and facilities to be provided by LIFT Co will be reached. By appointing members to the SPB, local authorities are able to work with the other statutory bodies in health and social care (e.g. PCTs) and representatives such as GPs, dentists and voluntary sector groups to agree priorities for service development and improvement. Due to the nature and legal form of voluntary sector bodies, special considerations will apply when working with the voluntary sector in NHS LIFT, such as who will be the contracting authority for the procurement, the placing of demand risk and to whom will the Lease Plus be awarded (generally, voluntary sector bodies are not able to take long leases). However, such considerations are not insurmountable. The SPB will also include a representative of LIFT Co. Members appointed to the SPB by local authorities may only act within the parameters of the approvals given by their respective local authorities.

<sup>50</sup> PFI: Meeting the Investment Challenge: HM Treasury.



- 5.102 Strategic Partnering Board – The SPB will meet at least quarterly, although decisions will be taken by a majority vote. Such decisions will only be binding on the local authority participants if their representative has supported the decision. The SPB will act as a forum for the exchange of ideas and enable local authorities and other statutory health and social care bodies to discuss the forthcoming accommodation and service delivery needs to ensure an integrated co-ordinated approach to fulfilling such requirements. The SPB approves the annual Strategic Service Development Plan (SSDP) for health and social care provision in the NHS LIFT area and encourages proposals from LIFT Co for new projects to improve facilities and/or services in compliance with the SSDP.
- 5.103 LIFT Co – LIFT Co will be a joint venture company limited by shares. The private sector partner selected at the end of a procurement process will have a majority shareholding in LIFT Co (60%) and local statutory stakeholders (including PCTs, health authorities and local authorities) known as Participants, will have a minority shareholding (20%), the remainder (20%) being held by Partnerships for Health. LIFT Co will enter into various contractual arrangements with Participants most notably the Strategic Partnering Agreement ('SPA') and individual Lease Plus Agreements ('Lease Plus(es)') to facilitate the objectives of the LIFT. The shareholders in LIFT Co will also enter into a Shareholders Agreement to regulate their relationship within LIFT Co.
- 5.104 Strategic Partnering Agreement – The partnering arrangements for NHS LIFT are supported by a SPA entered into between the Participants and LIFT Co. The SPA will set out how the parties act together over the long term in a collaborative, partnering, non-adversarial, open manner with a view to achieving the objectives of the local LIFT. It establishes a framework within which the Participants in the LIFT and the other local health and social care stakeholders can work with each other and LIFT Co to provide integrated solutions within the LIFT area for an initial term of 20 years. This period may be extended by 5 years by any one or more of the Participants.
- 5.105 For Participants not wishing to continue, the SPA expires at the end of the initial term. The SPA will establish the SPB and LIFT Co as the partner for the provision of new services and facilities in the LIFT area. LIFT Cos are responsible for identifying and proposing ways in which service delivery can be improved, for example through new property management techniques, technological developments or other property solutions. These are called Partnering Services and are provided by LIFT Co without specific remuneration, although the cost of providing such services is expected to be factored in by bidders as part of the overall management costs of the business.
- 5.106 'Exclusivity' means that LIFT Co will have the exclusive first right of refusal to provide new facilities and/or services commissioned by the Participants in accordance with the annual SSDP. However, Participants must be satisfied that LIFT Cos proposals meet their respective approval criteria, are affordable and the solution proposed by LIFT Co demonstrates best value. Where such criteria are not satisfied, the Participants can either proceed through an alternative procurement route for the required services or decide not to proceed. The exclusivity provisions are intended primarily to apply to primary care providers

such as PCTs and it will be a matter for local authorities to determine the extent to which, if at all, they are prepared to grant any exclusivity to LIFT Co.

- 5.107 Where local authorities wish to include properties within the initial tranche of a LIFT programme, then these properties will be transferred to LIFT Co in accordance with the SSDP. Furthermore, where, in future, new projects to improve facilities and/or services are brought forward and they involve existing local authority properties, once again the properties will be transferred to LIFT Co at full open market value and LIFT Co will be responsible for obtaining all necessary planning permissions. LIFT Co will pay a proportion of the profit or overage (i.e. a share of anticipated development gain) to the local authority on the uplift of the value of any properties transferred if planning permission is granted within ten years of the transfer of all or part of the property. The overage payment will be 50% of the enhanced value.
- 5.108 Lease Plus – LIFT Co is expected to provide serviced accommodation from new, refurbished or existing premises. To achieve this, LIFT Co will enter into a Lease Plus Agreement with the occupants of the accommodation. A Lease Plus is in many respects akin to a conventional lease, but there are additional provisions in the Lease Plus for LIFT Co to provide ‘managed accommodation’, including such services as repair, maintenance and insurance. Payment of the rent under the Lease Plus is dependent upon the accommodation being available for use by reference to the standards contained in the tenants’ requirements (or output specification). Where the required standards are not met, no rental payment is made. Where the required standards are not met, but the failure does not prevent the facility being used then, once defined response and rectification times have passed, the local authority as tenant will have the right to remedy the failure at LIFT Cos expense. It is intended that the length of Lease Plus(es) will be flexible to cater for the individual needs of occupants including those of local authorities who may, in appropriate circumstances, seek a long term lease.
- 5.109 New Projects – LIFT Co will be expected to deliver initial and future services to the SPB and occupants under Lease Plus(es) by way of arrangements with supply chain contractors rather than by itself. Due to the long term nature of the strategic partnership, local authorities (indeed all other public sector bodies such as PCTs) will be obliged to demonstrate value for money for their on-going and future requirements. These considerations would be unlikely to be demonstrated if LIFT Co had complete freedom over its own sub-contracting arrangements. There is a market testing obligation on LIFT Co to demonstrate value for money for new projects.
- 5.110 Shareholders Agreement – LIFT Co is a joint venture company with a majority shareholding for the private sector partner. The local authority will, if it wishes to engage at this level, together with other local stakeholders such as PCTs, take a minority shareholding. There will also be a minority shareholding for PfH who will invest on the same terms as the private sector partner and will act both to protect its return on its investment and as a common investor across the LIFT initiative. The Shareholders Agreement is structured to allow LIFT Cos sufficient commercial flexibility to manage the business, whilst providing important protections for all shareholders in respect of the activities

of the company. For example, certain matters for decision by LIFT Co will require the consent of all shareholders. Share transfer provisions lock the initial shareholders in for a defined period, give rights of first refusal to PfH and local stakeholders over each other's shareholding and ensure the suitability of any successor private sector partners.

