



May 2004

BRIEFING 04/27

To All Local Authority Chief Executives and Best Value and Procurement Contacts in England

To Best Value Contacts, Scotland, Wales and Northern Ireland for information.

Trading guidance consultation – Office of the Deputy Prime Minister

Key issues

- ODPM publish Draft Statutory Instrument on The Local Government (Best Value) Power to Trade (England) Order 2004 and adjoining guidance on the Power in the Local Government Act 2003
- APSE in response to the ODPM is now consulting member authorities and trade unions on the draft SI and draft guidance

Local authorities have been trading in goods and services between authority to authority and to the private sector under a range of existing powers namely;

- The Local Authority (Goods and Services) Act 1970
- S111 of the Local Government Act 1972
- S2 Local Government Act 2000 (Power of Well Being)
- and express powers in other legislation:-
- Civic Restaurants Act 1948
- Local Government Miscellaneous Provisions Act 1976
- and the new power to charge for discretionary services under S 93 of the

Local Government Act 2003 (which provides a basis services to public / private bodies)

It is APSE's view that the existing powers provide a sufficient basis for local authorities to continue to operate trading arrangements. However a new power has recently been added as a result of the Local Government Act 2003 (LGA 2003). Within that Act in Sections 95, 96 and 123 a power was given to local authorities to charge and trade for services subject to an Order (Statutory Instrument) of the First Secretary of State.

The draft Order by way of a Statutory Instrument (SI) and guidance to accompany the Order and the trading powers laid down in the LGA 2003 has now been published by the Office of The Deputy Prime Minister (ODPM). For information whilst the primary legislation applies to Wales secondary guidance will be the subject of further guidance from the Welsh Assembly.

The purpose of this APSE briefing is to inform members of the initial response from APSE and to seek further comments in order that a collective response of the APSE membership can be made to ODPM no later than the **11th June 2004**. Responses are therefore sought by the **5th June 2004** to be emailed to mbaines@apse.org.uk or posted or faxed to Mo Baines at the APSE secretariat.

The Draft Order

The draft SI applies to best value authorities that are local authorities within the meaning of SI (2) of the Local Government Act 1999 and applies by virtue of the 1999 Act to authorities that are categorised (CPA rated) as 'excellent', 'good' or 'fair'. The SI does not apply to authorities that act in a capacity as a fire authority exercising functions under the Fire Services Act 1947 and those public authorities specifically excluded under the LGA 2003.

Scope of the Guidance

The draft guidance is intended to form the basis of statutory guidance made by the Secretary of State under the auspices of S 96 (2) of the LGA 2003. If the guidance is

finalised authorities will need to have regard to the guidance in their trading operations.

The Powers Conferred

The guidance and the SI both refer to the ability of local authorities to trade in function related activities for a commercial purpose. However whilst the SI is of itself related solely to trading the guidance also refers to charging issues.

APSE has consistently campaigned for the introduction of new powers in order to clarify the situation with regard to local authority trading and charging and to provide local authorities with a certainty that their trading functions are lawful.

A general ability for authorities to trade was anticipated both in the enabling legislation and in the SI itself. However APSE's initial view of the SI, and the accompanying guidance, is that the conditions that have been attached, and the prescriptive nature of them, will be more restrictive than originally expected. As such the nature of the SI could in effect mean local authorities are better served, by relying upon existing powers, without the arbitrary conditions that are attached to trading by utilising the powers conferred within the LGA 2003.

Differences between Charging and Trading

- All authorities are able to charge for discretionary services regardless of their CPA rating
- Charging is limited to the cost recovery of providing services whereas trading can be at a profit
- Trading powers extend to all services provided that the authority has an 'excellent' 'good' or 'fair' CPA rating.
- Trading must be exercised through a company. There is no need to form a company if an authority merely wishes to levy a charge on a discretionary service.

The distinctions in terms of trading are problematic. Had Government wished to confer a general trading power it could have provided for this in much the same way as to the charging provisions but expanded the ability to trade to statutory

functions. It is necessary to examine the following issues when considering trading under the LGA 2003:-

The Business Case

Before commencing trading, using the LGA 2003 powers, an authority must produce a business case which must have the support and approval of the authority.

