Appendix 2

ESPO Review – Legal and Governance Work Stream
Alternative Legal Structures - Appraisal Paper

Current Situation

1. The Consortium Members that own ESPO have agreed to undertake a fundamental review of the role and purpose of ESPO.

2. The aims of the review is to assess:

    - The anticipated future role and purpose of ESPO;
    - The value of partnering with ESPO for the Consortium Member;
    - The appropriateness of the current business strategy; and
    - The potential future strategic options for ESPO.

3. The Phase 3 Report - ESPO Review of Business Strategy (the Review) produced by Deloittes investigated potential alternative commercial structures for ESPO i.e. Joint Committee, Limited Company, Limited Liability Partnership, Hybrid Model and Social Enterprise, the report analysed the benefits and limitations of each option and recommended that the existing model (Joint Committee) remains but the current weaknesses with this options are addressed and resolved.

4. At the Management Committee on the 24 June 2011 members raised concerns regarding the extent to which alternative governance models, particularly that of a Limited Company had been explored and given sufficient weight in forming the Reviews conclusions and recommendations.

5. Members of the Management Committee have requested that the Legal and Governance workstream revisit the work done on alternative governance models.

Aim

6. The aim of this paper is to examine the current structure of ESPO i.e. a Joint Committee against a Company structure. This will involve examining the following:

- Powers;
- Key Issues;
- Advantages and Disadvantages;
- Financial Implications; and
- Key Considerations

7. The above analysis should provide enough information to ensure the reader is fully informed of all the implications of the two alternative legal structures.

8. It is important that when considering the viability of the alternative legal structures the vision for ESPO is taken into account.

9. As part of the Review it was agreed that the following would be the current vision statement for ESPO:
"ESPO will bring vibrant mix of commercialism, market insight, category expertise and best practice sourcing. ESPO will work in partnership with Member Authorities, its customers, Pro5, and other partners, to engage markets and thereby achieve optimum outcomes for the benefit of its customers. ESPO will proactively challenge current practice, serving as a focal point for Member Authority collaboration, bringing leadership and articulating new commissioning and sourcing strategies.

   Based on the above the following key requirements have emerged, namely that ESPO will:
   - *Identify best value in any procurement category;*
   - *Build and maintain credible category knowledge across the major spend areas;*
   - *Be able to engage with, support and work proactively with Council service departments (buyers) and markets to innovate and achieve value;*
   - *Pursue supply chain management excellence, including developing and sharing market intelligence;*
   - *Identify opportunities for collaboration at a local, regional and/or national level based on market and client insight. ESPO will also work with other public sector organisations and create effective relationships with other PBOs in order to aggregate market intelligence, or customer needs, for the benefit of members;*
   - *Underpin Consortium Authorities to meet their strategic commissioning objectives;*
   - *Enable major cost reduction both within ESPO and Consortium member authorities;*
   - *Be seen as an extension of the Consortium Authorities, rather than as a supplier;*
   - *Make decisions in a collaborative and transparent way, balancing risk and reward, using an informed evidence base;*
   - *Manage effective relationships with member and non-member authorities, other public sector organisations, PBOs and suppliers."*

Key Delivery Options

Joint Committee

10. ESPO is a Joint Committee formed under section 102 of the Local Government Act 1972. Seven local authorities discharge its functions through the Joint Committee (the Consortium Members).

11. A Joint Committee has no corporate status and it therefore cannot enter into contracts or hold property.

12. Leicestershire County Council therefore acts as the 'servicing authority' on behalf of the Consortium and holds property and other assets on behalf of the Consortium.

13. The Joint Committee is governed by a contractual Partnership Agreement and Constitution. Under these documents each Consortium Member shares liabilities equally.

14. In the current format the above legal documents do not provide Consortium Members with an adequate framework regarding the management of and accountability for risk. It has been agreed that if the Joint Committee model is retained, the governance model and the legal documentation underpinning the Joint Committee will be enhanced to ensure they are fit for purpose and give the Consortium members the clarity required.

Company

15. This paper provides an analysis of the implications of ESPO turning into a company limited by shares, wholly-owned by the current Consortium Authorities.