- 5.111 As a Shareholder in LIFT Co, local authorities will be entitled to dividend payments in accordance with an agreed dividend policy.

#### *The Levels of Engagement in NHS LIFT for Local Authorities*

- 5.112 The principle options for each local authority are:

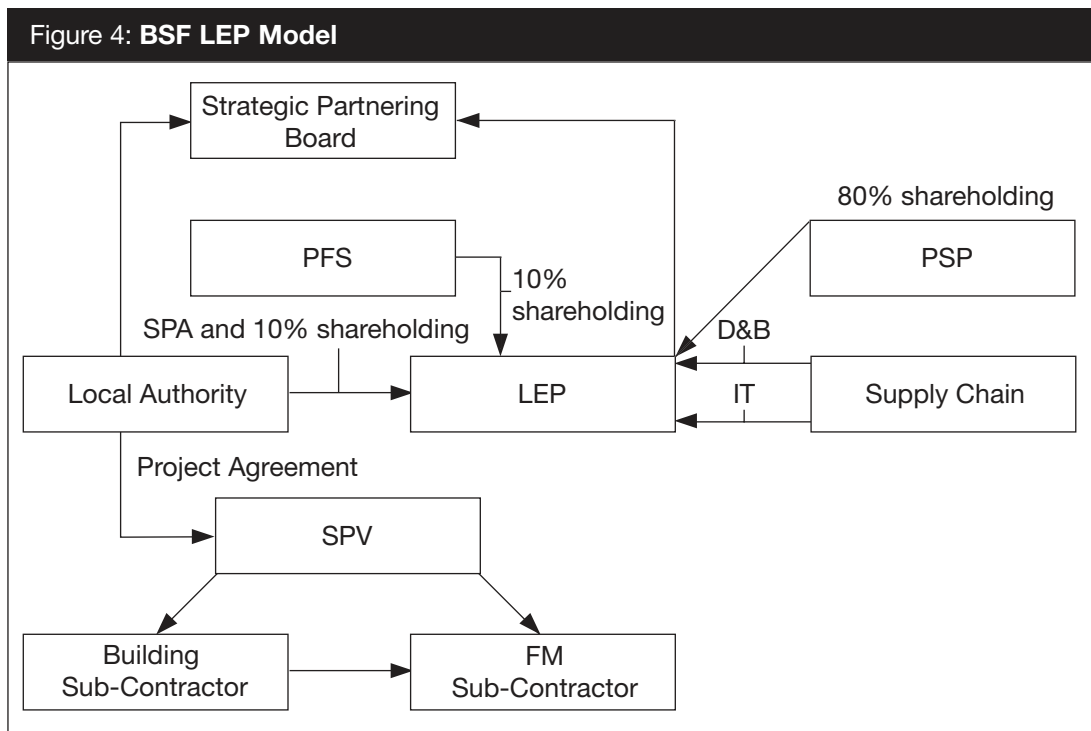
- no involvement in NHS LIFT at all;
- Level 1 – To take up Lease Plus agreements in respect of individual premises without signing the SPA (this will mean that the local authority will obtain and have accommodation);
- Level 2 – To agree to be a Participant in the SPA without exclusivity (in this case the local authority will be part of the strategic partnering arrangements participating, for example, in the development of the Social Services Development Plan. However, the local authority will not grant an exclusive right for its new health and social care premises);
- Level 3 – To agree to be a Participant in the SPA with exclusivity (in this case the local authority, in addition to participating in the strategic partnering arrangements will grant exclusivity over which of its new health and social care premises it so determines); and
- Level 4 – To take up shares in LIFT Co. This option can either be combined with Levels 2 and 3 or can be a stand-alone option (the local authority also invests in LIFT Co with the aim of returns).

#### **Building Schools for the Future (BSF)<sup>51</sup>**

##### **Structure**

- 5.113 A strategic partnering model has also been developed for investment in secondary schools (although key to the model is the expectation of transformation in school standards as a consequence of the programme). At the core of the model is the Local Education Partnership or LEP. The LEP is a joint venture company established by a private sector partner procured following a competition. Once appointed the private sector partner will subscribe for 80% of the shareholding in the LEP. The other 20% will be split equally between the local authority and Partnerships for Schools or PfS (Non Departmental Public Body established by DFES to invest in the BSF programme). **Figure 4** illustrates the BSF LEP model.

<sup>51</sup> There are various useful publications on BSF on the Partnerships for Schools website [www.p4s.org.uk](http://www.p4s.org.uk). Some of the material in this section is extracted from those publications.



