



*General Power for Local Authorities
to Trade in Function Related
Activities Through a Company*

*Guidance on the Power in the Local
Government Act 2003*

Amendments to paragraphs 1–30



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The text below replaces paragraphs 1-30 of the *General Power for Local Authorities to Trade in Function Related Activities Through a Company: Guidance on the Power in the Local Government Act 2003* which can be found at http://www.communities.gov.uk/embedded_object.asp?id=1133791

Introduction

1. The *Local Government Act 2003* ('the Act') received Royal Assent on 18 September 2003. Section 95(1) of the Act provides power for the Secretary of State, or (in relation to authorities in Wales) the National Assembly for Wales, to make an order enabling best value authorities (with certain exceptions) to trade in any of their ordinary functions. The Act is available from The Office of Public Sector Information Website:
http://www.opsi.gov.uk/acts/acts2003/ukpga_20030026_en.pdf

SCOPE OF THE GUIDANCE

2. The purpose of this guidance is to provide assistance to local authorities in England on trading through a company in anything that they are authorised to do for the purpose of carrying on their ordinary functions. Now that the relevant order has been made under sections 95 and 96 of the Act – the *Local Government (Best Value Authorities) (Power to Trade) (England) Order 2004* (S.I. 2004/1705), ('the Trading Order') (as amended in relation to Fire Authorities) this guidance explains how, in the view of the Secretary of State, issues in relation to trading may be handled. This is statutory guidance issued under section 96(2) of the Act, to which authorities are required to have regard.
3. This guidance should not be taken to constitute legal advice or to provide a comprehensive view of the law.

SECTIONS 95 & 96 OF THE LOCAL GOVERNMENT ACT 2003

4. The Act contains new powers for best value authorities to trade in function-related activities through a company and also provides for the regulation of these trading powers. Section 95 provides power for the Secretary of State, to make an order enabling best value authorities (with certain exceptions¹) to trade in any of their ordinary functions through a company. Orders made under the power may relate to all best value authorities or to particular best value authorities, or descriptions of best value authority. This enables the scope of the trading powers to be related to an authority's performance categorisation under the Comprehensive Performance Assessment regime ('CPA'). The Trading Order is framed by reference to descriptions of authority which, by virtue of an order made from time to time under section 99(4), of the Act are of a particular category. *The Local Authorities (Categorisation) (England) Order 2006* (S.I. 2006/3096) categorises local authorities in England into ten categories according to performance.

¹ See section 95(7) of the Act for the best value authorities that are not included within the scope of the power

5. Section 96(1) provides an order-making power to impose conditions on the exercise of any trading power by a best value authority, including where this is undertaken through a company.

THE STATUTORY INSTRUMENTS

6. The Trading Order made under sections 95 and 96 of the Act provides, in respect of English local authorities, powers to trade in function-related activities through a company.

The Local Government (Best Value Authorities) (Power to Trade) (England) Order 2004

In summary, the Trading Order:

- applies only to best value authorities which are local authorities within the meaning of section 1(2) of the Local Government Act 1999 and by virtue of such order, as may be made from time to time under section 99(4) of the Act, are within one of the following categories – ‘4 stars’, ‘3 stars’, ‘2 stars’, ‘1 star’, ‘excellent’, ‘good’ or ‘fair’. (This Order does not apply to authorities referred to or specified in article 1(3) of the Order, when acting in their capacity as fire authorities).

It provides that:

- a best value authority is authorised to do for a commercial purpose, anything which it is authorised to do for the purpose of carrying on any of its ordinary functions
- before exercising the power, a best value authority is required to prepare a business case in support of the proposed exercise of the power which must be approved by the authority
- a best value authority shall recover the costs of any accommodation, goods, services, staff or any other thing it supplies to a company in pursuance of any agreement or arrangement to facilitate the exercise of the power
- where a best value authority ceases to be a best value authority to which this Order applies anything which that authority is in the process of doing at the time the Order ceases to apply to that authority, may be completed by that authority; and any agreement or arrangement shall cease to have effect at the end of the period of 2 years from the date of the Order ceasing to apply to that authority.

The Local Government (Best Value Authorities) (Power to Trade) (Amendment) (England) Order 2006

This amending Order extends the power to trade to those local authorities whose performance has been categorised by an order, made under section 99(4) of the Local Government Act 2003, as ‘4 stars’, ‘3 stars’, ‘2 stars’ and ‘1 star’.

