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Dear Member

**GOVERNANCE AND AUDIT COMMITTEE TRADING ACTIVITIES SUB GROUP - TUESDAY, 1
SEPTEMBER 2009**

I am now able to enclose, for consideration at next Tuesday, 1 September 2009 meeting of the Governance and Audit Committee Trading Activities Sub Group, the following reports that were unavailable when the agenda was printed.

Agenda No Item

- 2. Audit Commission Review of Commercial Operations (Pages 1 - 14)**

Yours sincerely



Peter Sass
Head of Democratic Services & Local Leadership

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Review of Commercial Operations

Kent County Council

Audit 2008/09

August 2009



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Status of our reports

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body. Reports prepared by appointed auditors are addressed to non-executive directors/members or officers. They are prepared for the sole use of the audited body. Auditors accept no responsibility to:

- any director/member or officer in their individual capacity; or
- any third party.

Summary report

Introduction

- 1 There has been considerable interest in Kent County Council's commercial operations over a period of years and more recently this has culminated in a press campaign about the way the Council competes against the private sector following representations from a range of Kent-based businesses. We have received correspondence from a number of people who have concluded that the Council's commercial operations are successful because it provides direct financial support and/or subsidy to them. Particular public attention has been focussed on the activities of one of the Council's subsidiaries which is successfully providing temporary staff and winning passenger transport contracts to both the public and private sectors. Other activities, which are solely offered to the public sector including grounds maintenance and landscaping, have been subject to similar public interest.
- 2 This report sets out our audit approach to this review of the Council's commercial operations and our findings and conclusions.

Background

- 3 Kent County Council is a 4 star authority under CPA and is known as being innovative. As part of its ambition to ensure value for money for taxpayers it has set up a number of commercial operations including limited companies. This was partly in response to its concerns at escalating payments to the private sector for some services, such as the employment of temporary staff, specifically supply teachers and care workers.
- 4 The first of the Council's commercial operations were established in the 1960s when a Commercial Services division was created. Over the years new business units have been added. Commercial Services is effectively a directorate of Kent County Council and as at the June 2009 there are 7 business units and three limited companies, one of which is a dormant company. In total the directorate employs around 800 staff. The 7 business units produced an income of £327 million in 2008/09 which gave rise to the surplus reported in the Council's financial statements for 2008/09 of £6.4 million. Of the income, £39 million came from the Council, with £288 million from other public sector bodies. The two operational companies are wholly-owned and neither utilise private capital. They were set up with the intention of trading at a profit including with the private sector. Clear targets have been set to monitor their performance. These companies are:
 - Kent Top Temps Limited provides employment services and also trades under the name of Kent Top Travel which supplies transport services. It had a turnover of £14.4 million in the year to 31 March 2009 and reported a profit of £0.34 million before tax (£0.26 million after tax); and

- Kent County Facilities Limited which trades as Inside Out. It had a turnover of £0.8 million in the year to 31 March 2009 and reported a profit of £0.05 million before tax (£0.04 million after tax). We have given less attention to this company in this review as it is relatively new having started to operate in 2007 when it dealt with public sector business only but has since started to operate in the private sector also. The scale of its business is low and we have undertaken no detailed work in this area.
- 5 The Local Authorities (Goods and Services) Act 1970 provides the power for authorities to trade with other public bodies. There are few constraints on this power and it can be carried out without the creation of a specific department or division of a council to administer its activities under the Act. The decision of a council to use such a power is likely to mean that it will be competing for and winning business from other public sector bodies at the cost of the private sector. The landscape services unit operates within Commercial Services is a good example of this.
 - 6 Sections 95 and 96 of the Local Government Act 2003 gave new powers and provided associated regulations to best value authorities, such as the Council, to trade through companies in activities that it has existing powers to undertake. This effectively extended a council's powers to trade 'where this helps to achieve best value and the delivery of public services'. The Act enables the Council to trade with private bodies and persons for profit.
 - 7 In July 2004, the Office of the Deputy Prime Minister (now the Department for Communities and Local Government) issued guidance on the power contained in the Local Government Act 2003. The key requirements set were:
 - it must be done through a limited company which can be wholly owned or jointly owned with another entity;
 - it must 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; and
 - any assistance should be provided under a formal agreement with the company.
 - 8 We understand that plans to expand the activities of either Commercial Services or its subsidiary companies are on hold because of the current economic climate and that it would be in conflict with the Council's 'Backing Kent Business' campaign which seeks to support and advise on a range of issues that affect both new and existing businesses.

