



# Committee report

Committee	<b>CABINET</b>
Date	<b>10 OCTOBER 2019</b>
Title	<b>COMMERCIAL TRADING COMPANY</b>
Report of	<b>DEPUTY LEADER AND CABINET MEMBER FOR RESOURCES</b>

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## EXECUTIVE SUMMARY

1. This report sets out the options open to the council for the potential establishment of a commercial trading company in order to provide the necessary means to fully operate on a commercial basis and open further channels for income generation.
2. This decision is set out in accordance with the aspirations of the council's medium-term financial strategy and proposed commercial strategy also tabled on the agenda for the meeting. It takes account considerations of services that could have potential to trade, our internal capacity and expertise to successfully operate a trading company, together with the operating models and options available to us that can secure the greatest success.
3. As a result of this analysis, members are recommended to adopt Option 2: To explore the potential to enter into a joint venture with another local authority or allied public sector organisation.

## BACKGROUND

4. Our medium-term financial strategy makes it clear that the council's financial position remains the most significant challenge for the longer-term sustainability of public services on the Island. Since 2011/12 savings of more than £76 million have been delivered (40 per cent of the council's controllable spending) to meet government funding reductions. Key to the delivery of continued savings necessary is through income generation, economic regeneration and efficiency measures before considering service reductions as a last resort. Against a backdrop of such significant savings already delivered, it is necessary to strive for yet more innovative ways in which to secure reductions in expenditure and wherever possible generate additional income to protect services that are most

needed by the Island's communities.

5. Under the Local Government Act 2003, there are established means by which the council can apply fees and charges for its discretionary services, but these are often limited by regulation or are subject to specific national charging regimes and cannot be used where charging is prohibited, including those services the council is mandated to deliver. Where flexibility permits, fees and charges are regularly reviewed as part of the preparations for annual budget setting and maximised to their full potential, taking account of the limits the recipient is willing to pay.
6. The Local Authorities (Goods and Services) Act 1970 also introduced the ability for councils to enter into shared service arrangements between a local authority and a public body for the provision of goods, materials and administrative, professional and technical services. This offers a degree of flexibility to councils and through our strategic partnerships with Hampshire County Council, Portsmouth City Council and Hampshire Fire and Rescue Service it has been possible to secure efficiencies in service delivery; significant reductions in costs as well as having secured substantial improvements to services. Under this legislative provision, it has also been possible for the local authority to trade with schools for its administrative services on a commercial footing. Our One Island, One Public Service ambition is the basis for further potential to be gained from such an approach.
7. The Local Government Act 2003 does make provision for local authority trading for commercial purposes but involves councils establishing a trading company. Any profits generated may go back to the council through dividends or service charges which can then be invested back into services. To date, the council has not pursued this option.
8. Entering into such a commercial venture for the purposes of traded services does however require careful consideration and clarity of purpose. As important are the considerations of capacity and expertise to successfully operate a trading company; the operating models and options available; undertaking a thorough market analysis to inform whether or not there is a business case to proceed and whether entering a particular service market is the right thing to do, as well as whether there is sufficient officer and project resource to deliver the required outcome.
9. As an alternative to outsourcing, in 2010 the council established its own in-house shared service centre. This saw the centralisation of many common administrative and transactional functions across the council, including those of ordering, invoicing, payments, human resource administration; pensions; payroll etc, with the sole purpose of securing efficiencies and cost reductions for the council. Utilising a model of generic working, it was possible to deliver some £1.9 million of savings while increasing both efficiency and resilience in service provision. Since then it has also been possible to further develop the model through which it is now possible to offer services to schools for the provision of human resource administration, pension and payroll services, within the remit of the legislative powers open to the council alongside many other council services such as the health and safety and human resource advisory service, legal service, property services and fleet management.

10. This, alongside the council's savings programme; strategic partnerships; regeneration schemes; commercial property investments, ongoing review of fees and charges and other income streams from trading where it is feasible to do so, it is perhaps timely to consider whether there are wider opportunities for income generation by the establishment of a trading arm for the council.
11. Whether this is a feasible opportunity for the council is something that requires testing and detailed consideration of the options open to enter into a competitive market, with the purpose of making a profit. There are three main potential options open to the council to consider in this respect:
  - (a) Establish a wholly owned Isle of Wight Council trading company
  - (b) Enter into a joint venture with another local authority or allied public sector organisation
  - (c) Enter into a joint venture with a private sector company
12. Whichever option, if any, is chosen, there will also need to be careful thought given to the types of market and services that have the most potential to deliver a profitable return through trading in the wider market, our commitment to environmental considerations, but which do not severely impact on the Island's own businesses and therefore livelihoods of our communities. The following services which are either currently commissioned services or have the potential to be traded, could include:
  - (a) cleaning services;
  - (b) facilities management;
  - (c) handyperson service;
  - (d) building control;
  - (e) Legal, human resources & health and safety advisory services;
  - (f) internal enforcement;
  - (g) grounds/site maintenance;
  - (h) agency staff;