16. Under a limited company model, the seven local authorities would want to ensure that they each have sufficient control over its activities. Therefore, all the Consortium Authorities would become owners of the company. The company's Board of Directors would comprise whoever the local authorities deemed appropriate to give the company direction and decision-making rigour. It is important to note that the primary responsibility of the Board of Directors must be to the company, and not to represent the interests of their local authority.

17. The company's constitutional documents - the Memorandum and Articles of Association - would set out the powers of the company and its rules for decision-making. However, just as importantly, the local authorities would enter into a Shareholders' Agreement which would underpin the public constitutional documents and which ensure that the interests of the local authorities are sufficiently promoted in the company's management. For example, the Shareholders' Agreement would set out a number of key decisions and issues over which the local authorities would have a right of veto. This would refine the ordinary legal position namely that a company is an autonomous legal entity whose direction and decision-making in nearly all aspects is in the control of the Board of Directors.

Powers

POWERS	JOINT COMMITTEE	COMPANY
	Section 102 Local Government Act 1972 Section 2 Local Government Act 2000 Local Authorities (Goods and Services) Act 1970 (note provisions in the Localism Bill)	Section 2 Local Government Act 2000 Section 95 Local Government Act 2003 Section 111 Local Government Act 1972.

Key Issues

KEY ISSUES	**JOINT COMMITTEE**	**COMPANY**
Powers to Trade	The Joint Committee currently has no power to trade with the private sector (subject to Designated Bodies as defined by under the Local Authorities Goods and Services Act 1970).	Powers of trade is permitted under the Section 95 of the Local Government 2003.
Public Procurement	The Public Procurement Rules - unlikely to be breached where trade is solely between public bodies.	In order to comply with EU Procurement Law the Company will have to bid for any contract to provide services to any distinct entity, including services to Consortium Members. The only route around this would be if the Company were a “Teckal Company”, and only provided services to Consortium Members. Currently, nearly 70% of ESPO’s revenues come from organisations outside of the Consortium..
Liability	Liability is unlimited. The Partnership Agreement sets out how liability is shared between Consortium members. At present liability is shared equally between the Members. The Partnership Agreement is currently being revised to improve the clarity of how and when liabilities are shared.	Liability is limited. The Company itself is liable to the full extent of its assets. This offers members long-term protection from Creditors. Shareholders liability is normally restricted to the amount paid on their shares. However, local authorities may have to provide loan or guarantee facilities in order to reassure suppliers and customers of the company’s financial standing. Such a guarantee or loan would be subject to the State Aid regime. If guarantees or loans are made, which is likely, the authorities would share liability up to their value.Furthermore, as a wholly-owned local authority company, the reputation of

		the company is likely to inherently tied to the owners.
Assets	Assets are held by the Servicing Authority on behalf of the other Consortium Members. If the Consortium was to terminate, the new Partnership Agreement will clarify how the value of assets / liabilities will be distributed.	All assets and liabilities would be transferred to the company. On incorporation there will need to be a disposal of the ESPO building to the company. Therefore issues such as ownership, valuation, title, security and other due diligence issues affecting disposal will need to be explored. Stamp duty will be payable on the transfer.
Staff	Staff are employed by the Servicing Authority. The Consortium Members equally share any risk associated with employment of staff.	Employees will need to be transferred to the new Company under TUPE and will, therefore, retain their existing terms and conditions. The transfer process will need to accommodate employee consultation timescales and trade union engagement..
Pension	The Servicing Authority is responsible for pensions. However, any pension liability is shared equally between the Consortium Members. The new Partnership Agreement will deal with how any pension deficit will be shared if the Joint Committee terminated.	Any pension deficit will crystallise at the point of transfer. This liability would be shared by the Consortium Members. As a trading company, providing non-statutory services, is it unlikely that it would be able to gain admitted body status. However, under TUPE, the company must provide a broadly comparable pension scheme.
Decision Making	Decision Making is in accordance with the Partnership Agreement. It has been agreed that if the Joint Committee model is taken forward, the Partnership Agreement will be revised to improve the transparency of	Careful consideration will need to be given to the appointment of the Board of Directors. In accordance with the Companies Act, the company's memorandum