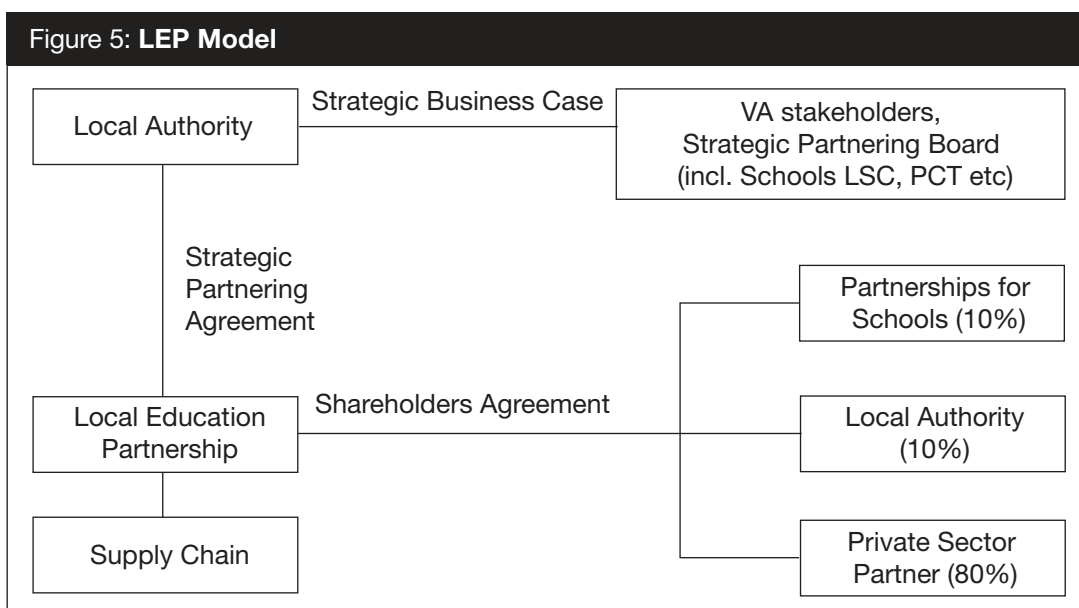
#### *How Does BSF Differ from Other Models?*

- 5.114 Rather like NHS LIFT, the BSF LEP model is based on an incremental long term strategic partnership. It is fundamentally about each Local Education Authority engaging a partner (following a competitive procurement exercise) to deliver, through a supply chain, investment and related services (and consequential transformation of education standards) into that Local Education Authority's secondary school estate. As with NHS LIFT the BSF LEP model is not concerned with the delivery of a single facility but rather with ongoing investment needs across the whole of the Local Education Authority's secondary school estate.
- 5.115 Inevitably, given that BSF is a long term programme and involves a complex mix of funding routes, services and contracts, the initial procurement has been designed to select a private sector partner ('PSP') with a very wide range of skills and expertise and the establishment of a long term partnership in order to develop and deliver future projects in a manner that would deliver BSF Programme requirements at a local level.
- 5.116 The LEP model operates at two levels:

Standard Document	Purpose	Signed between	When	Term
<b>Creating a long term partnership</b>				
Shareholders Agreement	Establishing the LEP company as a joint venture partnership between the Local Authority, PfS and the PSP	Local Authority, PfS and PSP	Following selection of preferred bidder in initial procurement	No fixed time limit
Strategic Partnering Agreement	The grant of a long term exclusive role in the local area by the Local Authority to the LEP company to develop and deliver future capital projects in its secondary school estate	Local Authority and PSP	Following selection of preferred bidder in initial procurement	10 years with a possible extension to 15 years
<b>Delivering BSF projects through the long term partnership</b>				
PFI documents	Delivery of PFI projects developed by the LEP company	Local Authority and SPV controlled by LEP Co	Following approval of LEP proposals by Local Authority	

*Strategic Partnering Arrangements*

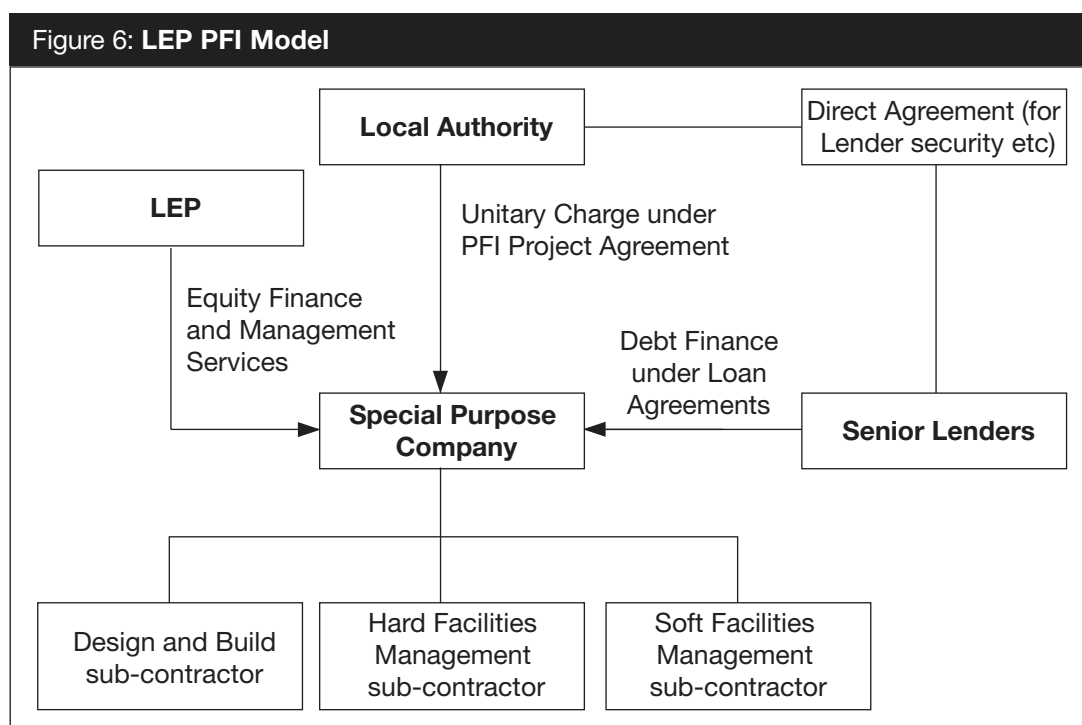
5.117 The basic LEP model structure is illustrated in **Figure 5**.