The Local Authorities (Categorisation) (England) Order 2006

This Order categorises local authorities in England into ten categories according to performance, namely; ‘4 stars’, ‘3 stars’, ‘2 stars’, ‘1 star’, ‘0 stars’, ‘excellent’, ‘good’, ‘fair’, ‘weak’ and ‘poor’. The categorisation follows a report of the Audit Commission on 31 August 2006.

7. The Trading Order does not generally apply to best value authorities that are not local authorities (with the exception of certain named Fire Authorities). However, it is intended to consider in due course, whether further orders should be made to confer the trading power on the wider family of best value authorities.

Background

8. The *Local Authorities (Goods and Services) Act 1970* governs the way in which local authorities are allowed to ‘trade’ with other **public** bodies. It authorises local authorities to enter into agreements with public bodies for the provision of goods, materials, and administrative, professional and technical services, for the use of vehicles, plant and apparatus, and for the carrying out of maintenance. There is also a power for the Secretary of State to designate by order that any person(s) exercising functions of a public nature shall be a public body for the purposes of the Act.
9. The Consultation Paper, *Working with Others to Achieve Best Value: Section 16 of the Local Government Act 1999 – A Consultation Paper on Changes to the Legal Framework to Facilitate Partnership Working* (DETR, March 2001), proposed to provide a new power alongside existing powers to enable best value authorities to provide a full range of goods and services to others working in partnership with them. The Local Government White Paper, *‘Strong Local Leadership – Quality Public Services’* (DTLR, December 2001) went further than the earlier Consultation Paper, proposing to provide wider powers to trade for all authorities where this helps achieve best value and the delivery of public services.
10. The powers under the Act enable local authorities to trade with private bodies and persons for profit (i.e. charges fixed at more than cost recovery). In the case of local authorities in England (which fall within the definition of a best value authority), the powers have been introduced as part of a new package of freedoms and flexibilities following the CPA. The powers are available to councils assessed as ‘1 star’, ‘2 stars’, ‘3 stars’, ‘4 stars’, ‘fair’, ‘good’ and ‘excellent’ in the CPA. They are not available to councils assessed as ‘0 stars’, ‘weak’ or ‘poor’ in the CPA. The power to trade is only exercisable through a company. This will help to ensure a level playing field with the private sector.

Context for Trading

11. Trading will help create a dynamic and entrepreneurial public sector that will increase diversity and choice in the delivery of public services. Trading should encourage local authorities to extend and improve the range of services they offer and will introduce new players into the market. Trading with a wider range of bodies should help to increase the scope for partnership working and provide business opportunities for the private sector.
12. Trading activity needs to contribute towards Best Value in the related function. Local authorities can only set up trading arms in **function-related** activities. Authorities need to be clear that they have the power to engage in an activity before they trade in it.
13. Surpluses on commercial operations under the section 95 trading power (i.e. post tax surpluses) would be available to individual authorities to use as they see fit. Trading should be conducted on a fully transparent basis and authorities should not distort markets through the provision of inappropriate subsidies to trading companies.

Charging and Trading

14. Sections 93 and 94 of the Act provide a new power for best value authorities to charge for discretionary services. Discretionary services are those services that an authority has the power but not a duty to provide. An authority may charge where the person who receives the service has agreed to its provision. This new power to charge does not apply where the power to provide the service in question already benefits from a charging power or is subject to an express prohibition from charging. Best value authorities are required to have regard to any guidance that may be issued by the Secretary of State. Guidance has already been published, *General Power for Best Value Authorities to Charge for Discretionary Services – Guidance on the Power in the Local Government Act 2003* (ODPM, November 2003). This Guidance is available on the Communities and Local Government Website:
http://www.communities.gov.uk/embedded_object.asp?id=1500951
15. The charging and trading powers are separate and may be exercised separately. The essential difference between charging and trading is that charging for discretionary services is limited to cost recovery whereas trading (through a company) permits the making of a profit. There are 4 main differences in the powers:

Differences Between Charging And Trading

- (i) charging relates only to discretionary services, whereas the power to trade is for all services
- (ii) all best value authorities can use the power to charge whereas the power to trade is available only to councils rated '1 star', '2 stars', '3 stars', '4 stars', 'fair', 'good' or 'excellent' under the CPA
- (iii) charging is limited to the recovery of the cost of providing the service whereas trading can be at a profit
- (iv) the power to trade is only exercisable through a company

Relationship with Local Authorities (Goods and Services) Act 1970 and Local Government Acts 2000 and 2003

16. The *Local Authorities (Goods and Services) Act 1970* has served local government well. Authorities have made extensive use of these powers to provide goods and services to other authorities, both to make use of surplus capacity and to secure the benefit of economies of scale. However, the 1970 Act restricts the type of services provided and the bodies with whom an authority can trade. The new trading powers contain no such restrictions.
17. Section 2(1) of the *Local Government Act 2000* ('the 2000 Act') permits local authorities to engage in a range of activities including the provision of staff, goods, services and accommodation to any person, in connection with their power to promote the economic, environmental and social well-being of their

area. This power is constrained by section 3(2) of the 2000 Act which prevents authorities from exercising their ‘well-being’ powers simply in order to raise money.

