

## Cabinet

9 November 2017

### Establishment of ESPO Trading Company

#### Recommendations

It is recommended that:

- a) The decision of the ESPO Management Committee, having reviewed the detailed business case and other documents, to recommend each of the six member authorities to establish a new trading company, be noted;
- b) Approval be given to the establishment of a new trading company, 'ESPO Trading Limited' on the basis outlined in this report and that the Joint Managing Director (Resources) be authorised to agree the terms of and sign the necessary documentation to give effect to this decision;
- c) It be noted that the Board of Directors of the trading company will include five officers, acting as Executive Directors made up as follows:
  - (i) Three officers from ESPO being the following office holders:
    - Director of ESPO
    - Deputy Director and Chief Commercial Officer
    - Assistant Director of Finance and IT
  - (ii) The Director of Corporate Resources (Leicestershire County Council) or his nominee;
  - (iii) An officer nominated by the other Shareholder (member authorities) of ESPO;
- d) Approval be given for arrangements to be put in place to indemnify the ESPO and other Council officers in discharging their role as Executive Directors of the Company;
- e) It be noted that the Shareholders (member authorities) may nominate up to two Non-Executive Directors to serve on the Board of the Company;
- f) It be noted that each of the six member authorities will be equal shareholders in the new Company and that the shareholder representative on the new company will be one elected member from each member authority drawn from the membership of the ESPO Management Committee;

- g) It be noted that the shareholder representatives (Elected Members) will be responsible for taking strategic decisions and agreeing the Annual Business Plan for the Company.

## **1.0 Key Issues**

- 1.1 The purpose of this report is to advise the Cabinet of the recommendations of the ESPO (Eastern Shires Purchasing Organisation) Management Committee and senior officers of the six member councils concerning the establishment of a new company, ESPO Trading Limited.
- 1.2 The report has been written to enable consideration of the matter in public. As such the detailed business case and draft documents necessary to incorporate and begin trading through the company are not appended to this report. These documents have been closely scrutinised by the ESPO Management Committee, and the senior officers and legal and financial teams of each of the six member authorities. With the exception of the business case the other documents necessary to incorporate the company have been drafted by external specialist legal advisors for Leicestershire County Council and shared with all member authorities.
- 1.3 The ESPO Management Committee which comprises two elected members from each of the six member authorities has over the past six months considered the detailed business case that supports the establishment of the new Company. At its meeting on 20<sup>th</sup> September 2017 the Management Committee, having considered the advice of its Chief Officer Group and independent legal advice, agreed to recommend the establishment of a new company.

## **2.0 Proposal**

- 2.1 ESPO is established as a joint committee set up in accordance with the Local Government Act 1972 and the Local Government Act 2000. Its servicing authority, Leicestershire County Council, is limited to trading under powers in section 1 of the Local Authorities (Goods and Services) Act 1970 with a limited number of organisations defined as public bodies under that Act.
- 2.2 Member authorities of ESPO have the opportunity to explore alternative markets that are not public bodies, by using the powers under:-
- i) Section 4 of the Localism Act 2011 and Section 95 of the Local Government Act 2003 to trade for profit, through the new separate company;
  - ii) Section 3 of the Localism Act 2011 and Section 93 of the Local Government Act 2000 to make a charge through the existing joint committee and servicing authority for goods and services to organisations other than those with which ESPO may trade by virtue of the Local Authority (Goods and Services) Act 1970.

- 2.3 By virtue of being able to trade with organisations in addition to public bodies, ESPO and the new Company will be able to secure ESPO's position in an increasingly competitive market and deliver the growth and profit targets set by the ESPO Management Committee in its Medium Term Financial Strategy.
- 2.4 There will be no cost to any of the member authorities arising from the recommendations in this report, other than £100 each to subscribe for shares in the new Company, as the working capital for the new Company will be met from existing ESPO reserves.
- 2.5 The ESPO Management Committee agreed a target surplus of £6m by 2020/21. Whilst most of this will be achieved by growth rate based on ESPO's existing core business, a number of new projects and initiatives are also needed. It is considered that there is potential for sales growth of around £1 - £1.4m within the first two years of operation of the new ESPO trading company: figures are based on a cautious approach to the selected markets.
- 2.6 More detail is given in the Appendix to this report.

### 3.0 Timescales associated with the decision and next steps

- 3.1 The ESPO Management Committee on 20 September 2017, agreed to support the creation of ESPO Trading Ltd on the basis as set out above, pending the necessary approvals by the six member authorities. Each authority is taking a report to its appropriate member body.

