Southampton City Council - Highways Future Project

Full Integration Model Joint Venture Analysis

1.0 Background

The Outline Business Case (OBC) evaluated four Public / Private Partnership models against a number of Critical Success Factors. A Full integration model was identified as the preferred option for the future delivery of highways services in Southampton (paragraph 3.7.15).

A key factor in the selection of the preferred option was that greater integration leads to greater opportunities to deliver the Council's objectives (see Key Findings, paragraph 1.1.7). The OBC was not specific about the legal nature of the preferred model. Whilst it is not disputed that integration has the potential to deliver increased efficiency and effectiveness or that a Joint Venture has the potential to deliver integration, there are alternative service delivery models that could achieve the same level of integration without the requirement to set up a JV.

This paper sets out the key features and implications of a Joint Venture Company, the steps involved in setting up such a vehicle and alternative options for integrated service delivery.

2.0 The Public/Private Partnership Models

Four models for public/private partnership were considered by the OBC (paragraph 3.3.16 – 3.3.18), namely

- Virtual Partnership
- Co-location
- Partial Integration
- Full Integration – e.g. Joint Venture.

The JV model is a fundamentally different legal form and risk profile to the other three options.

In models 1 to 3, the Council enters into a contract with the private sector for the provision of certain services. The respective rights and obligations of the parties are defined under the contract - the private sector partner has responsibility for delivering those services ascribed to it in accordance with the requirements defined under the contract. Models 1 to 3 as described in the OBC differ from "traditional" services contracts in that they include mechanisms to better align the objectives of the parties and encourage collaborative working e.g. target costs, partnering boards. Models 1 to 3 differ from each other by virtue of the extent of staff co-location and use of common business systems and processes utilised by each i.e.:

- Virtual Partnership – two organisations working jointly but in separate locations
- Co-location – two organisations working alongside each other
- Partial Integration – two organisations amalgamated

The JV model differs from the other three models because it entails the Council and the private sector forming a separate organisation to deliver the Highways Services. That newly formed organisation then enters into the services contract with the Council and has responsibility for delivering the services to the requirements of the contract.

3.0 The Joint Venture Model

For the purposes of this paper a Joint Venture is a new company with its own separate legal entity formed by the public and private sector shareholders. Because it is part owned by a private sector shareholder, it is likely to be a company incorporated in England and Wales, limited by shares in order for it to trade for profit and pay a dividend to shareholders. This structure also enables long term value to be captured (by increase in share value) and for participants to withdraw or be changed by transfer of shares to the existing or new shareholders.

A Joint Venture Company is typically established where:

- organisations have complementary business needs which they would be unable to achieve independently.
- there is a potential and desire to grow the business through trading and entering into other contracts/ventures.
- the public sector wishes to maintain control or influence over the strategic direction of the service provision.
- there is insufficient private sector expertise in the service area or in the geographic area.

Key features of a Joint Venture Company include:

- The public and private sector will own shares in the JV, usually in proportion to the investment made.
- The JV will have a Board of Directors, usually in proportion to the shareholding.
- The JV will have its own legal capacity which owns and deals in assets.
- The JV will employ people and it is likely that staff from the public and private sector parents will be TUPE transferred to the JV.
- The JV will enter into a services contract with the Council for the provision of the services and has the ability to trade and enter into other contracts e.g. for other authorities.
- The JV will have separate audited accounts and make a profit or loss depending on its performance and will pay dividends to its shareholders.

In essence it is a separate limited company set up to provide services to the Council of which the Council is a shareholder. Such an arrangement has a number of advantages relevant to Southampton City Council's objectives, including developing a single integrated team, a focus on business planning and access to private sector skills and capacity – these and other advantages are more fully set out in the OBC. However other key features and advantages of a JV such as the ability to trade and grow the business and the ability to raise capital off the Council's balance sheet do not appear to be key objectives of the Council. It may be able to better achieve the Council's objectives through a different contractual mechanism.