18. As a result of section 95 of the Act, activities under section 2(1) of the 2000 Act, such as the provision of goods and services can now be traded, that is made available at a commercial rate in connection with a well-being purpose. An activity undertaken in connection with the exercise of the well-being function is to be regarded as something which local authorities are ‘authorised to do for the purpose of carrying on any of their ordinary functions’ (see section 95(1)(a) of the Act). The authorisation to trade conferred by the Trading Order amounts to an entirely separate free-standing and specific primary power which can be used in conjunction with the well-being power. There is no basis for regarding the restrictions on raising money provided in section 3(2) of the 2000 Act as having any application to the exercise of the trading power for the following reasons:

- the effect of the prohibition on raising money in section 3(2) is to prevent local authorities from using the well-being power primarily to raise money – in short, ‘revenue raising’ or commercial purposes’ are not purposes which in themselves fall within the scope of the section 2(1) well-being power;

however

- Section 95 trading is a separate power which authorises ‘function-related’ commercial activities and so may be exercised in conjunction with an activity or service whose primary purpose is to achieve the promotion of well-being.

Trading in ‘Well-Being’ Function-related Activities (Illustration)

- 1) The well-being function is an ‘ordinary function’ for the purpose of section 95(1)(a)
- 2) A local authority makes a decision to carry out an activity or provide a service which it considers is likely to promote or improve the economic, social or environmental well-being of its area
- 3) The Trading Order will authorise that authority to do those things for a commercial purpose where the authority is categorised as ‘1 star’ and above or as ‘fair’ and above. The power to trade in well-being function-related activities is a primary power specifically conferred by the Trading Order. The local authority cannot be acting in breach of the restriction on raising money in section 3(2) of the 2000 Act, quite simply because it is not, and indeed cannot be, trading under the well-being powers.

19. Existing *public to public* trading activities under the *Local Authorities (Goods and Services) Act 1970* (‘the 1970 Act’) will remain. These will operate in parallel with the section 95 trading power. Applications from bodies seeking public body designation under section 1(5) of the 1970 Act will not receive Ministerial approval where it appears that the body seeking the designation is largely a local authority sponsored vehicle designed perhaps to avoid the statutory framework in sections 95 and 96 of the Act, or to facilitate quasi private trading opportunities for local authorities categorised as ‘0 stars’, ‘weak’ or ‘poor’ under CPA. The powers contained in the Trading Order are primarily concerned with *public to private* trading.

20. There are also powers permitting trading, other than the 1970 Act viz
- *Civic Restaurants Act 1947*
 - Section 145 of the *Local Government Act 1972* (Provision of entertainments)
 - Section 19 of the *Local Government (Miscellaneous Provisions) Act 1976* (Recreational facilities)
 - Section 38 of the *Local Government (Miscellaneous Provisions) Act 1976* (Power to provide computers and computer facilities and making use of spare capacity)
 - Orders made under section 150 of the *Local Government & Housing Act 1989* (ie HMOs Charges for Registration Schemes, Recovery of Costs for Public Path Orders, Charges for Land Searches and Charges for Overseas Assistance and Public Path Orders)

There may be other powers as well. These powers remain unaffected because the purpose of section 95(2)(b) is to preserve existing trading powers.