### Background papers

None

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The report was circulated to the following members prior to publication:

Local Member(s): N/A

Other members: Timms, Butlin, Boad, O'Rourke, Singh Birdi

### Background

1. Leicestershire County Council established joint arrangements for the purchase of goods and supplies and the provision of agreed services by forming a joint committee with Lincolnshire County Council, Cambridgeshire County Council, Norfolk County Council, Warwickshire County Council and Peterborough City Council, which has the trading name the Eastern Shires Purchasing Organisation (ESPO). A joint committee was established in accordance with section 102 of the Local Government Act 1972.
2. ESPO is a public sector buying organisation operating as a Local Government Committee, jointly owned by six local authorities. As it is not a separate legal entity its functions are performed through Leicestershire County Council, which acts as the Servicing Authority to the joint committee.
3. Its main objective is the provision of a professional, comprehensive value for money purchasing, contracting and supplies service for its member authorities and other public bodies under the provisions of the Local Authority Goods and Services Act 1970. It does so by providing access to a catalogue containing nearly 27,000 product lines and over 150 framework solutions.
4. In financial terms ESPO not only has a statutory duty to recover its operating costs but also to keep these to a minimum commensurate with the level of service required and the long term development of the business. Any surpluses accrued are distributed to the member authorities in line with an agreed formula after a proportion of the profits have been set aside for a development reserve and as working capital. Last year ESPO generated a profit of nearly £4.2m of which £2.8m was distributed to the member authorities.
5. ESPO now trades successfully on a self-funded basis and is recognised as one of the leading public sector buying organisations in the country, supplying to a broad range of customers principally in the education sector. However, as its sole power to trade through its Servicing Authority is under the Local Authorities (Goods and Services) Act 1970 as a joint committee, ESPO is limited to being able to trade with organisations identified and listed under that Act. This list is updated from time to time but is strictly limited and does not include all contracting authorities that wish to buy ESPO's goods and services, such as central government departments. Whilst the Act and joint committee facilitated ESPO's creation of the organisation, it is also constrained by its constitution and structure and can trade only with other public bodies in the UK. This market is shrinking as local authority resources reduce and services are outsourced to private or voluntary sector organisations.

## **New Trading Company**

6. Restriction on trading has led ESPO's Management Committee to explore alternative markets: potential customers that are not public bodies. These fall into two groups:-
  - (a) customers that are not contracting authorities, such as charities and others in the voluntary sector, using alternative powers to trade through a separate company; and
  - (b) charging those that are contracting authorities but not public bodies, such as central government departments, on a cost recovery basis, using alternative powers to charge that do not require the use of a company.
7. The charging model for 16(b) above enables ESPO to continue to serve its existing customers from the wider public sector on a non-commercial basis. It is not intended as a means for actively pursuing commercial growth, rather to enable those customers to continue using ESPO as a public sector supplier. Charging will be based on the guidance laid down by the Chartered Institute for Finance and Accountancy (CIPFA).
8. In 2015/16 the ESPO Management Committee set a target to achieve a surplus of £6m by 2020/21. Whilst most of this (£4million) will be achieved by growth rate based on ESPO's existing core business, new projects and initiatives will be needed to deliver the target surplus. These include:-
  - Creation of a Private Trading Arm
  - Automation in Warehouse (in progress)
  - Personalised Procurement Service (PPS) (marketing activity)
  - International Sourcing (business as usual buying activity)
  - Mergers and Acquisitions (reviewed as opportunities arise).
9. The creation of ESPO Trading Ltd. is one of the key projects intended to drive future growth. Through it, ESPO intends to exploit the opportunity to trade in current products and services, through its existing infrastructure, but to new markets and customers. It will also allow ESPO to trade with confidence with organisations with a public sector ethos, but which are not designated as 'Public Bodies' under the Local Authority (Goods and Services) Act 1970.

## **Structure, Management and Staffing of the new company**

10. The Company will be a separate legal person, distinct from the local authorities that comprise ESPO's joint committee. The Company's operations, whilst related to those of ESPO, will not be governed by the Consortium Agreement. Instead, the Companies Act 2006 and the Company's Articles of Association will regulate in part the relationship between the local authorities who are or subscribe to become shareholders in the Company. Overlaying these, a shareholders' agreement will complete the relationship between the shareholders.