- 5.118 Following the selection of the PSP, the LEP for a BSF area will be established with the three shareholders signing the Shareholders Agreement (SHA). The Shareholders Agreement establishes the joint venture company, and provides a framework within which it is to operate, including adhering to a Business Plan approved by all shareholders. The SHA also provides PfS and the Local Authority with consent rights over some important reserved matters like business planning, project structures, market testing, management controls and dividend policies.
- 5.119 The LEP once incorporated will enter into a long term Strategic Partnering Agreement (SPA) with the relevant local authority. The SPA sets out:
- the exclusivity granted to the LEP to develop and deliver future schools projects in the area (in consequence with the Strategic Business Case for that area), and
  - the terms under which such exclusivity will be granted including the provision of Partnering Services as set out in the Partnering Services Specification, compliance with a two-stage approval process for each project and demonstration of continuous improvement (through meeting KPIs) and value for money (through benchmarking and/or market testing of the supply chain).
- 5.120 Once new projects are approved by the local authority under the terms of the SPA, the local authority will enter into contracts for them, either directly with the LEP, or with subsidiary project companies set up by the LEP (e.g. SPVs for PFI schemes).

#### *Contractual Structure for PFI Projects*

- 5.121 The local authority will enter into PFI Project Agreements for the delivery of schools projects through PFI. These contracts will be design, build, finance, operate and maintain arrangements, under which the LEP, or as likely a subsidiary project company, will take responsibility over a 25 to 30 year period for the design, build, finance, operation and maintenance of schools facilities.
- 5.122 To recover the capital invested in these facilities, the LEP (or a subsidiary project company) will be paid a Unitary Charge every year of the contract, subject to performance against pre-set standards. The terms and conditions governing the local authority's payment of the Unitary Charge will be set out in a PFI Payment Mechanism, which will be a schedule to the PFI Project Agreement. The local authority's output requirements and performance standards will be set out in the Output Specification, which will also be a schedule to the PFI Project Agreement. Deductions will be made from the Unitary Charge for shortfalls in service standards.
- 5.123 The contractual structure for PFI contracts will in general reflect that set out in Part 2 of this Chapter 5 and is illustrated in **Figure 6**.



- 5.124 The LEP will be required under the terms of the SPA and the SHA to enter into Management Service Agreements with any project companies that it sets up, for the management of such companies. This, together with the proviso that such project companies are to be subsidiaries of the LEP for the lock-in period, provides the LEP with overall control of performance across the programme.
- 5.125 Finally, funders providing limited-recourse finance to PFI project companies set up by the LEP are likely to require a Direct Agreement with the local authority, under which the local authority agrees not to terminate the project while the lenders have stepped in to resolve default situations, and also suspends action under its own collateral warranties with the sub-contractors for a given time period.

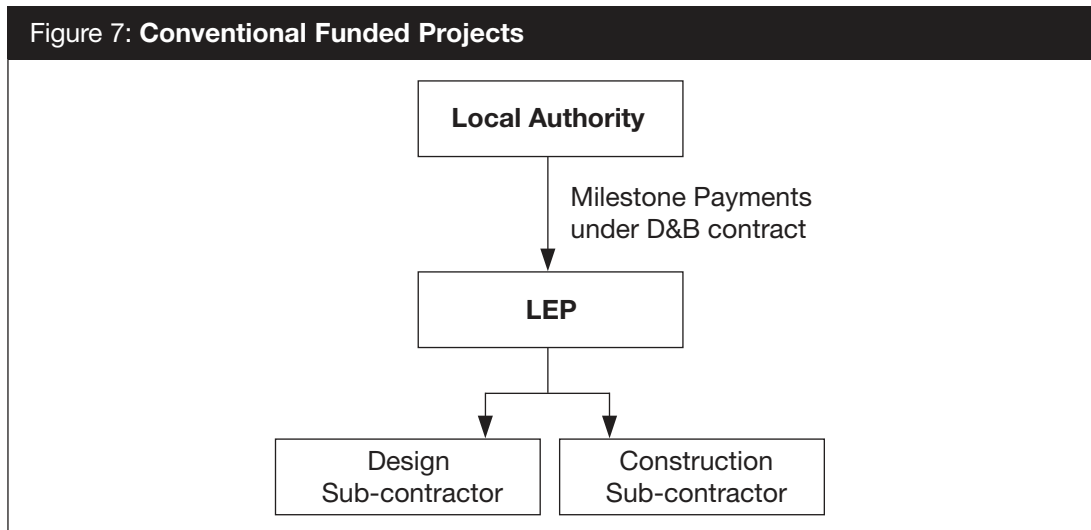
#### *Contractual Structure for Conventional Projects*

- 5.126 For conventionally funded projects (i.e. using public finance), the local authority will enter into a Design and Build Contract. These contracts will require the LEP (or its subsidiary companies) to design and build the schools facilities to the local authority's specifications.
- 5.127 The starting point for the specification will be the same as the Output Specification, but the contractual form may well be more 'input-based' depending on the specifics of the project and value for money considerations. Payment will be made by the local authority to the LEP on the achievement of milestones set out in the contract. A Guaranteed Maximum Cost (GMC) and a Target Cost will be agreed between the LEP and the local authority. If the outturn cost is less than the Target Cost, savings will be shared equally between the local authority and the LEP. If the outturn cost is more than the Target Cost but less than the GMC, the LEP will only be entitled to half the additional cost above the Target Cost. To the extent that outturn cost exceeds



the GMC, it will be the sole liability of the LEP. Payments will be made against actual cost data, the form and content of which will be agreed in advance.