There are a number of key disadvantages to a Joint Venture including:

- The potential liability of Directors arising from their duties and insolvency legislation.
- The risk of insolvency of the JV resulting in loss of equity and disruption of service delivery for the Council
- Potential conflict of interest for the Council's staff transferred to the JV between duties owed to the Council and to the JV
- The potential for obscuring public accountability
- Potential for conflict between the public and private sector parents over future direction of the JV and the potential for damage to the Council's reputation.
- The time and costs required to set up and operate a JV
- The need for commercial insurance
- Public sector retains commercial risk through costs of redundancy, workload variations, profit/loss
- Potential unattractiveness of the model to the private sector due to perceived lack of control and reduction in profit

4.0 Setting up a Joint Venture

The setting up of a JV is relatively straightforward but there are a number of issues to consider and a number of governing legal documents.

It is considered that there are three fundamental questions to be addressed by the Council prior to further consideration of setting up a JV:

1. Vires:
   - Does the Council have the legal powers to set up the JV?
   - Is the Council improperly or unlawfully delegating any powers to the JV?
   - Is the Council authorised to expend monies in connection with the JV in accordance with legislation or its own internal rules?

2. Council Policy / Appetite
   - Is the formation of a JV acceptable to Members, staff, Trade Unions, the public and other stakeholders?

- o Is there a risk that is could lead to a loss of reputation of the Council and/or be contrary to the public interest?
- o Would employees of the Council be willing / able to be Directors of the JV?

3. Market Acceptability
   - o Is the formation of a JV acceptable to potential bidders / partners? Whilst a number of JV's are in operation in local government service delivery, there is a well established market for other forms of partnership models which may be more attractive and perceived to be less risk to the market.

These three issues would need to be addressed prior to any further action on establishing a JV.

The following issues would also need to be considered in setting up a JV (but would not necessarily be barriers to its implementation):

1. Resources to be Committed:
   Generally the public sector contributes property, equipment, skills, IPR to the JV - the Council will need to confirm that it owns and has the powers to contribute the assets. The Council's shareholding will reflect the value of the assets contributed, so it will need to value those assets in order to determine its shareholding and ensure that it provides sufficient influence over the JV.
2. Accounting and Tax:
   How will the JV be treated for tax purpose i.e. will it be classified to the public or private sector.
3. State Aid:
   The Council would need to confirm that the formation of the JV does not amount to unlawful state aid to a commercial venture
4. Commercial Insurance:
   The Council would need to consider the merits of taking out insurances to cover any liabilities arising out of the actions of the JV
5. Competition law:
   The Council will need to ensure that the formation of a JV does not breach competition law.

The primary legal documents that would be required to establish a JV are:

1. Memorandum and Articles of Association:
   Sets out the objectives of the JV and define its constitution. These are lodged at Companies House.
2. Shareholders Agreement:
   This sets out how the JV is to be managed including the equity input of the parties, future funding requirements, payment of dividends, exit provisions and realisation of assets, confidentiality, IPR etc.
3. Subsidiary Contracts:
   These are contracts with the parent organisations which set out their obligations to provide skills, investment etc to the JV.
4. A Business Plan setting out the future direction and viability of the JV.
5. The Service Contract between the JV and the Council for the provision of the services.

There will also be a need to set up a Board of Directors which is proportionate to the shareholding of the participants. There will therefore be a need to ascertain and value the assets/investment being contributed by each of the participants.

5.0 Implementation Costs and Timescales of a Joint Venture

<u>Costs</u>
The OBC has identified the following costs in setting up a Full Integration Partnership

Staff Costs	£547,650
External Advisors	£450,000
Contingency	£50,000
Total	**£1,047,650**

The External Advisor Costs have been broken down as follows:

Financial	£125,000
Legal	£125,000
Technical	£150,000
Other (not defined)	£50,000
Total	**£450,000**

The description of the outputs (Table 27 p. 101) would appear to be related only to the development of the services contract between the Council and the delivery partner and procurement through the Competitive Dialogue process e.g. Payment Mechanisms, financial models, project contract, service specifications, support through CD and tender evaluation. The financial and legal costs above (both £125,000) do not appear to cover the costs involved in establishing a JV.