	decision making.	and articles of association will identify how decisions are made at both shareholder and director level. Board Directors will have specific fiduciary duties and responsibilities to the company. Important considerations are, for example,: • What right will each shareholder have? Does the business have sufficient powers to operate without recourse to the shareholders?
The Servicing Authority	Leicestershire County Council is responsible as the servicing authority to enter into all contracts (including contracts of employment) and hold property on behalf of the Consortium. This means Leicestershire is currently subject to more risk than the other Consortium Members. The revision of the Partnership Agreement will re-evaluate and clarity the distribution of liabilities and accountability of risk.	There will be no servicing authority. The Company is a legal entity and is able to enter into contracts.. As an independent company, it will need to employ or procure corporate support services (e.g., legal, HR, audit, etc) at an additional cost. This will impact ESPO's current operating margins.
Funding	The Joint Committee is self funding. ESPO has seen a 42% growth income over the past 5 years, from £62.6m to £89.2m. This has resulted in a surpluses of £1m for the period of 2009/10. State Aid is not an issue.	The Consortium Members will need to be careful not to breach State Aid Rules if giving advantageous loans, injecting capital etc. Into the Company. However, the company will require an injection of capital for the initial set-up and as working capital. Any external financing (e.g., bank loans) would need to be guaranteed by the local authority owners due to the poor balance sheet of the company in the short term. A key consideration will be how the shares should be allocated: for example, should shares be distributed

		equally, or based on the scale of historic spend?
Tax issues	A Joint Committee is able to take advantage of the tax benefits available to local authorities, as Section 33 bodies.	The company would be subject to corporation tax, VAT, stamp duty, etc. The company will have to register for VAT in its own right and will be subject to the impact of any VAT liabilities, and any Corporation Tax on profits..
Insolvency	If ESPO is running in deficit, the governance documents should set out what decisions can be made and how liabilities will be shared. The Management Committee will be responsible for deciding what course of action should be taken.	If the Company cannot afford its liabilities as and when they fall due then the Company will be put in an insolvency process. • This will result in loss of control, as the insolvency of a company is regulated by law and involves an insolvency practitioner dealing with the process on behalf of the creditors. Insolvency would have significant reputational implications for the owning authorities. In reality, could the local authorities walk away from the company's liabilities? Potentially, the business could be sold, by the insolvency practitioner, as a going concern.
Termination	The Partnership Agreement currently deals with termination of the Consortium, but will need refining.	The Company i.e. shareholders can decide to wind up the Company at any point in time as long as the company is solvent. The Shareholders Agreement should set out the process of consequence of winding up the Company.
Reporting Requirements	Reports go to Management Committee. This process will be reviewed and refined as part of the current Review.	Companies Act Requirements including Articles and Memorandum of Association. Forms 10 and 12 –statutory declaration. - Directors' Report and business review detailing how directors have complied with

		their obligations to promote the companies success. - Public disclosure issue. - CTSA tax return to the inland revenue.
Scope of Services	This has recently been reviewed and ESPO is aiming to provide to its members and other customers a comprehensive, cost effective contracting and procurement service through a diverse range of commodities, products and services.	More scope to increase services and diversify. However, this could be in conflict with ESPO strategic objectives. This would be a Board / Shareholder decision.
Customer and Market	ESPO's main customer (other than other local authorities including consortium members) is schools (40% of income), School have stated they feel confident using ESPO as it is local authority owned.	There is a risk that their business may be lost if ESPO is no longer seen as a not-for-profit public service organisation. Appropriate consultation and 'comforts' will need to be given to key customers in advance of forming a Company. The Company may find it difficult to win contracts in its early years, due to a poor balance sheet and no track record.
Governance	Governed by the Partnership documents	Governed by legislation and the company's constitution.
Existing Contracts	No change. However under the Review customers will be expected to sign up to a new set of terms and conditions which protects ESPO's position and binds anyone that conducts business with ESPO.	Existing contracts with customers and suppliers will need to be novated. However, due to the poor financial standing of the company at its inception, it is likely that suppliers, at least, will expect a guarantee by the local authorities to cover potential liabilities.
Setting up/Refining	Refining and drafting new documents require additional resources. A legal and governance team have been tasked to start this	Cost of setting up a company and the time taken can be extensive (a minimum of 18 months).

	work.	The Company will need 'working capital' injected into on the outset.
Owners of ESPO	The Consortium Members	The Shareholders, initially the seven consortium members but new shares could be issued or shares could be sold by a consortium member.
Relationships with other public sector buying organisations	A Joint Committee will support ESPO's desire to continue to play a lead role within the Pro-5 group and will continue to support the process of improving alignment and co-operations with other Consortium Buying Organisations.	By becoming a corporate entity, ESPO will need to leave Pro-5 and establish a conventional supplier–customer relationship with them and, similarly, Buying Solutions.
Competition Act	Unlikely to be an issue.	The Consortium Members will need to be careful that they do not distort or restrict competition by entering into an anti-competitive agreement with the Company.

