Rethink

GOVERNANCE AND CONTROL AREAS FOR CONSIDERATION WHEN ESTABLISHING LOCAL AUTHORITY COMPANIES

LOCAL GOVERNMENT COMPANIES

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LANDSCAPE OF LOCAL GOVERNMENT COMPANIES

The incorporation of local authorities trading companies (LATCOs) to deliver direct services to their communities has increased over the past ten years in an environment of reduced funding from Central Government. Companies have been set up to deliver waste services, energy supply, support services, social care services, housing development, as well as other key services. If properly constituted and effectively governed and managed, the benefits of companies can include:

- Generation of revenue through delivery of services to commercial businesses, other public sector bodies and local residents
- Improvement in the quality of direct services delivered to residents by developing a dedicated company managed by specialists in the industry
- Increased competition to the private sector to reduce prices of staple utilities to residents
- An increase in the supply of affordable housing in local areas
- Greater innovation and speed of response.

This short guide provides some governance and control areas for consideration when establishing and monitoring LATCOs. It is not a comprehensive list of all areas to be considered and professional advice should be taken when making decisions on these areas. An options appraisal prior to entering into such arrangements should be undertaken.

BACKGROUND TO THE LANDSCAPE OF LATCOs

There has been growth in LATCOs over the past decade as a means of generating extra income for local authorities to off-set reduced funding from Central Government.

LATCOs have been established in a variety of sectors to deliver services to local authorities using the Teckal exemption*. In many instances the quality of the service has improved for residents and commercial businesses through close cooperation between LATCOs and council management. However, whilst this option is being increasingly explored by local authorities, issues concerning governance and oversight of LATCOs has resulted in high-profile failures in the past year, notably Robin Hood Energy Ltd, Brick-by-Brick and Bristol Energy Ltd.

Through our delivery of local authority audit and advisory services we have seen these challenges in managing fully-owned companies first hand.

ROBIN HOOD ENERGY

Robin Hood Energy Ltd (RHE) suffered losses in excess of £20m leading to further injections of cash by the Council to prevent failure of the company. Insufficient industry expertise on the RHE Board and inadequate oversight of financial performance caused a lack of accountability of RHE. RHE's customer base was purchased by Centrica in September 2020.

BRICK-BY-BRICK LTD

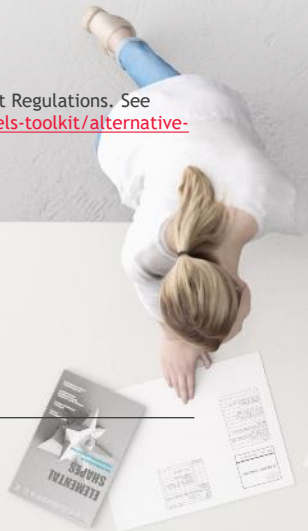
The London Borough of Croydon Council lent over £200m to Brick-by-Brick Ltd. Despite extensive investment the Council had inadequate monitoring of the loan covenants and performance of Brick-by-Brick who suffered losses each year. This was exacerbated by inadequate check and challenge at Cabinet level, including of the financial position.

BRISTOL ENERGY LTD

Bristol Energy Ltd has cost tax payers an estimated £43m and is being wound up through a voluntary liquidation. Inadequate governance structures caused issues not to be reported to the Cabinet and the business plan was overly ambitious and unrealistic. Bristol Energy made consecutive losses between 2016 and 2020.

In 2020, the London Borough of Croydon Council issued a Section 114 notice, identifying that it would not be able to balance its budget. It was reported in December 2020 that Nottingham City Council were on the verge of issuing a Section 114 notice however this has not been issued to date.

* Assuming the Teckal exemption criteria have been met under the Public Contract Regulations. See https://www.gov.uk/government/publications/libraries-alternative-delivery-models-toolkit/alternative-delivery-models-explained for further details



GOVERNANCE STRUCTURES
COUNCIL TO COMPANY

Governance and oversight by the Shareholder of the Company, and internally within the Company is essential for delivering success.