This is unlikely to create any significant difficulties for authorities since Local Authority Financial Standing Orders will undoubtedly already prescribe for due diligence and financial propriety, as do public sector accountancy procedures, such as the various CIPFA codes. Moreover many local authorities will have established this as good practice prior to trading under any one of the existing range of powers.

In the case of the draft SI there is explicit reference to the following;-

“Business case” means a detailed case setting out the objectives of the business, forecast as to financial and other circumstances of the business in the event that the objectives are achieved, the investment and other resources required to achieve those objectives and any material risks involved”. [Direct quote from the draft SI]

The Need to Form a Company:-

The need to form a company is explicit within the primary legislation, the draft SI and the accompanying guidance. There is not however a requirement to form a Trading Company where authorities are using existing powers to trade. **In other words it not intended that the draft SI or indeed the intention behind the LGA 2003 is to remove existing trading powers and arrangements.**

In terms of the requirement to form a company in order to trade under the LGA 2003 powers there are a number of points in respect of this. The ‘company’ must be a company within the meaning of Section 5 of the Local Government and Housing Act 1989 (LGHA 1989). Under the current regulations this means that a local authority company is generally restricted in terms of securing capital finance

unless it were regarded as a 'private influenced' company.

APSE is pressing ODPM to revise the definitions of what constitutes a 'public influenced' company to allow local authorities to have a greater involvement in joint venture companies, but in the absence of revised legislation and guidance the current regulations remain as the un-amended Part 5 of the LGHA 1989. It is widely reported that CIPFA are looking to produce a revised code in re-determining the definition of a 'private influenced' and 'public influenced' local authority company. In advance of the new Code and revision to the Local Authority Companies Order one must question the merits of issuing guidance on trading when clearly amendments to the status of local authority companies are needed in order to fully exploit the purportedly 'new found freedoms and flexibilities' stemming from the 2003 Act.

Nevertheless profits from a Trading Company, regardless of its company status, can be used to support borrowing under the terms of the Prudential Code. However where the company is a public influenced company its activities would be recorded in the parent authority's grouped accounts and any capital raised through the company is likely to count against that authority's self-established capital borrowing limit.

Relationship to the Trading Company to CPA scores and consequences of a reduction in CPA scores

The guidance and the SI prescribes that if an authority were to lose its CPA rating to less than 'fair' its trading activities derived by virtue of the LGA 2003 must cease within 2 years of the revised rating (Unless of course the CPA score were to be subsequently amended). The 'two year rule' is a welcomed improvement on the original intention which was to stipulate that trading ought to cease immediately; nevertheless even the 'two year rule' is problematic for a number of reasons.

Firstly the Trading Company may wish to invest in land or property as part of its business case. In effect, in order to do this, the authority would have to agree a two year break clause in any such arrangements. This is hardly likely to provide best value in terms of the current property markets and moreover could lead to

difficulties for the Trading Company in securing suitable premises.

Secondly the two year rule is unhelpful to the operation of prudential borrowing. If a local authority treasurer is considering the viability of a prudential borrowing route, in relying upon income generated by a Trading Company, he / she would undoubtedly need to consider the risk elements of relying upon an income stream that could be cut off from the parent authority after a two year period. For authorities that are on the cusp of the CPA scoring mechanism i.e. just having obtained a 'fair' rating treasurers, and indeed auditors, are likely to be nervous of relying upon trading income for capital borrowing that expands beyond a two year time frame, which any large borrowing plans are bound to be, in order, to make such plans affordable to the authority.

The 'two year rule' that is cited in the guidance is extremely prescriptive and a markedly different approach from the controls that are exercisable in the prudential borrowing framework. In terms of the prudential framework powers are reserved to the Secretary of State should an authority put at risk its own economic standing or in general terms if the actions of a number of authorities were to jeopardise macro-economic interests. This is a sensible approach since it allows for a case by case consideration. It is difficult to reconcile this difference in approach with the supposed aims of the primary legislation in conferring a power to trade.

As members are also aware APSE has already criticised the CPA arrangements (APSE briefing 71-03) that can skew an authority's overall score by one major departments under performance in comparison to other areas of its activities. This skewing of results would be even more unfair in terms of the following illustrative scenario:-

'Newtown MBC has a very successful trading operation in Building Maintenance providing value for money building maintenance services to local Smiley supermarkets. The profit generated from Newtown's buildings maintenance service can be used by Newtown MBC to fund school building improvements because the profits help to service a self-supported borrowing debt (Prudential Code). In order to trade Newton MBC has established a Company Limited by Shares.'