- 5.128 The contractual structure for the Design and Build Contracts is illustrated in **Figure 7**:



#### *Contractual Structure for FM Services*

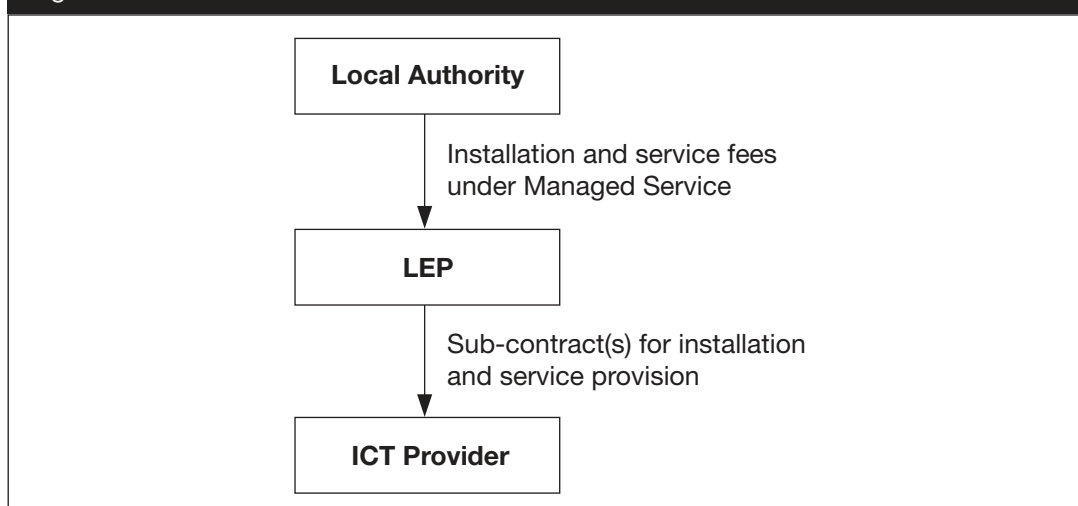
- 5.129 Once a BSF school has been procured under a conventionally funded Design and Build Contract, there will be on-going bespoke maintenance requirements identified for each school which may involve the local authority requiring the LEP to price and contract for such facilities management arrangements. These contracts will need to be developed on a project-specific basis for the time being, reflecting local decisions on scope and funding for FM services, and existing local arrangements for these services.

#### *Contractual Structure for Managed ICT Services*

- 5.130 BSF schools will require ICT facilities, and it is proposed to provide these as an integrated ICT managed service. The ICT Services will be delivered under an ICT Services Contract, which will place design, installation, managed service and training obligations on the LEP. Payment for the installation phase will be made in milestones against completion, and payments for the service period will be paid through on-going service charges against pre-set performance standards.

- 5.131 The contractual structure for ICT Services Contracts is illustrated at **Figure 8**:

Figure 8: ICT Contracts



## REGULATORY, COMMERCIAL AND LEGAL ISSUES

### Powers

- 5.132 Local authorities have sufficient powers to enter into NHS LIFT documents (any of levels 1 – 4). The express power for the function for which the accommodation is to be provided, e.g. National Assistance Acts, will be the underlying power together with Section 111(1) of the Local Government Act 1972, Section 1 of the Local Government (Contracts) Act 1997 and Part 1 of the Local Government Act 2000. Similarly in relation to the BSF document, the underlying powers will be education provision, Section 14 of the Education Act 1996 and Section 2 of the School Standards and Framework Act 1998 taken in conjunction with additional powers mentioned in relation to NHS LIFT.

### EU Procurement

- 5.133 The private sector partner (and initial supply chain) for LIFT Co and the LEP will be procured under the EU rules. It is important for the OJEU in both models to be sufficiently wide to enable all the contemplated works and services to be undertaken without a further procurement. It is also important, particularly in respect of NHS LIFT, to ensure that every potential contracting authority under the arrangement is included in the OJEU.
- 5.134 Once LIFT Co and the LEP are established, then each entity's day to day activities and decisions will be governed by economic consideration and each entity will bear all financial risk. The amount of public funding in LIFT Co and the LEP will be well below 50% of the total funding of the LEP. There will also be no close dependency between LIFT Co, the LEP and the State. As a consequence, each LIFT Co and LEP will not be a contracting authority.
- 5.135 Could the arrangements be construed as a Framework Agreement? Pfs has taken legal advice on this point which is available on its website. In summary, the advice is that the arrangements are unlikely to constitute a framework agreement in practice as:

- the LEP and its underpinning standard documents have been structured in such a way as to emphasise that the arrangements are a framework contract. A framework contract is a legally binding agreement between a contracting authority and a contractor where the essential terms of the contractual arrangements, such as price and the technical specifications, have been fixed but where other matters, such as precise quantity and delivery dates, have yet to be decided. Framework contracts already exist as a concept and whose legality did not depend upon the Consolidated Directive coming into force. None of the concerns relating to four-year time limits apply to framework contracts;
- in so much as the Consolidated Directive appears to provide contracting authorities with the option of awarding framework agreements, it is open to the BSF local authorities to make it clear in the OJEU advertisement that they have not exercised such an option; and
- the exclusivity arrangements which are at the heart of BSF and the fact that the Strategic Partnering Agreement is itself a binding agreement provide strong evidence that what is being procured is not a framework agreement but a framework contract.