Comprehensive Performance Assessment

RE-CATEGORISATION UNDER CPA

21. As the power to trade is limited to authorities categorised as ‘4 stars’, ‘3 stars’, ‘2 stars’, ‘1 star’, ‘excellent’, ‘good’ and ‘fair’ under the CPA, if an authority is re-categorised as ‘0 stars’, ‘poor’ or ‘weak’ under CPA, it will no longer be able to exercise the power to trade under the Trading Order. Such a re-categorisation will not render unlawful the performance of any obligations under trading contracts already entered into by the authority whilst it had those powers. The transitional provisions in the Trading Order provide that existing trading by local authorities re-categorised under CPA as ‘0 stars’, ‘poor’ or ‘weak’ may continue for up to 2 years maximum, after which trading shall cease if the authority fails to regain ‘4 stars’, ‘3 stars’, ‘2 stars’, ‘1 star’, ‘fair’, ‘good’ or ‘excellent’ status. ‘1 star’ and ‘fair’ authorities should therefore exercise caution before entering into trading arrangements if they have any reason to believe they might drop into a lower CPA category. This would be an appropriate item for consideration and evaluation in the business case before trading begins.
22. The Trading Order provides that any “agreement or arrangement entered into for the purpose of facilitating the exercise of (*the trading power*) shall cease to have effect at the end of the period of two years beginning with the date on which this Order ceases to apply to the authority”. As the trading power is exercised by the authority, any agreement or arrangement entered into by the authority will cease to have effect (and be incapable of performance) from the expiry of the relevant second anniversary (but will not be void). This provision will apply to any agreement which the authority may have entered into with the trading company (eg for the supply of works, goods or services) and also any other arrangement entered into by the authority with the trading company (which will include the acquisition of shares, giving of grants and secondment of

employees etc). Any other agreements or arrangements entered into by the trading company outside of the agreements or arrangements with the authority will remain unaffected. Any rights, liabilities and obligations which may have accrued under an agreement or arrangement prior to the relevant second anniversary will still be capable, in law, of being enforced.

23. There are a number of practical consequences that arise from the potential loss of the power to trade through CPA re-categorisation:
- authorities need to take into account the potential loss of the power to trade in the contractual relationships which they may enter into. For example, authorities may wish to include **'break clauses'** to extricate themselves from agreements and other arrangements, since otherwise there may be a claim for breach of contract against the authority;
 - the inclusion of such break clauses in an agreement may result in a loss to the trading company. As a consequence, the authority will need to agree the extent of any **compensation** which should be payable in such circumstances. The levels of any such compensation should be included in the original contract (or at least a formula for calculating the level of compensation) as the authority's bargaining position will be weak at the time of exercising the break clause. In doing so the authority should have regard to the nature of the company as a trading entity doing business with others and accruing creditors whilst also having regard to their fiduciary duties to council tax and ratepayers. Authorities will need to build any assumptions for compensation into the business planning;
 - authorities will also need to take into account the potential loss of the powers to trade in the arrangements which they enter into. In particular, authorities will need to have regard to shareholdings, loans and other financial arrangements which will cease to have effect. As with agreements, authorities will need to include provision for **'exiting'** such arrangements. As a consequence, authorities will need to determine (well in advance of the expiry of the relevant second anniversary) whether they should dispose of their shareholding in the trading company or sell the business as a going concern and/or put in place arrangements to wind up the trading company;
 - if the authority has the power to secure the winding up of the trading company and wishes to choose this route as the exit strategy (particularly if the trading company is wholly owned by the authority, but less so if the trading company has other shareholders) then the authority will need to have included 'break clauses' in the agreements or arrangements which the trading company has with third parties. Such provisions will result in the payment of **compensation** but will enable the venture to be wound up. When the agreement and arrangements have been terminated and any compensation due has been paid, the trading company can be wound up and assets distributed after payment of outstanding debts (which will invariably include redundancy costs).

If the shares are not sold, nor the company wound up during the two year transition period, then the shareholding and other agreements associated with the venture will cease to have effect beyond the two year deadline.