It is likely that additional financial costs will be required for a number of additional functions in relation to a JV including identifying and valuing the Council's assets and establishing the accounting and taxation requirements of the JV. Additional legal costs will be incurred for advising on and preparing the Memorandum and Articles of Association, Shareholder's Agreement, Subsidiary Contracts as well as the Services Contract. Consequently, the financial and legal costs for establishing a JV may be 2 to 3 times those set out in the OBC.

It is considered that the costs set out in the OBC (£1,047,650) are reasonable estimates of developing and procuring a partnering contract between the Council and a private sector provider. Some of the costs are relatively fixed regardless of the partnering model ultimately chosen e.g. Pre-Qualification Stage, Competitive Dialogue, specification writing, drafting services contract, stakeholder communication etc. Therefore it is considered that the Implementation Costs set out in Table 17 on p59 for Option 1 and Option 2 are unrealistically low and would be closer to the costs for Option 3.

Timescales

As set out in the OBC, the establishment of a JV arrangement is more complex than the other options. For a relatively straightforward arrangement such as Option 1, the mobilisation period from contract award to start of service delivery can be achieved in a minimum of 3 months although 4 to 5 months may be more realistic.

However, if there is a requirement to procure new premises, which is probable for Options 2, 3 and 4 due to the need to co-locate staff, the mobilisation period is likely to be governed by the time to procure and establish such premises – this could be approximately 5 to 6 months. This would allow sufficient time to undertake the necessary legal processes to set up the JV.

6.0 Alternative Models to Joint Venture

The OBC rightly highlights the ability of a JV company to establish a single integrated management structure for the delivery of the Council's highways services. Options 1, 2 and 3 can also be configured to establish integrated service delivery by adopting collaborative working practices including co-location of teams and the use of common systems and processes between the retained and transferred teams. It should be noted that Option 3 is potentially high risk strategy due to the "blurring" of management accountability lines by making staff from the public sector report to a private sector line manager and vice versa.

In addition to the 4 models considered by the OBC there is one other model that could be used to achieve the same level of integration without the need to form a new business entity; Strategic Service Partnership .

In this model a private sector partner is selected to take on delivery of the highways service through a partnership contract. The Council's staff would typically transfer under TUPE to the private sector partner with a contract management team remaining in-house. This is now a well established approach and there is a volume of 'best practice' available to guide the Council. The following list covers the typical range of issues that have been highlighted by the experience of other Local Authorities with this kind of arrangement:

- Service best described through an output specification allowing the partner to innovate in the design of its service delivery arrangements
- Need for a properly resourced and skilled contract management team (the competencies required in this role are quite different from those required for service delivery)
- The partnering contract must be subject to an effective, transparent and focused performance management system which provides realistic incentives for successful delivery
- Contract should be flexible to allow for changes in workload and the option to add additional services during its term (sometimes described as incremental partnering)

The extent to which the service delivery team is integrated into one vehicle will be determined by the extent of the services defined by the Council to be delivered by the private sector.

Although this approach can achieve a highly integrated team, it will require working in partnership with the Council both at a contract management level, through a strategic management board and through its interface with other parts of the service retained by the Council (e.g. policy and planning etc). Careful consideration will be required of the mechanisms to achieve a successful partnership approach including shared goals and objectives, appropriate contractual incentives, co-location, shared systems / processes and shared culture.

7.0 TUPE Implications

As identified in the OBC, the transferring of staff into the JV Company would be carried out under the TUPE Regulations - the use of a secondment model would not be appropriate.

The OBC implies that TUPE may not apply to the other options. It is worth noting that the extent to which TUPE will apply depends on the final scope of the services to be delivered by the private sector partner and not on the form of the delivery model adopted. If services are currently carried out by the Council but are to be carried out by the private sector partner in future, TUPE will apply to those transferring services. Equally, TUPE will apply as between any outgoing service provider currently employed by the Council (e.g. Halcrow) and the incoming service provider but this is generally a matter between the outgoing and incoming provider.