11. The activities of the Company will be restricted to those agreed in a business plan that the shareholders will review and update when they determine.
12. Each shareholder will subscribe for an equal number of shares in the Company. Any prospective shareholder in the Company must join ESPO's joint committee, if not already a member, and agree to become bound by the shareholder agreement and the Consortium Agreement.
13. Control of the Company will be split between the shareholders and a Board of Directors. The Board of Directors will be responsible for the day-to-day management of the Company. It will comprise of up to five officers employed by the shareholders, three representing ESPO, one nominated by Leicestershire County Council and one nominated by the remaining shareholders. Each category of director must be present for the Board to be quorate.
14. In addition, shareholders will appoint two Non-Executive Directors to the Board and may appoint observers to attend Board meetings. Observers appointed will not have the right to speak or vote at Board meetings.
15. Shareholders will take strategic decisions in general meetings of the Company, where an elected member will represent each shareholder. This provides the option for shareholders to arrange for member participation in general meetings to coordinate with the separate management of ESPO through its Management Committee. These strategic decisions will concern matters reserved to shareholders and set out as such in the shareholders' agreement.
16. The shareholders agreement also describes: how the directors of the Company will determine the distribution of the Company's profits as dividends to shareholders; the financial information to be provided to shareholders; the limitations on shareholders' ability to transfer shares to others and the potential for shareholders to be required to transfer shares if they cease to be members of ESPO's joint committee or act in breach of the shareholders' agreement; the mechanism for settling any dispute; and arrangements, should the Company be wound up.
17. The primary objective of the new Company is to legally trade outside of ESPO's current boundaries. It is not envisaged as an employment vehicle. It is intended that current ESPO employees will continue to be employed by Leicestershire County Council as the Servicing Authority. If additional staffing and resources are required to fulfil operational and governance requirements of the new company, a tax efficient transfer-pricing model will be adopted, under which a recharge will be made between the new Company and ESPO.
18. Leicestershire County Council (on behalf of ESPO) and ESPO Trading Ltd. will need to enter a management agreement under which the Council provides all the services and goods to the Company. ESPO Trading Ltd will, at least in the short term, simply be a shell company with no employees or assets as a necessary requirement of statute in order to act for a commercial purpose.

## **Business Case**

19. ESPO is an established, well known and reputable brand in its current markets of education, local government and the wider public sector.
20. ESPO provides a catalogue offer for goods. It also provides procurement services, primarily in the form of access to a range of frameworks (agreements with providers or a range of providers, enabling buyers to order services without running full tendering exercises). Frameworks enable customers to access goods and services by contracting directly with the supplier.
21. The education market accounts for the majority of ESPO's catalogue business. This market has been declining in recent years, reflecting real-term reductions in funding per pupil. According to the Institute for Fiscal Studies, this market is forecast to decline by 8% over the next five years.
22. ESPO's MTFS has financial growth expectations for which it has set a target to increase its market share. ESPO intends to obtain these new sales by accessing new customer markets through ESPO Trading Ltd.
23. ESPO Trading Ltd will prioritise the marketing of existing products where there is already a high level of internal experience. The impact on the organisation will therefore be limited with ESPO already well positioned to form a foundation on which ESPO Trading Ltd can be established and developed relatively easily.
24. Utilising the current products, staffing, and overall infrastructure will enable ESPO to enter the new and extended markets by simply extending its existing offer to new customers. Rather than being a new supplier in the market, ESPO Trading Ltd will simply be a new way of trading, and as such will not be subject to the barriers to entry most new company's face.
25. ESPO's competitors now trade with both private and public sector customers. They have already set out that public sector education providers can trade with private customers, so the work has been done to establish this as a viable proposition to the customers targeted. In addition, the attractive price point by which ESPO is known will also remain, making the sales pitches less difficult and will make converting new customers more achievable.
26. With the majority of ESPO's current catalogue sales in education, it has a good range of products to offer to the private, charitable and voluntary sectors. ESPO Trading Ltd also provides opportunities to expand the business, offering familiar products to organisations that fall outside the scope of public bodies and contracting authorities.
27. ESPO has examined its current trading trends and markets as well as those that will be most suited to ESPO Trading Ltd and, through a process of filtration and funnelling, has prioritised its target customer groups.

28. The commercial opportunities or target markets identified for the new Company are broadly: education sector collaboration, independent sector diversification, residential care, charities and volunteering groups, as well as potential for international education sector trade and the wider offering of framework solutions to private sector users. All of these draw on the existing infrastructure and skillsets within ESPO while addressing the legal limitations to trade within the current constitution.
29. ESPO's strong brand has performed well in the UK education market and is recognised in the wider public sector for its extensive framework solutions and individual contracts. The branding will feature in all marketing strategies in new growth areas.

### **Summary of Sales Growth potential in years 1 and 2**

30. The consolidated commercial opportunities for growth outlined above equate to a combined indicative turnover of £1m to £1.4m. This is based on a cautious approach to the selected markets:

	£m	
	Year 1	Year 2
Education via collaboration		
Region A	0.104	0.156
Region B	0.175	0.260
Region C	0.300	0.450
Education via diversification	0.140	0.210
Care, Charity and local private sector	0.281	0.350
	<b>1.000</b>	<b>1.426</b>

31. Through the 'Charging' aspect of this proposal, catalogue sales and rebate income on frameworks will also be protected. Those customer types that are not included within the Local Government Goods and Services Act 1970 list of public bodies, but which nevertheless appear to be public bodies, could be transferred from ESPO to ESPO Trading Ltd or continue to be served under a 'Charging' mechanism.

