

# Legal considerations for a local authority trading company

In our recent webinar around our 'Spreading their wings' report, we had the opportunity to discuss the key legal considerations around setting up a local authority trading company with Peter Ware, Head of Government and Infrastructure at Browne Jacobson.

## What are the most commonly used powers and what do they allow local government to do?

There are in fact a wide variety of powers that a local authority can rely on to charge for services and indeed trade for profit ranging from:

- esoteric powers like the ability to charge for the licencing of animal boarding establishments under the Animal Board Establishment Act 1963
- through to the widely used Local Authority (Goods and Services) Act 1970 which allows certain public bodies to trade with one another reasonably freely.

However there are two very specific sets of powers which give the ability to local authorities to charge and trade. These are found in:

- The Local Government Act 2003,
- The Localism Act 2011

s93 of the 2003 Act, introduced the power to charge for discretionary services provided this is done on a cost recovery basis this can be done directly by the council.

s95 of the 2003 act (and subsequent enabling orders) provides that most local authority may for a commercial purpose do anything that they are statutorily empowered (but not required) to do

- These powers can only be used when they do not have an obligation to provide, where the trading is function-related and where an alternative trading power does not already exist.
- Where you are trading for a commercial purpose (i.e. for a profit) this must be done through a company or an IPS

s 1 of the Localism Act 2011 gave public authorities a general power competence (GPOC). This allows a local authority to generally do anything that a natural person might otherwise be able to do unless there is a limitation on that power in any other legislation

S3 of the Localism Act 2011 provides that GPOC may be used as a power to charge for services provided the

council does not do so for a commercial purpose and provided that it is not obliged to provide that service.

s4 of the Localism Act 2011 allows a local authority using GPOC to do things for a commercial unless they are required to do them, otherwise prohibited from doing them for a commercial purpose and provided they do such things through a company or an IPS.

## What is the Teckal exemption and what does it allow local authorities and their trading companies to do?


This is commonly known as the “in-house exemption” and allows the contracting authority or indeed authorities to establish a separate vehicle (ordinarily a company) to provide services back to it (or them) and provided the requirements of that exemption are met then a procurement exercise will not be required. It is most commonly used to deliver shared service.

The exemption was formerly based on case law and whilst case law will continue to be important it has recently been codified in the new Public Contracts Regulations 2015. In round terms exemption requires that:

- The authority controls the vehicle as if it were an internal department
- More than 80% of its activities are with its controlling authority
- There is no direct private share or ownership participation in the company

The exemption is also available to vehicles controlled by several local authorities where those requirements can be delivered jointly.

The new regulations also permit one controlled body to award a contract to another controlled body where both of them are owned by the same contracting authority this is sometimes known as “horizontal teckal”. The same provision also permits a controlled body to award a contract to its controlling contracting authority owner – this is sometimes referred to as “reverse Teckal”.



However, care needs to be taken where the teckal vehicle is owned by more than one authority as this provision does not apply to controlled bodies which are jointly controlled by more than one contracting authority.

### **What are the risks associated with Teckal, and how can it go wrong?**

On a practical level the greatest problem is often that the creation of teckal vehicle is not always used to deliver transformative change. Collaboration between public bodies is a great opportunity to make improvements.

However, if this opportunity is not grasped then existing problems are just moved over to the new vehicle and can continue and exacerbate.

On a legal level, it must be remembered that the requirements of the exemption will be strictly applied by the courts. So:

- Control needs to be delivered both on paper and in substance. For example the courts have considered that (*Risk Management Partners v LB Brent*), where contracting authorities appoint a private company to run the day-to-day activities of the vehicle on behalf of the local authorities, the appointment could indicate that the authorities do not exercise a sufficient level of control. Ownership is not always sufficient for the *Teckal* exemption to apply.
- the *Teckal* exemption only applies where there is no direct private capital involvement. Even a minority shareholding by a private investor will prevent the exemption applying. This can sometimes be a limiting factor to *Teckal* companies growth. Especially if the local authority does not currently have all the skills needed to operate a specialist commercial-type company. Also be aware that “No private participation” covers non-profit organisations as well.
- The Vehicle must carry out 80 % of its business with its controlling authorities, this can be a limiting factor particularly where the vehicle wishes to trade externally and it is limited to 20% of its activity.
- The criteria can be very hard to meet so we do recommend that you seek legal advice if you decide to set up such a company to ensure that you meet the requirements successfully. Particularly where you also want to carry out some trading activity. Often a more complex corporate structure may need to be established in order to do this.
- As discussed above the PCR 2015 allows a *Teckal* vehicle to be created and for the public body to provide to it various services under the reverse teckal exemption. However, where there is more than one controlling authority this exemption is not automatically available. This is proving quite a challenge for a number of vehicles at the moment

- TUPE provisions are likely to apply so this will have to be considered if employees are transferring from the council to the vehicle. Alongside this pensions provision and costs associated with admittance to the LGPS are significant challenges. Particularly where admittance is coupled with the requirement of a bond or a guarantee.
- One final warning, is that whilst you may meet the requirements of the teckal exemption don't forget your other legal obligations particularly in relation to state aid, this will include the giving of guarantees, soft loans and unduly favourably contractual terms. I discuss this in more detail below.

### **How can the control and function test associated with Teckal be applied and the risk local authorities should have in mind?**


The control test is the requirement that the local authority exercises control over the vehicle similar to that which it exercises over its own department.

- The Crown Commercial Service has defined “Control” as where an organisation has a decisive influence over the strategic objectives and significant decisions of the vehicle.
- This will mean that key decisions about the direction of the business must be reserved to the council or councils this must be explicitly set out somewhere so that the ability of the directors of the company to take decisions without the consent of the councils is limited.
- Additionally, we would always suggest that if not all the directors are council appointees then a majority should be.

The function test ensures that the vehicle carries out the essential part of its activities under the control of the local authority.

- It has now been codified in the PCRs 2015 that “essential part” means that 80% of the vehicle's activities should be ordered by the local authority.
- There is no requirement to consider anything about the activities that it not purely quantitative.
- This can be assessed over a three year period so that an average can be taken where there are some peaks and troughs





## Is the concern of state aid relevant to local authority trading companies and if so, what kind of issues are arising?

It is certainly very relevant and breach of EU State Aid rules can come with very harsh penalties. In very brief terms aid will amount to state aid if:

- The measure is granted by the state (e.g. a local authority)
- The measure confers a selective advantage to the business
- The measure distorts or potentially distorts competition
- The activity has to potential to affect trade between member states

State aid can take many different forms and they are not always obvious, soft loans, grants, guarantees, overly favourable contracts, soft support such as free office accommodation or services to name but a few examples.

State aid regulation is complex and whilst there are many types of exemption the simplest and often the best way to ensure that illegal aid does not occur, the local authority should charge commercial rates for all services, products or work that it provides to the vehicle and not treat it favourably compared to other companies in its area.

It is sometimes argued that state aid does not arise between local authorities and their *Teckal* vehicles. The argument is that the local authority “co-operating” with the vehicle would be an internal contract and would not have an impact on competition. This is quite a difficult argument to maintain and is very unlikely to be successful where the *Teckal* company is to allowed to trade outside of the council or councils. It is therefore recommended that the avoidance of state aid is considered throughout the setting up of a *Teckal* vehicle.

## If you were talking to an authority considering setting up a local authority trading company what is the key piece of advice you would give them?

Trading companies and teckal vehicles are great opportunities for new ways of working, collaboration, staff retention and even financial return. However, they need to be carefully thought through and should not be entered into lightly. In particular you should ensure:

- The staff group are actually bought into the process and are willing to make it a success, whilst you may not be able to get everyone to come along on the journey open hostility will not make it easy
- Where you don't have the expertise in the existing work force, particularly on the finance side, buy it or recruit it in early
- Make sure there is a business or market for the vehicle, note many councils are looking at trading vehicles and believe that their customers will be other Councils this can't obviously be the case in every scenario
- Be mindful of the legal and financial requirements, they are not always an obstacle! But if you don't comply they can come back and bite you when you least expect it.

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