CASE STUDY

A local authority client has set up a LATCO with the intention of generating income growth through dividend payments paid to the Council by the Company.

The Council has a Shareholder Group and a Scrutiny Panel. The Shareholder Agreement sets out clear decisions that are reserved for the Shareholder to maintain a sufficient level of control. The Scrutiny Panel monitor performance and business plans on a more granular level and make recommendations to the Shareholder. The Scrutiny Panel Chair attends Shareholder meetings.

This has worked as an effective governance structure which has ensured effective oversight and scrutiny by Members. The Council have also mapped weaknesses identified in the public interest reports for the London Borough of Croydon and Robin Hood Energy and have ensured that their arrangements mitigate against the risks identified in these cases.

SHAREHOLDER GOVERNANCE/OVERSIGHT

- **Monitoring and Oversight:** A Shareholder Group, or similarly structured group of senior Council members, may be established to monitor LATCO performance and make strategic decisions. The Group's remit could include approval of the LATCO's business plan and reporting against key performance indicators
- **Decision Making:** A Shareholder Agreement will usually be signed off between the Council and the company from incorporation to clarify decisions reserved for the Shareholder Group
- **Council Oversight:** Membership of the Shareholder Group should be an area of focus issue to ensure that there are adequate skill sets. Issues to consider when deciding the composition of the Shareholder Group include:
  - **Political Make-Up** – the political balance of the Shareholder and whether this is predominantly from the Cabinet. Local authorities have taken different approaches, with some opting for the Shareholder Group to be composed of Cabinet members and others opting for cross-party representation
  - **Sub/Advisory Committees** – advisory groups to the Shareholder may be set up to scrutinise the actions of the Shareholder. We have noted this to be a particularly effective approach where there is single-party representation in the Shareholder.

OFFICER MONITORING/GOVERNANCE OF COMPANIES

- **Performance Monitoring:** Operational performance monitoring meetings allow the Council's senior leadership team to monitor the services provided by the company
- **Financial Oversight:** The Section 151 Officer may be provided with the management accounts within a week of the month-end and meet with the Finance Director of the company monthly to discuss the financial position. The level of financial autonomy for the company is often an area of focus:
  - It may be agreed from incorporation of the company whether the Council will have direct access to the company ledger and finance system
  - Company budgets may be reviewed annually by the Section 151 Officer and approved by the Shareholder.

GOVERNANCE STRUCTURES
INTERNAL GOVERNANCE WITHIN COMPANIES

Internal governance structures are key to the success of the company and the delivery of the business plan. Achieving the correct balance of influence from the Council and ensuring there are adequate skills in the company are essential.