Advantages and Disadvantages

JOINT COMMITTEE	Advantages	Disadvantages
	The local authorities have direct involvement in the provision of the services Consortium Authorities are able to challenge, scrutinise and influence ESPO. Joint Committee is less adversial and more collaborative Do not take on additional Company law responsibilities Procedures are not prescribed A high degree of flexibility and freedom to work in the way best suits issues to be addressed	Has no corporate status and it cannot therefore enter into contracts or hold property. Therefore, the servicing authority must bear this responsibility and the risk attached to it. In managing this risk, the Servicing Authority may be perceived as exerting greater influence. No limited liability, risks are shared between member authorities. Can only trade with other public bodies.

	EU procurement rules does not apply (trade between public bodies) Tax and financial arrangements are relatively straightforward Any surplus generated by ESPO can be distributed as 'dividends to Consortium Authorities and is not subject to Corporation tax. Easy process for new Members joining or leaving the Consortium.	

COMPANY	**Advantages**	**Disadvantages**
	The share equity held by the member authorities could realise a capital gain in the longer term. A company can be used to limit liability to the local authorities but need to consider implications of guarantees and reputation May be able to raise additional funds without impinging on the local authority's finances (e.g., commercial loans or raise capital by way of share issue and charge property). More scope for innovation, subject to the Shareholder's appetite to risk. Can distribute dividends.	The local authorities would have less control, as the Board would be responsible for its direction, in the best interests of the Company. Potential conflict of interest for local authority appointed Directors of the Board. ESPO would need to compete, competitively for customer contracts (subject good practice and EU procurement directives). Investment in the set-up costs (time and working capital donation/loan) and higher running costs of the company (e.g., VAT admin, Corporation Tax, audit, Companies House returns, etc) Risk of insolvency – loss of equity stake and discontinuity of the service TUPE implications Pension issues (e.g., crystallisation of deficit and future pension provision)

		Profits would be subject to Corporation Tax, and VAT inputs/outputs would require careful management. Payment of stamp duty on transferred real estate. Likely requirement for the local authorities to act as guarantors of the company to potential suppliers, customers and investors. State Aid issues. Adverse impact on customer base and membership of Pro-5.

Key considerations:

- Alignment with ESPO's vision and key requirements
- EU Procurement regulations
- Impact on customer and supplier relationships
- Taxation
- Extent of risk mitigation
- Pensions
- Conflicts of interest
- Risk of discontinuity of service

Recommendations

The current vision of ESPO concentrates on the holistic benefits the Consortium can deliver for its Members. It is therefore important to ensure that ESPO's legal structure moving forward can in fact deliver ESPO's visions.

One of the main benefits the current ESPO structure has for its Member is the fact that no EU procurement process is required when a Member wants to buy ESPO's goods and services; this is a benefit that Consortium Members wish to retain. On the other hand, a concern with the current structure is exposure to the risk of liabilities and the perception of financial uncertainty.

Based on the information in this paper it is the view of the Legal and Governance Workstream that a Joint Committee has distinct advantages over the Company structure and aligns with ESPO's current vision. However the Group is also clear that if the Joint Committee structure is retained the issue of reducing the exposure to liability would need to be considered further, e.g. this could mean exploring either increasing or adding additional insurances to cover Consortium Members' risk

exposure or putting further checks and balances in place to reduce the possibility of a risk arising in the first place.

It is also the opinion of the Legal and Governance Workstream that circumstances can and do change such that a corporate model (e.g. a company) should not be ruled out and that it may be beneficial to reconsider the issue at a later date. Recognising the need for work to be undertaken to establish the new governance arrangements and for a period of stability the corporate model could be further considered after a period of three years.