Audit approach

9 Our audit approach was set out in a document presented to Members and officers of the Council in December 2008 and centres around establishing the completeness and reasonableness of the recharges made by the Council to its commercial operations and if there are any forms of other financial support. We have reviewed the legal background to the operation of the Council's commercial activities. We also met with a small number of private sector business representatives who had contacted the Audit Commission with specific concerns about the Council's commercial operations. We have also considered a number of other aspects of the Council's arrangements including:

- the structure of Commercial Services and the Council's subsidiary companies;
- how Commercial Services was originally financed when set up in the 1960s;
- how the subsidiary companies are financed;
- the basis on which Commercial Services and the Council's subsidiary companies occupy its premises at Kings Hill;
- how the Council and Commercial Services ensure that contract tendering rules are adhered to strictly in situations where Commercial Services is tendering to the Council;
- how Commercial Services prices its tenders to the public and private sector; and
- the process by which Kent Top Temps Limited established itself as a master vendor for the Council in respect of supply of temporary staff.

Main conclusions

10 Our conclusions reached from this review are:

- the Council's commercial operations are structured in accordance with statute. Commercial Services and the Council's subsidiaries understand the limits to their powers and act within them;
- the Council has a robust methodology for allocating its costs incurred on behalf of its commercial undertakings to the business units operated by Commercial Services directorate and the Council's own subsidiaries;
- we identified no evidence of any financial support or cross-subsidisation of the commercial operations by the Council that gives any competitive advantage;
- the commercial operations are driven by a need to supply goods and services at competitive prices to both the public and private sectors and to both reduce the Council's costs and make surpluses and profits for the Council; and
- the Council should evaluate opportunities to address the concerns expressed by the some parts of the public about access to information in respect of its commercial operations, subject to the Council's consideration of maintaining appropriate commercial confidentiality. The outcomes of this evaluation should be formally reported to members.

Detailed report

Main findings

Financial support to the commercial operations

- 11** Commercial Services has no actual financial borrowing although it pays interest on a nominal amount of £12 million to the Council annually. Interest at 1% above the London Inter-bank Bid (LIBID) rate is calculated on a daily basis on the £12 million less any positive cash balances held by Commercial Services. This arrangement resulted in an internal charge to Commercial Services by the Council of £0.23 million in 2008/09. It was charged before Commercial Services made its agreed contribution to the Council of £5.7 million for 2008/09. This shows that the Council is not providing financial subsidy to its Commercial Services division.
- 12** Kent Top Temps Limited and Inside Out have formal loan arrangements with the Council which are at the lower end of market rates for businesses of their size. We have considered whether the rates charged give competitive advantage to the companies and concluded that they do not. Kent Top Temps Limited has an arrangement with Commercial Services to borrow up to £1.2 million and at 31 March 2009 the amount borrowed was £0.74 million. The loan is repayable on demand and since April 2008, interest is charged at a rate of 5% above the Bank of England's base rate (from April 2007 it was at a rate of 3% above and previously 1% above). Working capital is also provided as required from Commercial Service's positive cash balances at a similar rate. In August 2007 a formal loan arrangement was set up between the Council and Inside Out which allows the company to borrow up to £0.4 million which is repayable on demand. With effect from April 2008 interest is charged at a rate of 3% above the Bank of England base rate (previously 1% above) and as at 31 March 2009 the amount of the outstanding balance under this arrangement was £179k.
- 13** As is required by the Local Government Act 2003, both of these loan arrangements are the subject of formal agreements. These have been seen and are signed and dated by authorised Council officers. Strictly, the Kent Top Temps Limited arrangement should be between the company and the Council rather than Commercial Services which is not an entity in its own right.
- 14** Kent Top Temps Limited has paid a dividend to the Council for the first time recently but there is no policy on dividend payment despite CLG guidance stating that councils who operate trading companies should expect to receive income from them either in the form of dividend or growth in the value of their shares in the company. In the case of this company it would appear to be the intention of the Council to maintain ownership given its role in seeking to regulate a local market which helps it reduce costs but no dividend policy existed despite the company now being four years old and it being profitable.

Recommendations

- R1** The loan agreement with Kent Top Temps Limited should be re-drawn in the name of Kent County Council rather than Commercial Services.
- R2** The Council should develop a dividends policy for its subsidiaries.