## STRATEGIC CONTEXT

13. This paper considers further potential opportunities to create an income stream for the council. This is in line with the intentions of our medium-term financial strategy to protect services from cuts as far as is reasonably possible and only as a last resort. It also aligns closely to the proposed commercial strategy tabled for members consideration at this meeting. It also directly contributes to the council's refreshed corporate plan outcomes, namely that of securing a financially balanced and stable council, as agreed by Full Council at its meeting of 24 July 2019.

## CONSULTATION

14. There is no formal or statutory requirement for consultation to take place for the purposes of the decision requested within this paper. However, to inform the decision-making process, initial discussions have taken place with a range of service areas to understand the potential service offer and appetite for the development of such a model for the future. This highlighted that it is

considered that a commercial trading company would be a natural step forward in exploring greater opportunity for income generation.

15. A task and finish group of the Corporate Scrutiny Committee investigating commercialisation also reported their findings to its meeting of 9 July 2019. Its report highlighted the challenges of operating commercially within the confines of local government structures and regulations and indeed recommended that consideration be given to the development of a commercial trading arm for the council.

#### FINANCIAL / BUDGET IMPLICATIONS

16. At this point in time, the only financial implications will be that of officer time in undertaking the exploration and development of a business case to determine whether the model will stack up as a viable commercial opportunity for the council. However, there may be some costs incurred in taking appropriate legal and financial advice if there is insufficient capacity in-house to do so. Any decision to proceed with a commercial trading company will have full details of the financial implications and requirements set out.

#### LEGAL IMPLICATIONS

17. The powers for the local authority to charge and trade commercially are set out within the report above.

#### EQUALITY AND DIVERSITY

18. The council as a public body is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation.
19. Under the Equality Act 2010 we are required to have due regard to our equality duties when making decisions, reviewing services, undertaking projects, developing and reviewing policies. It is not considered that this decision will have an impact on any of the protected characteristics.

#### OPTIONS

20. **Option 1: To explore the potential to create a wholly owned Isle of Wight Council trading company**

Under this model, a local authority trading company can operate as a commercial business. That means the company can provide its services to a wider market than the council can. It remains owned and controlled by the council to provide services back to the council via a service contract whilst also creating the opportunity for trading in the open market.

21. Any services the council determines to operate from the trading company also allows the application of what is known as the Teckal exemption codified in Article 12 of the Public Contracts Directive 2014 and Regulation 12 of the Public Contracts Regulations 2015, negating the need for it to undertake an open procurement exercise. Any staff that transfer into the company do so with their employment conditions protected by the Transfer of Undertakings (Protection of Employment) regulations (TUPE). The terms of the Teckal exemption requires the following:
  - (a) The council to maintain control the company as if it were an internal department with there being no direct private share or ownership participation in the company
  - (b) More than 80 per cent of the company's service activities must be provided to the council.
  - (c) The company would become a designated body under the Local Government Pension Scheme regulations and would need to account for pension fund employer contributions at the same rate as those applied to the council.
22. Any surplus income (profit) secured in the company's operations may be returned to the council (in the form of dividends or service charges) or re-invested into the delivery of its services. A local authority trading company would be required to pay corporation tax on any profits, in the same as a commercial company and take account of any requirements for value added tax (VAT) and its management.
23. Other advantages of this model are that it creates a clear commissioner/provider split meaning that the council can act as the commissioner of the service and incentivise the trading company to secure efficiencies and develop service offers for wider trading purposes and the establishment and mobilisation of such a trading company can be released within a relatively short period of time, anticipated to be in the region of six to nine months.
24. However, the process of establishing a local authority trading company can be complicated and resource intensive and as such would require specific project resource to be identified. The council has no direct experience of setting up a local authority trading company and would also require additional capacity and expertise in its financial, human resource, procurement, property and legal professional advice services. Separate group accounts would also be required and potentially a separate audit, if current public sector auditors are not able to undertake it. This would require financial resources to be identified and would inevitably also extend the period in which a trading company could be established to between 12 and 18 months whilst the necessary skills and expertise were sourced, and processes understood and delivered.
25. **Option 2: Explore the potential to enter into a joint venture with another local authority or allied public sector organisation**
26. Under this model, the council would form a joint venture company with another

local authority or public sector body so that it can operate as commercial business. Each partner would contribute resources to the venture and a new business is created where the two parties collaborate and share the risks and benefits associated with it. It would be usual for both parties to have a shared vision about the objectives and outcomes desired for the joint venture. Entering into a joint venture company with a suitable public sector partner would enable the council to access and share expertise that it currently does not have in the establishment and operation of a trading company.