Newtown MBC's Social Services department drastically falls in its performance. The authority's CPA score is reduced from 'fair' to weak'. This means that the power to trade under the terms of the Local Government Act 2003 (and the current subject draft SI and guidance) ceases. Under the terms of the guidance the authority's interest in the trading company must also therefore cease. It must divest itself of the shares that it owns.'

This creates a number of both practical and value for money considerations. Aside from the problems of short term break clauses within contracts – particularly those that relate to leasing land or property - in order to operate a trading operation the two year rule would fetter authorities from utilising the trading profit to generate much needed investment. It also creates unnecessary complications. In order to secure a position whereby the local authority is not left with, in effect, valueless shares the guidance recommends a pre-agreed share price being fixed at the point of forming the Trading Company; such arrangements provide a manifestly weak bargaining position for the local authority as would attempting to openly sell shares at the point when the power to trade is effectively withdrawn by the reduced CPA score.

Whilst there may be a plethora of alternative company set-ups and arrangements to ameliorate these difficulties it is nevertheless an unnecessarily convoluted route to allowing local authority trading. With such obvious pitfalls to trading in this way many authorities are bound to consider trading under the auspices of the LGA 2003 as a last resort if alternative powers can be identified.

Employment Considerations

The 'two year rule' also creates significant difficulties in the field of employment. The employees would not be redundant if the Trading Company continued to trade with new (possibly private sector) share holders but employees could go from being directly employed by the local authority to being employed by what is essentially a private company, with application of TUPE being somewhat clouded, as there is not arguably a transfer of the business entity. It is also possible that the employees would be excluded from the new Workforce Code (since there would

not be a contract under the terms of S101 and S102 of the LGA 2003) unless the reformed Trading Company were specifically contracted by the parent local authority to carry out work on its behalf, and in addition the prospect of the new private sector shareholding company needing to apply for admissibility to the Local Government Pension Scheme.

Indeed the guidance is very dubious in its assumptions as to the application of TUPE in the examples provided. The application or otherwise of TUPE is essentially a legal test that must be based on all material considerations specific to the individual circumstances.

Moreover the guidance contains what APSE believes to be a misleading statement in respect of staff secondments. The guidance states:-

“.....Employees for the new enterprise can only come from one of four sources, which are:

- (i) recruitment from the local / national market place***
- (ii) transfer of staff from within the authority***
- (iii) secondment of staff from the local authority***
- (iv) Another arrangement e.g., taking over employees of another existing business through a merger/ takeover/ purchase of that business.***

In the cases of ii) and iii) above TUPE is likely to apply. In the case of ii) the Code of Practice on Workforce Matters [recitals] concerned with new joiners to an outsourced workforce will also apply”.

Thus ODPM are attempting to establish as fact that the secondment of staff will lead ultimately to a transfer under the terms of TUPE. There is no evidence, case law or otherwise, to support this sweeping assumption. However it's inclusion in the guidance could mislead authorities into thinking that secondments are not a viable option, when in reality secondments can provide a sensible, swift and efficient way of staffing up a trading activity with none of the associated on costs of a formal staff transfer.

Moreover it was never envisaged by APSE members that the ability to trade would

generally lead to the need to create trading companies and separate legal employers, distinct from the local authority, and thus generate transfers of staff. The complexities of TUPE transfers for example are generally avoided by authorities using existing trading powers in the absence of a Trading Company set up. The potential cost and liabilities arising from the prospect of staff transfers to a Trading Company acts as a further disincentive for authorities to use the LGA 2003 powers.

However regardless of the employment implications of transferring staff to a Trading Company this is still unlikely to be the most economically advantageous option. The economic inefficiency of a Trading Company is examined below:-

Inefficiency in trading through a Local Authority Company (Taxation, Procurement and State Aid).

All local authority companies – whether public or private influenced companies are subject to taxation, especially VAT and corporation tax. Thus trading through a company structure is likely to increase service costs back to the local authority since the service would attract VAT that might otherwise be avoided if not traded through a company. This is aside from the ancillary costs associated with setting up a Trading Company.

Moreover any local authority company which is more than 50% owned by the local authority will be subject to the usual EC procurement rules. Therefore trading through a company can not be used as a means to avoid good procurement practice, potentially opening up services to competition that are not currently, because they are directly provided by the in-house workforce.