### **Commercial Legal Issues**

5.136 To summarise, the roles, risks and rewards of the parties in relation to NHS LIFT and BSF are as follows:

**The local authority** (in the case of NHS LIFT with the relevant Primary Care Trusts)

- procures the private sector partner for LIFT Co or LEP (in accordance with EU procurement rules)
- in the case of NHS LIFT enters into:
  - Lease Plus Agreement for accommodation; and if chooses
  - Strategic Partnering Agreement (for Partnering Services and New Projects); and
  - Shareholders Agreement (for participation in LIFT Co)
- in the case of BSF enters into:
  - Strategic Partnering Agreement (for Partnering Services and New Projects);
  - Shareholders Agreement (for participation in the LEP)and in relation to individual projects
  - PFI Agreement where investment is through the PFI;
  - Design and Build Contract where investment is through concentrated funding; and/or

- ICT Services Contract for the provision of ICT.
- provides the relevant output specifications
- determines the extent of Partnering Services (for new projects) required from LIFT Co or LEP
- manages the change process and staff transfer as required
- ensures delivery of the assets/services invoking payment deductions if necessary
- approves new projects brought forward by the LIFT Co or LEP
- subscribes for share capital in LEP (or LIFT Co if appropriate)

### **The private sector partner**

- subscribes for share capital in LIFT Co or LEP
- ensures there is sufficiently working capital in LIFT Co or LEP
- enters into the Strategic Partnering Agreement and provides the Partnering Services for new projects
- procures the supply chain:
  - building contractor
  - debt funder
  - FM provider
  - ICT services provider (in the case of BSF)
- ensures that the LEP in relation to individual projects
  - in the case of PFI, subscribes for (or procures) equity share capital in the project special purpose company, procures the special purpose company, enters into the Project Agreement, appoints relevant sub-contractor and debt funders;
  - in the case of conventionally funded projects enters into the relevant design and build contract;
  - in the case of ICT, enters into the relevant ICT Services Contract
- ensures that LIFT Co in relation to individual projects
  - enters into the relevant supply chain agreements, Lease Plus Agreements and funding documents with the debt providers.

- 5.137 Both for NHS LIFT and BSF the standard documents which have been produced allocate the risks between the local authority and LIFT Co or LEP as appropriate. There is little or no scope to negotiate these documents. Negotiations are limited to issues which are specific to the project (e.g. land issues).

**Documentation**

- 5.138 In relation to NHS LIFT:

- Strategic Partnering Agreement (covering exclusivity, partnering services and new projects)
- Shareholders Agreement (governing LIFT Co)
- Lease Plus Agreement (for individual serviced accommodation) which includes the payment mechanism and specification
- Supply Chain Agreements (for works and services)
- Funding Documents (generally similar to PFI)

- 5.139 In relation to BSF:

- Strategic Partnering Agreement (covering exclusivity, Partnering services and new projects)
- Shareholders Agreement (governing LEP)
- PFI Project Agreement and other PFI documents (these are set out above at paragraph 5.66) for projects funded through PFI
- Design and Building Contract including specification (for conventionally funded projects)
- ICT Services Contract (including ICT output specification) for ICT projects
- Managed Services Agreement (between the LEP and individual project companies for contract, company secretarial and administrative services).