27. It is possible for a public to public joint venture company to also apply the Teckal exemption under the Public Contract Regulations 2015, (subject to the criteria for exemption being met as set out in paragraph 21 above) negating the need for an open procurement exercise to be undertaken for the delivery of any services the council may decide to operate from the company. The joint venture company would also be capable of undertaking trading activities with the objective of securing a dividend or profit share back to the joint venture partners and there will be the considerations of corporation tax and value added tax (VAT) as set out in option 1.
28. This type of arrangement would require a company limited by shares to be established which would be split between the respective local authorities at an agreed ratio. A board of directors is established comprising of representatives from both organisations to undertake the statutory duties of the company and to make decisions about the company's activities. It would be usual for a liaison board to be established to ensure that there is the ability for the council to be engaged with the development and oversight of the company. Considerations will also need to be given to insurance arrangements and professional indemnity cover.
29. There are a variety of tenure arrangements that can be put in place for such a joint venture company of between three and ten years with appropriate break-clauses to allow for trading to cease or be extended. While the number of shares can be negotiated between the partners in the joint venture, under this model, it is likely that the council would have a minority stake as the experienced partner will be bearing a greater share of risk and as such will by necessity have greater control in decision making. However, there are also options for the council to acquire all the shares after a determined period, leaving it with its own wholly owned established trading company.
30. As with option 1 set out above, any surplus income (profit) in the company's operations may be returned to the council, although in this model, the amount of profit returned will be based on a 50/50 profit share basis and the council would not be liable for corporation tax as profit share is paid as a guaranteed rebate rather than a dividend. The establishment and mobilisation of such a joint venture company can also be realised within a relatively short period of time, anticipated to be in the region of six to nine months.
31. It would be usual for turnover to be relatively low in the early stages of inception, there is the potential for longer term external revenue to be established, resulting from tendering for contractual work.

32. Norse commercial services (part of the Norse Group, which is wholly owned by Norfolk County Council) is an example of a public organisation that has entered into joint ventures with many other local authorities over a period of some 30 years. They assist councils new to or inexperienced in public sector trading by utilising their commercial experience and expertise in sales and marketing to develop further external revenue streams.
33. Apart from their commercial expertise, Norse retains a public sector ethos in how it conducts business. Key to their ethos is to support local communities by providing local jobs as well as to help a council in achieving the objectives of local employment strategies. They also make a firm commitment to using local suppliers and contracts, especially small and medium enterprises for the purchase of goods and services.
34. Initial exploration of the potential to establish a joint venture company with Norse has shown potential opportunities to be realised although would by necessity be subject to a much more detailed exploration of such a business opportunity and due diligence. Norse has indicated that it is willing to work with the council in the development of a business case at no cost to the council to assist with the decision-making process. It would seem advantageous to enter this exploratory phase to help the council ascertain whether there is a strong indicator of success or not.
35. **Option 3: Explore the potential to enter into a joint venture with a private sector company**
36. Under this model, the council would form a joint venture company with a private sector organisation so that it can operate as commercial business activity. Entering into a joint venture with a suitable partner would also enable the council to access and benefit from commercial expertise and all other trading abilities as set out under option 2.
37. However, unlike the public sector joint venture company referred to in option 2, where it is possible to apply the Teckal exemption, a formal procurement process would need to be undertaken prior to establishing a private joint venture partnership. An EU procurement exercise would need to be undertaken in accordance with the Public Contract Regulations 2015 and assuming a competitive dialogue procurement process is operated, it is likely to take a minimum of 12 to 18 months to complete. It would require officer capacity to both determine a service specification and undertake the procurement exercise and will also require additional legal and contract lawyer capacity in the delivery of subsequent contractual requirements.
38. The business model adopted in this option would be primarily focussed on profit generation although with careful tender specification design, it is possible to ensure that aspects of social value and corporate responsibilities to the local community can be an integral component of the arrangements put in place although possibly limiting the range of providers that would be interested in bidding for such contractual requirements. It is also likely that the governance arrangements would mean that there would be little direct control for the council in the day to day running of such a venture and with the local authority owning

only a minority share.

39. Unlike option 2, the opportunity to explore the advantages and disadvantages of such a commercial model before entering a final decision will be limited and reliant on securing additional capacity and expertise to assist in the development of a tender specification and at cost to the local authority. The likelihood of a return on investment would be dependent upon the robustness and accuracy of the specification and a successful bidder for the work.