24. Where the trading company has third party shareholders (whether a joint venture or otherwise), then similar **exit arrangements** will need to be put in place. These will primarily be the sale of shares by the authority, probably subject to a right of first refusal in favour of existing shareholders (or an option for other shareholders to purchase). These arrangements should be reflected in the Shareholders Agreement and the Articles of Association of the trading company with provisions or a formula for an agreed valuation of the shares to avoid the authority being in a poor bargaining position at the time of sale. To cover the situation where there may be no buyer for the shares during the transition period, the authority may need to consider the inclusion of a '**put option**' (i.e. a right for the authority to require the other shareholders to purchase its shares at, say, a 'fair' value to be determined in accordance with a pre-agreed mechanism which would be contained in the Shareholders Agreement or in a separate option agreement).
25. Another possibility is for the trading company to issue a class of redeemable shares to the authority, on terms that the shares are redeemable out of profits (i.e. there must be profits) at the option of the authority in the event that the local authority's trading powers were suspended. The redemption price could again be a price to be determined in accordance with a pre-agreed mechanism. (Note that section 159(A) of the *Companies Act 1985* provides that the price must not be determined in accordance with any person's direction or opinion – it would need to be a pre-set mechanism, based on the last audited accounts). Once the shares were redeemed, the local authority's equity interest in the company will be at an end. For this option to be practicable, the shares would need to be issued as redeemable (i.e. non-redeemable shares cannot be re-classified as redeemable after issue).
26. The options for the authority on re-categorisation (and not returning to a '4 stars', '3 stars', '2 stars', '1 star', 'fair', 'good' or 'excellent' CPA rating by the end of transition period) are to dispose of its shareholding or to sell the business as a going concern and/or to wind up the trading company. This is because at the end of the two-year transition period the arrangements comprising the shareholding will cease to have effect, and it will not be practicable for the authority to retain a legal or beneficial interest in the shareholding. There are various arrangements which authorities may consider but they will need to take their own advice as to whether these are possible within the terms of the Trading Order. Such may include:
 - a temporary suspension of the rights attaching to the authority's shares (i.e. the right to vote, right to appoint directors, the right to income, etc). Ordinarily, it would be possible in principle to write such provisions into the Articles of Association of the trading company (similar 'dis-enfranchisement' provisions are commonly included in, for example, private equity (or 'buy out') articles for managers/directors who cease to be employed pending compulsory sale of their shares). The suspended rights would be reinstated once the trading power had been restored. However, as all arrangements in connection with the trading will cease to have effect so would any 'suspension of rights';

- the establishment of a trust. Should the shareholding be transferred to a third party to hold on trust for the authority, then as the authority will be the beneficiary of the various rights under the shares this arrangement would similarly cease to have effect at the end of the transition period;
- a purchaser could be sought for the shares in the trading company with the authority acquiring an option to purchase exercisable upon the authority's CPA rating being regained. If such an agreement or arrangement is entered into pursuant to the authority's trading powers then such will also cease to have effect at the end of the transition period.

POSITION OF CONSORTIA

27. Existing public to public trading activity by consortia under the 1970 Act will be unaffected by the provisions. The section 95 trading power is capable of being exercised jointly by local authority members of a consortium, where the constituent members have individual assessments under the CPA of '4 stars', '3 stars', '2 stars', '1 star', 'fair', 'good' or 'excellent'. Where individual members are assessed under the CPA as '0 stars', 'poor' or 'weak', and the remaining consortium members wish to exercise section 95 trading, it will be necessary for the local authorities concerned to review the membership of the consortium to exclude the '0 stars', 'poor' or 'weak' members from the consortium arrangement as it applies to the exercise of the section 95 trading power.

Trading through a Company

RESTRICTIONS ON POWER TO TRADE

28. Section 95 of the Act enables Best Value authorities to provide on a commercial basis, anything that is related to a function of the authority or is ancillary, conducive or facilitative to the exercise of that power. The power is widely drawn to include all functions, whether express, implied or incidental. This would therefore cover any functions carried out under section 111 of the *Local Government Act 1972* (incidental functions). Sub-section 111 (3) does not inhibit the use of these powers, as the power relied on to trade is section 95, and not section 111.
29. Whilst the power to trade is widely drawn it is subject to restrictions, principally:
- the power must be exercised through a company (within the meaning of Part 5 of the *Local Government and Housing Act 1989*);
 - the trading must be function-related;
 - the power cannot be used to authorise trading in anything which an authority is statutorily obliged to do in relation to a person;
 - Section 95 trading may also be regulated through the imposition of conditions by order, under section 96 of the Act;

- only authorities categorised as ‘4 stars’, ‘3 stars’, ‘2 stars’, ‘1 star’, ‘excellent’, ‘good’ or ‘fair’ may exercise the section 95 trading power;
- this power cannot be exercised by any Police Authority, the London Development Agency, or authorities when acting in their capacity as fire and rescue authorities;
- any company established for the purposes of carrying out trading under this section, in which a local authority has an interest, shall be subject to the rules about controlled, influenced, regulated and minority interest companies provided by Part 5 of the *Local Government and Housing Act 1989* and the *Local Authorities (Companies) Order 1995* (*).

(*) NB Part V of the *Local Authorities (Companies) Order 1995* has been repealed by the *Local Authorities (Capital Finance) (Consequential, Transitional and Saving Provisions) Order 2004* which came into force on 1 April 2004.

30. In deciding whether and how to exercise the trading power, authorities must still have regard to their own procedural rules, Wednesbury principles of reasonableness, proper purposes and fiduciary duty. A business case and risk analysis will be required. Local authorities will not be able to delegate some formal decisions and determinations to companies, unless they are covered by an Order under the *Deregulation and Contracting Out Act 1994*.