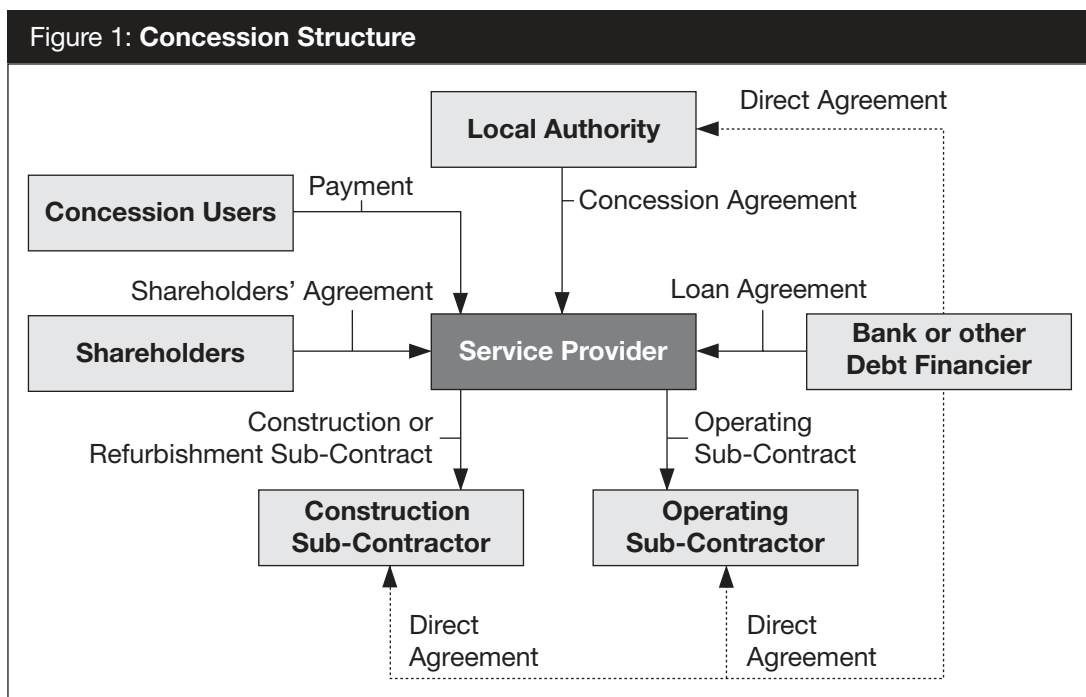
# CHAPTER 6

## Other Structures

### Concession

#### OVERVIEW

- 6.1 A concession or franchise (to be distinguished from the public public franchise arrangement explained in Chapter 2) involves the grant by the local authority of the right to exploit the revenues or cash flows from an asset(s). It is similar in nature to PFI (Private Finance Initiative) save that instead of the revenues or cash flows emanating from the local authority (and dependent upon performance), the revenues and cash flows emanate from third-party users of the asset(s) which are the subject of the concession (and therefore dependent upon demand).
- 6.2 A franchise arrangement might work in the reverse way. For example, the private sector would create some intellectual property rights around a particular function or process, say, local land charges. They would then license local authorities as franchisees to run this process probably using their own staff.
- 6.3 The concession only has a limited potential for local authorities in that it really can only be used in relation to income-providing assets (such as airports, bridges, trams and leisure facilities). It may be possible to have a hybrid structure part demand driven (concession) and part performance driven (Private Finance Initiative).
- 6.4 A concession invariably involves works comprising the construction (or part construction) or refurbishment of the asset and thereafter the exploitation of the completed asset for its revenues or cash flows.
- 6.5 The principal concern of the private sector holder of the concession or franchise and its financier will be to protect the revenues and cash flows from the assets to cover costs, debt service and returns on equity (or other investments).
- 6.6 Concessions (as with the Private Finance Initiative) are normally financed on a project-specific basis with the concessionaire being a special purpose company and the security taken by the financier being the cash flows of the concession.
- 6.7 The concessionaire will probably enter into various sub-contractors relating to the supply of works, goods and services to it. **Figure 1** illustrates a typical concession or franchise.



## DESCRIPTION

- 6.8 Where the concession involves a public works concession, the detailed provisions in Regulation 36 of the Public Contracts Regulations 2006 must be followed. Where the concession is a public services concession then the principles in the *Tel Austria* case will apply (see paragraph 2.71). In some circumstances where the concession involves a land deal, the EU procurement rules may not apply and in these circumstances this may make the option attractive.
- 6.9 Once appointed, the concessionaire will enter into a Concession or Project Agreement with the local authority pursuant to which the concessionaire will agree to design and undertake the works to provide or refurbish the asset to be the subject of the concession.
- 6.10 The Concession or Project Agreement will contain provisions identifying the risks to be transferred to the concessionaire and, if appropriate, those to be retained by the local authority. The Concession or Project Agreement is unlikely to contain service provisions (unless a hybrid contract is envisaged), with the contractual provisions being confined to the exploitation of the concession or project asset(s).

## Drivers

- 6.11 The potential drivers for this option are:
- to obtain capital investment for the local authority which is 'off balance sheet';
  - transferring the risk of the cost of provision and of the lifecycle and routine maintenance of the facilities throughout the life of the contract;



- maximising revenue from the concession assets;
- benefiting from the commercial acumen of the investors and debt provider in controlling construction and operating costs.

### **Disadvantages**

6.12 The potential disadvantages of this option are:

- the local authority is required to part with possession of the facilities for the contract period;
- the project financing structure is often a complex one;
- any local authority employees in the undertaking will transfer to the operator;
- unlikely to obtain certainty in revenue stream or concession fee as likely to reflect either use or profit share;
- rather inflexible to secure the Best Value duty of continuous improvement.

## **REGULATORY, COMMERCIAL AND LEGAL ISSUES**

### **Regulatory Issues**

6.13 Some of the regulatory issues to consider include:

- confirming the legal powers exist to enter into a concession in the situation being considered;
- unless services are to be provided to the local authority as part of the concession the concession agreement is likely to be incapable of certification under the Local Government (Contracts) Act 1997;
- there must be significant risk transfer to ensure 'off balance sheet' treatment of any works. If the local authority, as is likely, do not make payments to the concessionaire then it is unlikely that the concession could amount to a credit arrangement; and
- the appointment of the concessionaire is likely to be in accordance with the EU procurement rules.

### **Commercial and Legal Issues**

6.14 The Concession or Project Agreement will need to address the following commercial and legal issues:

- the duration of the concession;
- any provisions relating to the transfer of any assets and any ancillary warranties to be given by the local authority;
- provisions relating to the achievement of the construction or refurbishment works relating to the asset(s);

- obligations in relation to the availability of the asset(s);
- any provisions to ensure that the asset(s) are capable of being used by third parties etc;
- provisions apportioning the risk of changes in law;
- provision dealing with regulatory and perhaps political risk;
- the amount of any payment due to the local authority by way of a concession or franchising fee (including basis of that fee e.g. user or profit share);
- restrictions or prohibitions on sub-contracting and assignment;
- any circumstances or events which may relieve the private sector from performance, including payment of the concession fee;
- the extent of indemnities to be given by the concessionaire and local authority;
- the extent of required insurance;
- 'hand back' provisions in relation to the expiry or termination of the concession;
- provisions for the resolution of disputes;
- grounds for the termination of the concession: for example, insolvency of the concessionaire, material breach of contract and non-payment of the concession fee;
- compensation, if any, for concessionaire on termination;
- provisions relating to the transfer of assets on the expiry or termination of the concession;
- the extent of consequential adjustments between the local authority and concessionaire on termination; and
- provisions enabling the financier to 'step in' on default and termination.

### **Documentation**

6.15 This option will involve the following documentation:

- Concession or Project Agreement between the local authority and the concessionaire;
- Memorandum and Articles of Association of the concessionaire and a Shareholders' Agreement between the consortium members who are investors in the project;

- Loan or Credit Agreement between the concessionaire and financier relating to the provision of finance to the concession;
- Construction sub-contract between the concessionaire and construction sub-contractor in relation to the works; and
- Operating sub-contract between the concessionaire and the operating sub-contractor in relation to the services.

6.16 Security documentation in favour of the financier comprising:

- Direct Agreements with the local authority protecting the financier against termination and permitting the financier to 'step in' or take control;
- Direct Agreements with each of the sub-contractors containing duty of care warranties and permitting the financier to 'step-in' or take control;
- Guarantees in favour of the financier from parent companies of sub-contractors;
- Debenture (fixed and floating charge) from the concessionaire in favour of the financier assigning all rights to cash flows under the Concession Agreement and prohibiting disposal of the concessionaire's assets;
- Direct Agreements from the sub-contractors in favour of the local authority containing duty of care warranties and permitting the local authority to 'step-in' or take control on termination of the Concession Agreement.