Allocation of costs to commercial operations

- 15** The Council has a robust methodology for identifying, allocating and recharging central costs to Commercial Services and to its subsidiaries and it appears reasonable. Commercial Services occupies a large part of a substantial building in Gibson Drive, Kings Hill. The building consists of warehousing and office accommodation and is also used by the Council's subsidiaries. Commercial Services pays rent to the Council (£0.52 million for the year to 31 March 2009) for its occupation of the site and is responsible for all the usual costs including repairs and maintenance to the building and grounds it stands on. Commercial Services has formal agreements with the subsidiaries for use of the office space including charges for electricity, telephone, heating, rent, rates and other costs. The charge is reviewed annually. Council services that are supplied and relate directly to a business unit or subsidiary, such as legal advice, are recharged to that unit or subsidiary. Other costs incurred by the Council on behalf of Commercial Services are recharged to the units and subsidiaries on an appropriate basis, such as central IT costs being allocated on a per employee basis and premises costs according to space occupied. Our testing concluded that these costs are reasonable and comprehensive. Expenditure incurred by Commercial Services itself, such as its own finance, human resources and IT functions, are charged to the units and subsidiaries where attributable directly to them or are distributed across the units in proportion to their turnover where this is not the case. Commercial Services and within it, the individual business units and the Council's subsidiaries, are charged appropriately for the costs incurred elsewhere within the Council.

Kent Top Temps Limited

- 16** The operation of Kent Top Temps Limited's employment business has led to the Council making significant savings in employee costs as a result of influencing the temporary staff rates charged to the Council. The company's hourly charges for care workers supplied to the Council and other organisations have helped standardise rates at a level below that previously paid. There is anecdotal evidence that the company has also lowered specialist temporary staff costs such as those for supply teachers as they have been provided at the supply teacher pay scale rather than permanent teacher pay scale. This has allowed the Council to budget more accurately.

Detailed report

- 17** The Council acted lawfully in awarding master vendor status to Kent Top Temps Limited. In 2008 the company was awarded this status for the supply of temporary staff to the Council without the need to tender and this was based on legal advice on European Union procurement regulations obtained by Commercial Services from the Council's legal team (for which a fee was charged). We have reviewed this legal advice and have concluded that as the Council's external auditors we would not seek to challenge it. The main factors in determining the award were:
- the vast majority of Kent Top Temps Limited turnover is generated from its business with the Council and in total 90% of its income comes from the public sector;
 - there is no private capital in the company; and
 - the company is a wholly owned subsidiary of the Council.
- 18** Kent Top Temps Limited operates the master vendor arrangement fairly. It uses recognised industry standard systems and has acquired the Recruitment & Employment Confederation gold standard award which involves an external audit to ensure it complies with all relevant regulations. The arrangement has resulted in the Council requiring its managers to refer all requests for temporary staff to the company and if the company cannot supply from their own bank of staff it is required to use other suppliers to meet the Council's needs. When requests for staff are received and cannot be filled by the company they are released to external agencies simultaneously for them to bid to secure the business on an open basis.

Contract tendering arrangements

- 19** Overall the tender prices set by Commercial Services and the subsidiaries reflect the full costs incurred plus a surplus or profit element to cover the investment in the operations and the return required by the Council. We reviewed pricing across several areas of the commercial operations to ensure that they were fairly priced in terms of costs that would be incurred and there were no attempts to distort any local market and/or gain an unfair advantage over competitors.
- 20** The arrangements for Commercial Services bidding for Council-let contracts showed that there were appropriately controlled arrangements in place. For example, the tendering arrangements for bus services are managed by the Council's Corporate Procurement Unit which is located in County Hall, Maidstone. This creates a formal separation between the Kings Hill based Commercial Services and the parts of the Council that award contracts.