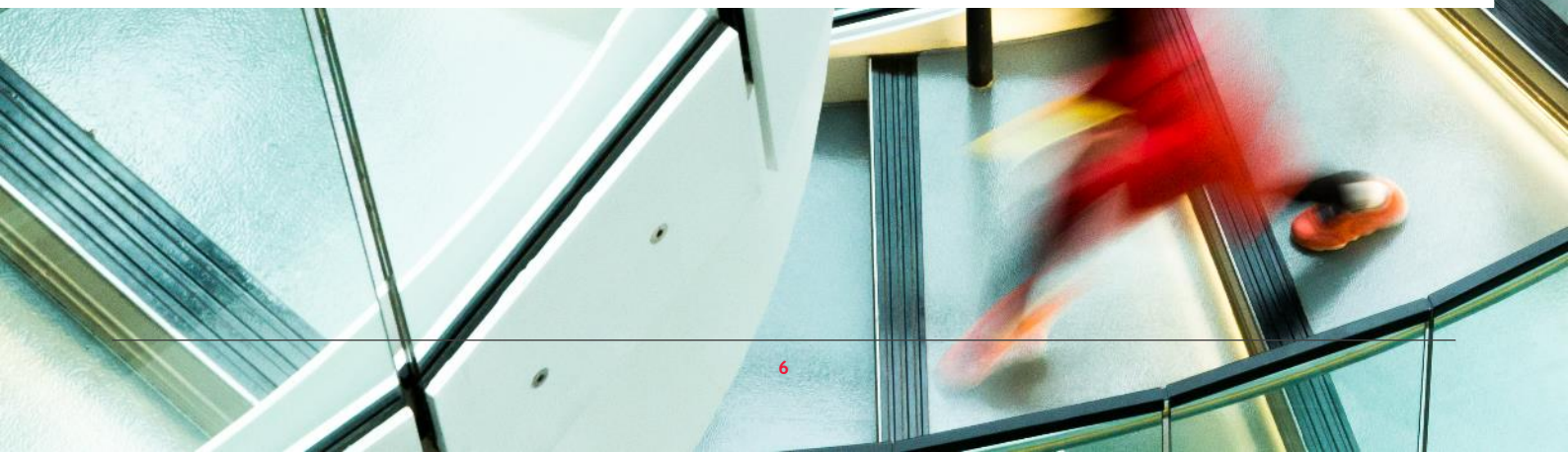
OPTIONS FOR BOARD GOVERNANCE

Composition of the Board of the company is often a contentious issue, however it is critical for the success of the company and delivery of the Council's objectives.

- **Member-Led Board:** This can lead to a lack of expertise on the Board which can have a negative impact on the company. Robin Hood Energy adopted this approach and it was identified as a factor in the oversight of performance
- **Fully Independent Board:** a Board consisting of entirely independent members, usually with expertise in the industry, to run the organisation as a commercial entity. This is less commonly used in LATCOs and taking this step would require careful consideration as to whether a Board can be fully independent given it is part of a group structure with Council oversight
- **Hybrid Model (Directors):** Officers from the local authority will be part of the Board as a director with fiduciary responsibilities to the company. These officers will tend to be senior officers in the Council. This can present challenges in managing conflicts between Council or Company interests
- **Hybrid Model (Non-Directors):** Senior officers from the local authority attend the organisation's Board meetings as an observer and an advisor. This model is effective in ensuring that the company are able to manage the business whilst having awareness of the Council's position on issues. Difficulties can occur here as any individual attending the Board as an observer may be seen as indistinguishable from the Board and therefore becomes a de facto Board member.

CONSIDERATIONS

- **New Companies:** New companies can benefit from the Hybrid Model (Directors) as there is a good balance between the autonomy of the company to develop business whilst the local authority can maintain a level of influence on the Board. This ensures that as the company is developing, the Council are able to shape it in accordance with its intended purpose. From a finance perspective, we have found LATCO's governance to be more effective where the Council's Section 151 Officer attends the Board meetings as an observer/adviser whilst managing the risks around conflicts
- **Mature Companies:** Governance structures for mature companies depends on the strategy. If the company is commercialising activities then the Fully-Independent Board model can be the most effective. However, we often see that the Hybrid Model (Directors) is adopted for mature companies.



KEY GOVERNANCE DOCUMENTS BETWEEN THE LOCAL AUTHORITY AND THE COMPANY

A robust suite of documents to outline the responsibilities of the company and of the Council supports effective governance.

SHAREHOLDER AGREEMENT

A Shareholder Agreement will usually be in place and signed by the local authority and the company. It may contain the following details:

- Matters reserved for approval of the Shareholder. We would expect this to include: taking out loans, amalgamation/mergers with other companies, issuing capital and adopt/amend the Business Plan
- Reporting frameworks between the company and the Shareholder, including key performance indicators and frequency
- Establish dividend policy or profit-sharing agreement.

SERVICE LEVEL AGREEMENTS (SLAs)

Where the local authority is continuing to provide specific services to the company (finance, legal, HR, ICT, etc.) Service Level Agreements will specify:

- Value and frequency of payments from the company to the local authority for the services
- Performance obligations for the services
- Dispute resolution arrangements/methods.

TERMS OF REFERENCE

Each group may have a terms of reference outlining its purpose, responsibilities and the objectives. This will typically be reviewed annually to ensure it remains relevant and appropriate.

BUSINESS PLANS

Business plans of the companies over an agreed period, eg five years, will often be scrutinised by and approved by the Shareholder to ensure that the company remains strategically and operationally aligned with the local authority.