Local authorities need also to be mindful that assistance to companies is open and transparent satisfying the need to ensure it has the appropriate vires (power) to provide support and assistance and having regard to the usual principles of assessing costs to the authority of providing such support.

Authorities must also be mindful that in setting up a Trading Company operation and in supporting its activities it does not violate the highly complex State Aid

rules that have been set up between EC member states. Prohibition of State Aid is explicit in order to avoid competition being distorted by the use of State Aid. Therefore authorities would need to be mindful of this in supporting a Trading Company.

Alternatives to Trading under the Local Government Act 2003

Given the problems that could emerge from an authority taking its power to trade under the terms of the LGA 2003 and, in particular, the draft SI and guidance, it is likely many authorities will view the new powers as extremely restrictive and not conducive to the overall views of authorities being that they ought to be trusted sufficiently, by central government, to create sensible trading opportunities and in doing so support prudential borrowing or simply allow for the promotion of Well Being.

The necessity to create a local authority company under the terms of Part 5 of the LGHA 1989 was in fact set out under the primary legislation. However the inclusion in the guidance of the two year rule is an onerous and arguably unworkable provision. The Secretary of State may find difficulties in imposing a sell off of shares (should the Trading Company fall foul of the new rules) since the authority may be able to justifiably claim to retain its ability to trade through alternative statutes or means.

For example the helpful case of *R – v – Yorkshire Purchasing Organisation and British Educational Suppliers Association 1997 (the YPO Case)* illustrates that it is not necessary for local authorities to restrict trading activities to merely 'surplus capacity' as has often argued to be the case. Indeed APSE is currently challenging a similar misinterpretation of the legal position within the Scottish Parliament. The *YPO* case clearly established that local authorities are able to trade beyond 'surplus capacity' drawing on powers conferred by the Local Authority Goods and Services Act 1970.

Moreover the scope and breadth of the provisions under the Local Government Act 2000 must surely be considered to provide the basis for authorities to undertake specific activity. S 2 confers on local authorities the following:-

“Every local authority is to have the power to do anything which they consider is likely to achieve any one or more of the following objects:-

- (a) the promotion of improvement of the economic well being of their area**
- (b) the promotion or improvement of the social well being of their area**
- (c) The promotion or improvement of the environmental well being of their area.**

Whilst the Well Being Powers specifically prohibit the raising of money (this was to prevent for example an authority raising a local precept to support Well Being) authorities need to have regard to where they may – regardless of the trading powers conferred by the Local Government Act 2003 – be able to draw an express power to trade and charge for discretionary services in pursuance of Well Being.

Indeed a local authority company formed in pursuance of well being could be deemed to be lawfully trading without the necessity of being in receipt of a CPA score of ‘excellent’, ‘good’ or ‘fair’ or a consequential threat of dissolution under the draconian two year proposals under the current draft guidance and draft SI.

Conclusions

APSE intends to raise our concerns with the appropriate Government department and if necessary the Secretary of State. We would recommend that if authorities intend to embark upon trading arrangements following on from the LGA 2003, and if the SI and the draft guidance remain un-amended that they seek legal advice to what alternative sources of authority they may draw upon in order to trade in the event of any unhelpful restrictions on trading activity / frustration of prudential borrowing plans that might occur.

The views of ASPE members and associates would be appreciated. Given the tight timescales to which we are working it would be appreciated if comments could be received no later than Friday 4th June 2004.

In addition given the complexity of this process APSE would like to know if

members / associates require a special meeting on this matter. Accordingly we would be grateful if you could indicate your requirements on the attached form.

Mo Baines
Principal Advisor

ODPM CONSULTATION ON TRADING

APSE FEEDBACK FORM

RECIPIENT DETAILS

Name of Contact Responding:.....

Organisation:.....

Email address:.....

Tel Number(s):.....

Fax Number:.....

SPECIAL MEETING?

Do you feel a special meeting ought to be held to discuss the proposed new Trading Powers? *(please tick)*

Yes

No

Do you have any comments on the Draft Statutory Instrument and Guidance?
(Please feel free to send in separate comments / queries)

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Please return this form once completed either via fax on 0161 772 1811 or via email to Mo Baines on mbaines@apse.org.uk on or before Friday 4th June 2004

Many thanks

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