- 21** Some bus and coach operators have commented that Kent Top Travel offers such low prices that there must be some form of support or subsidisation by the Council but this has not been identified. We have no access to private sector tendering documents to allow us to undertake a full comparison but we selected and reviewed one Kent Top Travel tender, the Canterbury Park and Ride contract in 2008, and concluded that the tender was comprehensive, based on reasonable principles and priced to produce a margin albeit a small one. This contract was awarded to Kent Top Travel as the second lowest bidder after the lowest withdrew before starting the contract. Kent Top Travel hired vehicles from Kent Fleet, a unit within Commercial Services, for this contract. As part of our work we identified a clause within the contract hire documents that referred to the residual value of the vehicles not necessarily being a realistic value based upon projected market conditions. It stated that "*the residual value has been set on your [Kent Top Travel] advice in order to make the annual payments competitive for your operating customer contract.*" We have discussed this matter with officers who stated that it was an isolated incident which had been identified before our audit and that the officers involved in tender preparations have been advised that this should not be repeated. Evidence was also produced to show that the original residual values set by Kent Fleet were more conservative than the residual values that were likely to be achieved. We concluded that no overall financial advantage would be gained from the use of lower residual values as any shortfall in the residual value at the end of the hire period would have had to be paid by the company. However we also concluded that this incident could give a perception that Kent Top Travel was seeking an advantage from another part of the Council.
- 22** The Council sets an annual target for Commercial Services which requires a contribution to the Council from its operating income. This means that Commercial Services must set prices including a return in order to meet the target. This provides a key focus for Commercial Services management and discourages pricing for a loss. Benchmarking data is used to ensure that prices set are competitive. There is evidence that Commercial Services management is alert to the need to disengage from an activity if the returns expected cannot be achieved and demonstrates a clear focus on having to make a return for the Council on its activities.
- 23** The Council's subsidiaries are run as profit-making business operations and we found no evidence of pricing work unreasonably to win contracts. We looked specifically at the care division of Kent Top Temps Limited to assess if the costs of supplying temporary staff are truly reflected in its pricing. We concluded they are and confirmed that prices are also set to achieve a return.
- 24** Public interest in and comment on how the Council's commercial undertakings are achieving success is likely to continue. There are no routine arrangements for independent reviews of tenders submitted by the undertakings to provide assurances to both the Council and the public that the tenders submitted are based on expected costs, cover the required returns and are without subsidisation. Member and officer time is being diverted into dealing with queries raised on the Council's commercial undertakings. Internal audit could periodically review tenders submitted by Commercial Services to provide such assurance.

Detailed report

Recommendation

R3 Independent reviews of Council contracts won by Commercial Services or its subsidiaries should be introduced to ensure that tendering procedures are adhered to fully and that no subsidisation occurs or could be alleged.

Other issues arising from our review

25 The businesses cases to support the operation of the Council's subsidiaries vary in their depth. The CLG guidance requires councils to produce a detailed business case. Inside Out's is comprehensive and Kent Top Temps Limited's demonstrates a clear objective for the company in terms of its employment services operations but does not extend to its business services provided by Kent Top Travel.

Recommendation

R4 A business case should be prepared for Kent Top Travel as a trading operation. If new business activities are undertaken in future, business cases should be prepared.

26 The Council is not paying its invoices received from Kent Top Temps promptly. The accounts of Kent Top Temps Limited show that debtors amounted to £1.5 million at 31 March 2008 of which the largest debtor was the Council. The debtors listing at 31 January 2009 was £1.6 million, of which the Council owed its subsidiary more than £1.5 million and £1.2 million of this had been outstanding for between one and four months. Kent Top Temps Limited pays fees to Commercial Services finance staff to chase these debts and pays interest to the Council for the loan which supports its cash flow. This payment arrangement does not offer value for money in that there are costs in chasing debts that should be paid more promptly under the subsidiaries own terms of supply and the Council's payments policy. It would be more efficient for the Council to pay its invoices within the agreed terms so that no debt recovery or interest costs are incurred by Kent Top Temps Limited and that the need for a loan to support the company's cash flow might be reduced.

Recommendation

R5 The Council should pay invoices raised by its subsidiaries promptly.

27 The disclosure of commercial activities in the Council's annual financial statements is in line with statutory requirements but other councils with significant commercial operations disclose more information. This applies to activities under both the Local Authority (Goods and Services) Act 1970 and information on subsidiaries created under the Local Government Act 2003. The provision of more information could result in improved engagement of readers and help address any suggestions of secrecy in the way it operates commercially.

- 28** The statutory accounts of Kent Top Temps Limited conform to the statutory requirements of the Companies Acts but contain limited information having been prepared in an abbreviated format. The Council as owner of the company can elect to prepare the accounts in a longer form containing more detail but this has not been done. This has given the impression to a number of representatives from the local business community that the Council is seeking to hide information and they have expressed frustration in funding the Council as local council taxpayers but cannot get access fully to how it is being used. The representatives have also sought to obtain information from the Council as part of the formal inspection period associated with the external audit of the Council's own accounts and through the Freedom of Information Act powers but the Council has adopted a general policy not to disclose information unless there is a specific legal requirement to do so on the grounds of commercial sensitivity. The Council has stated that it has agreed to a longer-form of financial accounts for Kent Top Temps Limited and Inside Out, although this alone might not satisfy all interested business representatives.

Recommendations

- R6** The Council should seek to maximise disclosure of information on its commercial undertakings, subject to exercising proper commercial sensitivities, including expanding the disclosure of its commercial activities in its own annual financial statements.
- R7** Statutory accounts for the Council's subsidiary companies should be prepared in long-form.
- R8** The benefits of the production of an annual report covering all Commercial Services activities including those of its subsidiary companies should be evaluated as part of its engagement with the local business community and other interested parties.

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