### **Finance**

32. The proposed share capital of ESPO Trading Ltd is 600 shares of £1 each held equally by each of the six member authorities. Working capital for ESPO Trading Ltd will come from ESPO's existing reserves through a mechanism which will reflect commercial rates.
33. ESPO Trading Ltd will operate within the assets of ESPO and therefore under the same IT systems and processes as ESPO.

## **Governance – Practical Considerations**

34. As stated earlier, ESPO Trading Ltd will not require a Servicing Authority. Instead, it will be governed by the Companies Act 2006, its Articles of Association, its shareholders' agreement, decisions of the shareholders in general meetings and by written resolution, and decisions of its Board of Directors.
35. As member authorities are also shareholders, each will have similar influence over ESPO Trading Ltd as they currently do over ESPO. It is therefore expected that these two entities will work under parallel but complementary systems ensuring good governance control.
36. The practicalities of running ESPO Trading Ltd are such that it would make sense for its governance arrangements to follow the meeting cycle and governance of the existing ESPO Management Committee and that matters relating to the new Company should be a separate item on the agenda for those meetings.

## **Risk Assessment**

37. If there is a failure of management to ensure proper governance such as being non-compliant with legislation (e.g. Health and Safety, Data Protection, Employment, Freedom of Information), this would result in fines and possibly legal action. This could make it difficult to obtain insurance cover or could increase premiums. The risk of this is, however, mitigated by the oversight provided by the Internal Audit of Governance arrangements, preparation of the Annual Governance Statement and the regular liaison meetings with the Servicing Authority.
38. There is also the possibility that existing customers loyal to ESPO for its public sector ethos may perceive the creation of a private trading company as tarnishing its public sector credentials leading to loss of business. This will be managed by appropriate marketing within both ESPO and ESPO Trading Ltd to ensure that customers understand that ESPO's commitment to the public sector is still at its core.
39. If ESPO Trading Ltd fails to achieve its business plan, then there is the possibility that ESPO would be unable to pay dividends to its members in line with the MTFs and unable to pay its suppliers. In addition, substantial interest charges could be incurred on borrowings and aggressive credit control practices would be required to maintain cash-flow.
40. This risk will be mitigated by balancing planned annual incomes and expenditure to ensure ESPO continues to generate trading surpluses and positive cash flows in line with its MTFs, maintaining robust customer credit control procedures and aged debtor reporting. Daily monitoring of Orders and Lines and weekly and monthly reporting of incomes and trading results against budget and target will also ensure that management have a detailed overview of the business and are able to course correct throughout the year as needed.

41. If ESPO Trading Ltd fails to achieve proper segregation from ESPO, this could result in inaccurate accounts, qualified audit reports, and an incorrect calculation of dividends. The risk of this happening will be minimised by employing Internal Audit investigations and Standard Operating Procedures designed to address segregation of duties.
42. There is also the risk of mergers in the market and emerging competitors coming from within existing key partners but as with ESPO itself, management will continue to undertake market monitoring and benchmarking.
43. While there are a range of risks as set out above, the Management Committee was satisfied that the proposed method of establishing ESPO Trading Ltd and its business model will ensure that risks are mitigated by control measures. Its risk profile will be within acceptable tolerances and will receive the same rigorous monitoring and audit as recommended by Leicestershire County Council's Internal Audit.

### **Legal Issues**

44. Legal Advice has been obtained on the formation of the company from external specialist commercial solicitors who have worked closely with Leicestershire County Council's in house legal team. This has enabled assurance in relation to the vires, regulatory, constitutional and governance issues arising from the proposed company formation.
45. As progress towards incorporation of the trading company is made, there will be a requirement for ongoing legal and regulatory advice. Thereafter, once incorporation has taken place, the Company will require its own separate and independent legal advice.
46. The legal rationale for the trading company and the statutory limitations on trading as a joint committee are as set out in the report.

### **Conclusion**

47. There is an underlying trend of volume decline in the core education marketplace and while ESPO continues to hold and even grow its market share, ESPO's Management Committee has agreed that continued growth will need to be underpinned by the development of new projects and initiatives. ESPO Trading Ltd is a cornerstone to ward off decline and to contribute towards ESPO's projected surplus growth being delivered to its members.
48. The member authorities' legal officers have scrutinised the legal basis for charging within ESPO and have been working with Browne Jacobson, independent legal advisors, to shape the shareholder agreement, articles of association and deed of variation required to establish a company, having due regard for the ESPO Management Committee Consortium Agreement and Constitution.

49. Having presented this groundwork to the Management Committee on 20 September 2017, they agreed to support the creation of ESPO Trading Ltd on the basis as set out above, pending the necessary approvals by the six member authorities.
50. Once established, ESPO Trading Ltd will complement the existing operation and facilitate commercial opportunities which are currently not accessible via the existing consortium arrangement.