When developing governance documentation the local authority should consider the following matters:

- The level of control or autonomy that the local authority would want the LACTCO to have. This depends on the strategy and purpose for incorporating the LATCO, eg whether it is designed to provide services to the local authority or grow a commercial customer base to increase revenues
- Whether support services from the local authority provide value for money
- Key decisions to be reserved for the Shareholder, or whether these can be delegated at an officer level.

AREAS FOR AUDIT COMMITTEES TO CONSIDER

ROLE OF THE AUDIT COMMITTEE

The role of Council Audit Committees in this context is to actively monitor risks, financial reporting and internal controls of the local authority in relation to its management of its companies. We have seen a trend recently in Audit Committees providing greater oversight of LATCOs, partly due to recent failures of Robin Hood Energy Ltd and the London Borough of Croydon Council.

EXPECTATIONS OF AN AUDIT COMMITTEE

Effective monitoring from a local authority Audit Committee of its LATCOs includes:

- Obtain assurance about the quality of the financial reporting from the LATCO
- Maintain an oversight of the local authority's risk management in respect of ownership of a trading company
- Communicate with the LATCO's Audit Committee to identify and address key risks which could impact the local authority.

KEY ACTIONS THAT AUDIT COMMITTEES CAN TAKE

INTERNAL AUDIT

An Audit Committee can use internal audit to assess the robustness of governance structures, communication mechanisms and performance reporting frameworks between the Council and its companies.

In addition to this, a company may procure its own internal auditors or utilise the service provided to the Council. Where this arrangement is in place, it should be clear how any assessments of the governance, risk and control environment of the company are reported to the Council Audit Committee and Shareholder Group.

FINANCIAL OVERSIGHT

Audit Committees should monitor the financial reporting controls of the Council and the companies part of its group.

The Audit Committee can monitor the financial performance, quality of financial reporting and the timeliness of the annual accounts to obtain assurance over the effectiveness of the financial controls in place.

Any concerns around the financial reporting and/or financial management of LATCOs can be investigated by the Audit Committee.

RISK MANAGEMENT

The Audit Committee of the Council can play an active role in risk management of its LATCOs, in terms of financial, strategic and operational risks of having a fully or partly owned trading company.

This could include the following:

- Reviewing the local authority's strategic risk registers relating to the LATCO
- Scrutinise local authority senior officers about financial, strategic and operational issues
- Engage with the LATCOs Audit Committee to identify key risks.

SOME KEY QUESTIONS THAT AN AUDIT COMMITTEE SHOULD ASK:

- Does the Audit Committee receive sufficient levels of financial information about its LATCOs to provide adequate oversight of financial reporting of the 'Group'?
- Is there consistency of risk management frameworks/reporting mechanisms between the local authority and its LATCO? Are there resources that can be provided to the LATCO to support mature risk management processes?
- Is the local authority able to utilise its internal audit function to support its LATCOs which will provide greater inter-connection and value for money for both parties?
- What are the arrangements in the LATCO around whistleblowing and complaints and are these arrangements fit-for-purpose and would be escalated to the Shareholder Group and Council where appropriate?

LESSONS LEARNED FROM BDO LATCO REVIEWS

KEY CONSIDERATIONS

STRATEGY FOR THE COMPANY

Before setting up a LATCO it is beneficial if the local authority is clear about what its ambitions for the company are, ie whether the company is to deliver direct services to the Council under the Teckal arrangements or whether it will expand as a commercial entity to grow profits, and dividends to the local authority.

RISK APPETITE/FINANCIAL MODEL

The local authority should have clarity over its risk appetite in relation to the LATCO's operations and the financial investment it is willing to make in the LATCO. Local authorities often provide loans to LATCOs to generate interest income but they should set limits on the levels they will lend to its LATCO.