### **Risk Transfer**

6.17 This option will result in the allocation of risks between the parties on the basis of which party is best placed to manage the risk. Risks associated with the design, build, finance and operation of the project will be borne by the private sector. Risks associated with changes to the concession arrangements by the local authority or specific or discriminatory changes in law will be borne by the local authority. Risks that do not represent good value for money or are beyond the control of the parties (e.g. fire, flood, accidental damage etc) will be shared.

6.18 The risks transferred by the local authority will have to be such as to ensure that the concession is 'off balance sheet'.

# APPENDIX 1

## The Prudential Framework and Structures for Partnership

### **Before the Prudential Framework**

The introduction of the Prudential Framework for Capital Investment by Part I of the Local Government Act 2003 from 1 April 2004 has given a new and substantial impetus to consideration of the ways in which local authorities manage and finance their capital strategies, and the value for money that they may be able to secure from the process.

Until 2004/05 authorities had been tightly constrained by Government control and discouraged from taking fully into account all the strategic and operational factors that should influence a comprehensive capital strategy. The consequences of being over-optimistic in terms of being able to balance the annual capital budget also encouraged authorities to be cautious. Authorities were also discouraged from taking the lead on partnership approaches to capital investment by their inability to act on a long-term basis.

### *The Promise of the Prudential Framework*

The Prudential Framework has gone a substantial way towards removing some of these obstacles to effective capital strategies, and authorities are now exploring the full scope of the opportunities that are offered. The Prudential Framework has swept away the huge volume of regulations that were required to maintain the restrictive 1989 Act regime and replaced them with arrangements that are far more businesslike, trusting of authorities to act prudently, and respectful of the professionalism of the authority's officers.

Prudential borrowing allows local authorities to tap into significantly cheaper funding, typically at least 2% per annum, compared to private sector project funding at the expense of having to retain more risk. So as the chart shows, prudential borrowing equates to low cost whereas project finance has higher interest cost but greater risk transfer to the private sector.



Previously, an authority's borrowing was subject to approval by the Government, with the benefit at least that such borrowing attracted compensation under the Rate Support Grant (RSG). Under the Prudential Framework, Basic Credit Approvals are renamed Supported Capital Expenditure (Revenue). The effect is the same in that they provide revenue support in future years to meet the costs of principal and interest payments on the debt.

Accordingly, capital expenditure incurred by an authority without reference to the Government is 'unsupported', in the sense that it does not attract any compensation through RSG. Authorities are given the ability to determine their own levels of capital investment based on whether their consequences can be afforded from future revenues. Authorities are able to look to the future and assess whether: new expenditure arising from a measure of depreciation, interest costs on any borrowing required to support the expenditure, and running costs of new facilities balanced by new income generated and efficiency savings arising from the investment will be affordable from all the council's revenues arising over the relevant period.

### *Opportunities for capital investment*

The following are opportunities for capital investment:

- authorities are not constrained in structuring a capital project by having to consider which option will give it the least unfavourable result in terms of controls over capital expenditure. All options should now be able to be judged equally on the basis of the contribution they make to service delivery objectives and value for money.
- provided that all relevant prudent considerations have been made (e.g., the exposure that an authority might have to changes in interest rates), affordability is to be judged over the whole life of the project, including the potential for efficiency savings and income generation. This will facilitate a longer-term view for the authority, extending well beyond the point of acquisition/construction, and allow a wider assessment of the benefits that investment will bring. The Framework removes the discouragement that might previously have applied to longer-term projects such as infrastructure investment.

- putting capital and revenue on an equal footing allows a more scientific approach to the profiling of maintenance and replacement, such that planning the point that replacement is to take place may be a more economic alternative than continued maintenance (e.g., for a road) can now be done without consideration as to whether capital resources are available to fund the replacement precisely in the year of replacement. Authorities should review maintenance and replacement cost profiles across all aspects of infrastructure investment. Authorities are able to factor commitments to make annual contributions to running costs into their analyses. Public or private partners can participate in a local authority project by committing to future payments, rather than having to make an up-front contribution towards capital costs. This makes it more feasible for authorities to take the lead on long-term projects and provide the funds for capital investment.
- local authorities have greater freedoms to enter into leasing transactions. They are free to enter into operating leases on a pay-as-you-go basis and find that finance leases are a relevant alternative provided that rentals are affordable and that the credit represented by the lease does not over-commit the authority.
- the loosening of the ties between the financial performance of companies in which an authority has a controlling interest and the authority's own financial position. Controlled companies can take a more commercial approach to the longer-term business opportunities without worrying about any immediate adverse effect on the authority. Authorities can take a majority interest in a new company as there is no disincentive for authorities to invest in companies whose activities will be capital intensive.
- although local authority powers to give guarantees are not extended by the Prudential Framework, authorities will now be able to do so without any financial impact until such time as it is likely that the guarantee will be called and accounting rules require the making of a provision.

### ***Experience to Date***

In November 2004, the Local Government Association published a report *Loosening the Reins: A Survey of Local Authority Approaches to Prudential Borrowing, Charging and Trading* on a study into the extent to which authorities are using the new freedoms and flexibilities in the Local Government Act 2003, particularly in relation to prudential borrowing. *Loosening the Reins* revealed that only around half of authorities are using the new borrowing powers or have plans to do so.

Overall, £900m of additional spending was planned for 2004/05, with a third of this being allocated to new-build transport projects. Looking forward to 2006/07, the planned level of new borrowing falls to £594m, with transport being overtaken in the list of priorities by education, leisure services and housing. In a survey undertaken for the South East County Councils projections of new prudential borrowing (unsupported by specific Government funding) made by respondents totalled £476 million over the next five years.

The opportunities for the use of prudential borrowing have yet to be fully exploited and the scale of future funding and replacement of expensive past funding has yet to be fully explored by many authorities.



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