## RISK MANAGEMENT

40. Entering into the operation of a trading company for the purposes of securing a profit, whichever option presented, would be a new venture for the council and which would require specific commercial expertise and additional capacity to deliver. These requirements are readily available and can easily be sourced but it will come with additional cost to the council although there would be a risk that these costs could not be returned should the venture fail to become established for business purposes or indeed fail to provide a return on investment longer term.
41. With option two, working alongside an experienced trading company such as Norse would help to substantially mitigate these risks. With the capacity and expertise already available to assist in the preparation of the business case and to undertake the required due diligence to determine the viability of such a trading company and its potential to bring a return to the council, without cost to the council is a significant advantage and would only require officer time to support the completion of this process. There would also be the additional advantage of such expertise being developed for ourselves over time and the potential for eventual transfer to a wholly owned local authority company in our own right.
42. There is the potential for complaints to be made by businesses who may see that when up against the local authority during a competitive procurement process that they may favour their own trading company for services it may wish to commission. Ultimately, this may also discourage private sector businesses from bidding for contracts, leaving the council with an incomplete picture of the true competitive market. It will necessitate therefore that the council is extra vigilant in its procurement activity as well as being truly open and transparent in its contract awarding processes and feedback to unsuccessful bidders.
43. It may also be the perception that a local authority trading company has an unfair advantage to put in a low-priced bid for work within the wider market by under-estimating the costs associated with the work. This does present a moral dilemma for the council as to whether it wishes to be a competitor in the open market. However, it will be necessary for the council should such a trading company be launched to have given full consideration to the markets it has a realistic opportunity to succeed within, the potential to stimulate new markets and which does not overly depress any existing flourishing competitive markets.
44. This would be a key component of developing a business case to determine the viability of such a venture and to ensure that there are appropriate



accounting methods utilised to ensure the true cost of services are identified for trading purposes and that there are no actual or hidden subsidies. Failure to do so may give rise to potential challenge by a competitor on the basis that the council is providing State Aid to the company.

45. Working with a private sector organisation as a joint venture company may present its challenges in this respect where their sole purpose is likely to be one of securing profit and may breed concerns of aggressive sales and marketing strategies. However, these challenges could be mitigated by pursuing either a wholly owned local authority trading company or public sector joint venture which would afford greater control over trading activities. As has already been identified, working with Norse may present an advantage in this respect where although commercial business and profit is a priority, the business operations maintain a public sector ethos in their approach. We must not forget either that in the current financial climate and the desire to protect front line services from cuts wherever possible, that the identification of additional sources of income have become a necessity rather than a desire.
46. There is a danger with all the options presented that there is a risk of failure either in the short or longer term and there are examples of companies either being wound up, contracts terminated, and commissioned services being brought back in house. A sound business case before entering a trading company model beforehand can often negate these risks but it may be necessary to accept that there is always a potential for failure to occur. Good governance arrangements and engagement of the essential business acumen required to succeed in a changing environment are paramount.
47. A wholly owned local authority trading company with little experience of commercial operations would be a high-risk strategy to avoid these potential circumstances and could also lead to inappropriate governance being put in place and becoming too involved in the day to day running of the company. While working with a private sector organisation adept at commercial business would mitigate this risk, the governance arrangements would be entirely within the control of the company, presenting little ability for the council to have any control in their actions. Working alongside Norse, it is anticipated that these risks could be significantly mitigated. With commercial acumen at hand and the establishment of a governance structure that enables full council involvement in its development and growth, makes provision for a board of directors (with representatives from both partners) who have the freedom to make decisions for operating in the commercial world.

## EVALUATION

48. It is a well-known fact that the council has ongoing challenges to secure a longer term financially stable position for public services on the Island due to the continued reductions in government funding. A significant amount of work has already been undertaken to address this situation and secured a 40 per cent reduction in controllable spending. However, the options and ability to secure further reductions is dependent, in part, upon the identification of further income generation streams. Having already set in place a number of opportunities in this respect, a further potential prospect is to investigate the potential of developing of a trading company.

49. This would be an entirely new venture for the council and as such would require additional capacity and expertise to develop. There are a number of potential options open to the council in doing so which have been presented and evaluated in this paper. It is considered that the option that has most merit and potential for success is that of option 2, to enter into a joint venture with another local authority. Having engaged in dialogue with one such local authority, that of Norfolk County Council and its trading company the Norse Group, it is proposed that a business case be developed to determine whether there is actual potential to launch a joint venture company.
50. This will afford members with the opportunity to examine all the potential advantages and disadvantages of such a business model, the potential markets for business and profit benefits could be realised in order to make a final decision as to whether to enter into such a partnership. This business case will be delivered at no cost to the council other than officer time and the risks associated in its development being borne by Norse itself.

#### RECOMMENDATION

51. Option 2: To explore the potential to enter into a joint venture with another local authority or allied public sector organisation.

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