GOVERNANCE DOCUMENTATION

- Inadequate clarity in the Shareholder Agreement to prevent the LATCO appointing its own Chair of the Board, rather than a representative from the local authority
- Lack of reference to the Director's requirement to comply with the Nolan Principles in Shareholder Agreements and Director Codes of Conduct
- Business plans were not in place or were out-dated providing the local authority with a lack of oversight into the LATCO's delivery against strategy
- Service Level Agreements between the local authority and its LATCO were not in place or were not signed leading to strained relationships arising where services are not provided adequately or payment is not received from the LATCO.

SCRUTINY / MONITORING

- A Scrutiny Panel, separate to the Shareholder, was not in place to monitor decisions relating to the companies. We have seen examples in the sector where the Chair of the Scrutiny Panel will be independent from the local authority, ie. not a Member, which has created difficulties for the Chair accessing internal information within the authority to apply effective scrutiny
- Inconsistent and irregular monitoring of the performance of LATCOs
- Local authorities not setting out clear and measurable performance targets from which to monitor its LATCOs
- The task of providing oversight was given to one senior officer in the local authority leading to issues around succession planning and knowledge across the senior management team
- In addition to risks that are presented, often an opportunity not maximised is around tax. This can include not effectively assessing how to maximise arrangements to manage tax affairs appropriately from how LATCOs are set up to one-off larger transactions around acquisitions.

RELATIONSHIP MANAGEMENT

- As the LATCO grows and obtains more commercial customers to increase revenue growth there can often be conflicts between the local authority's management and the LATCO management around the level of autonomy and independence of the LATCO
- Loan agreements between the local authority and the LATCO not being documented and signed
- Having unclear accounting and reporting frameworks. There can be delays from within the group structure which may involve different statutory external auditors causing a delay in the local authority accounts sign off process.

CONFLICTS OF INTEREST

- Conflicts of interest are not always recorded and policies to mitigate conflicts not in place. These may be undertaken as a one-off however, not maintained. This also applies to the conflict of local authority staff involvement with LATCO Boards which could present a conflict depending on the nature of the involvement.

OUR SERVICES AND EXPERIENCE

HOW BDO CAN SUPPORT LOCAL AUTHORITIES

GOVERNANCE AND FINANCIAL ARRANGEMENT AUDITS

We have significant experience of undertaking specialist audits into local authorities' governance and oversight of fully-owned LATCOs which has included assessing governance structures, performance monitoring and evaluating the risks that emerged in LATCO public interest reports. This mapped every lesson learned to the Council's arrangements and provided an action plan based on the gap analysis.

OPTIONS APPRAISAL AND WORKSHOPS

Our experience has led us to hold workshops for local authorities in the process of setting up a LATCO,jthrough the phases of devising the governance documents to preparation for the vesting day. This included setting out possible scenarios a company could face and providing approaches for how these scenarios could be handled. Through our experience we can also support the review of options appraisal by being an appointed strategic partner or assessing the options appraisal during its development against HM Treasury Green Book Guidance.

TAX MANAGEMENT AND ADVICE

Our tax professionals draw on deep experience and industry-specific knowledge to deliver clients the insights and innovation they need to maintain compliance and drive value. Our strategic tax planning expertise includes corporate tax, structuring of acquisitions and disposals, stamp taxes, VAT and capital gains tax to name but a few. We can deliver the right level of tax support that you need to achieve your goals - from tax consulting to help you document your corporate tax strategy to fully outsourced tax compliance services, our expert tax advisers can help grow and protect your business.

OUTSOURCED INTERNAL AUDIT SERVICES AND TRAINING

We currently provide internal audit services to LATCO's, delivering their full internal audit plans covering areas such as procurement, data protection and staff management. As part of this we have set up protocol arrangements across the group to ensure there is clarity on how reporting ensures all stakeholders are informed on all matters regarding governance, risk and control.

Our support has also extended to training to management and Board Members on risk management, good governance and the latest risks facing the sector they are in.

REVIEWS OF HIGH PROFILE COMPANY CLOSURES

Our specialist team have conducted significant reviews post company failure to assess the root causes and outline findings to support the Council to take necessary action. This has involved going beyond a governance assessment and reviewing the culture (invisible control environment) of the Council and company and identifying how behaviours and style contributed to negative outcomes.

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