

Date: 21.1.11  
Draft No: 1

BURNESS



**THE HIGHLAND COUNCIL**  
**PROPOSAL TO FORM ARM'S LENGTH ORGANISATION**  
**FOR**  
**COMMUNITY LEARNING AND LEISURE SERVICES**

**ANALYSIS OF KEY LEGAL ISSUES**  
**(legal capacity, procurement, state aids)**

**THE HIGHLAND COUNCIL**  
**PROPOSAL TO FORM ARM'S LENGTH ORGANISATION**  
**FOR**  
**COMMUNITY LEARNING AND LEISURE SERVICES**  
  
**ANALYSIS OF KEY LEGAL ISSUES**  
**(legal capacity, procurement, state aids)**

**1 INTRODUCTION**

- 1.1 It is understood that the elected members of The Highland Council (HC) agreed at the ECS Committee of 5 August 2010 the principle of advancing to an Arm's Length Organisation (ALO) for the delivery of all of HC's Community Learning and Leisure (CLL) activity. Following upon that meeting, we understand that further information was provided to the meetings of the ECS Committee held on 11 November 2010 and 13 January 2011.
- 1.2 Our understanding is that the services delivered through CLL comprise:
- 1.2.1 Adult and Youth Learning - 29 youth workers, adult learning service, outdoor education, managing service delivery contracts and providing in-kind support to a range of voluntary organisations;
  - 1.2.2 Culture - 3 art galleries, 3 archive centres, 2 museums, exhibitions unit and managing service delivery contracts with Eden Court Theatre, Highland Print Studio, Feisean nan Gaidheal and 19 independent museums;
  - 1.2.3 Facilities - 16 leisure centres, 9 swimming pools, 22 community centres and youth clubs, 6 community schools, 96 community pitches, managing service delivery contracts and providing in-kind support to a range of voluntary organisations;
  - 1.2.4 Libraries - 49 libraries and 9 mobile units;
  - 1.2.5 Sport - 38 Active Schools coordinators, coaching development, junior golf development, disability sports development, managing service delivery contracts and providing in-kind support to a range of voluntary organisations;
  - 1.2.6 Health and Well Being - partnership working with a range of agencies for community-based initiatives.

- 1.3 This paper is intended to provide a high-level analysis of key legal issues - more particularly, vires (legal capacity), procurement and state aids - insofar as relating to the proposals outlined above.

## 2 VIRES (LEGAL CAPACITY)

- 2.1 One of the most critical aspects to be considered in the context of proposals of this kind is the legal capacity (*vires*) of the local authority to carry through the project - in this case, the legal capacity to form the ALO and then enter into the contractual arrangements whereby the ALO is engaged to deliver the services outlined in paragraph 1.2.

### **Power to advance wellbeing**

- 2.2 Section 20 of the Local Government in Scotland Act 2003 contains the power to advance wellbeing i.e. the power for a local authority to do anything which it considers is likely to promote or improve the wellbeing of its area and/or the persons within that area; however, this power is subject to any limiting provisions contained within other legislation i.e. it will be limited to the extent that there is elsewhere a specific legislative provision prohibiting or limiting a local authority's ability to take a particular course of action.
- 2.3 With reference to libraries, the Local Government (Scotland) Act 1973 states that a local authority shall have a duty to secure the provision of adequate library services for all persons resident in its area. The Public Libraries Consolidation Act 1887 should be read in conjunction with the 1973 Act - it states that the local authority must manage, regulate and control the public libraries, museums and art galleries established under that legislation. When taken together, this wording could be interpreted as meaning that a local authority could not *delegate* the function of managing, regulating and controlling any public libraries, art galleries and museums established under the 1887 Act. We do not have any information at this stage which would enable us to assess whether any of HC's libraries and museums were established under the 1887 Act - but even if they were, some comfort can be taken from the fact that Glasgow City Council previously considered this issue and took the view that the provisions of the 1973 Act and the 1887 Act (taken together) did not displace the power to advance wellbeing. Culture and Sport Glasgow (established by Glasgow City Council as a cultural/leisure trust, and now operating under the name of "Glasgow Life") has been managing Glasgow's libraries for nearly four years.
- 2.4 It should also be noted that recent English case law has cast doubt on the ability of a local authority to rely on the corresponding power to advance wellbeing contained in English legislation, in a situation where the only real purpose in creating the new offshoot is to make financial savings for the authority. We believe that a major consideration underlying that judgement was a reluctance to sanction an arrangement which the court felt would expose the participating authorities to undue risk - but nevertheless, to minimise any risk of challenge on this ground, it would be important to record in the HC's decision-making processes, those reasons - over and above financial savings - which lie behind the proposal to create the ALO and transfer services to it. In particular, those other reasons ought ideally to be focussed on direct benefits to residents and others within the local authority

area, rather than benefits for the Council itself; and it would be useful to show that savings would be used to preserve or enhance particular elements of service delivery, again for the benefit of residents and others.

### **Summary**

- 2.5 Subject to the points noted above - and based on the outline of services set out in paragraph 1.2 - we are satisfied that there are no major obstacles, from a *vires* perspective, to HC's proposals for transfer of CLL services to an ALO
- 2.6 In addition to the issues of *vires* outlined above, it should be noted that:
  - 2.6.1 HC must be satisfied that the delivery of services by an ALO would demonstrate best value;
  - 2.6.2 there are specific statutory provisions relating to the maintenance of archives which will have to be respected in the context of transferring that element of the CLL services;
  - 2.6.3 the provisions of the regulations relating to the disposal of properties at less than market value will require to be followed in the context of HC granting leases/licences at a peppercorn rent/fee to the ALO..

### **3 PROCUREMENT**

- 3.1 The law with regard to EU procurement and state aids, in its application to proposals of the nature contemplated here, is far from straightforward. There is a need, in developing any analysis, to extrapolate from what can be relatively brief statements of principle in particular reported judgements of the European Court of Justice – and to seek to reconcile these with material (whether in the form of communications, decisions, frameworks or more informal guidance) issued by the European Commission. The logic underlying certain distinctions that appear to be drawn is not always apparent – and, further, the approach taken by the European Commission may seem in certain cases (eg in relation to services of general economic interest) to be directed towards protecting their jurisdiction over certain matters rather than being fully aligned with principles emerging from the case law. Against that background, the material which follows can represent only a broad summary of the key points.

#### **Analysis of key risks**

- 3.2 In developing a solution to the EU procurement and state aids issues – in a manner which remains consistent with the requirements of charity law and supports the preferred VAT treatment - consideration has to be given to the key risks, to guide the process of selecting a preferred option. In our view, the key risks in these areas are as follows:
- an organisation (whether private sector, third sector or public sector) involved in the provision of services of a nature akin to those included in the transfer to an ALO might argue that HC should have given them the opportunity to tender for provision of those services (or a query of that kind might be raised with the European Commission by some other party wanting to derail the structure for political or other reasons);
  - OSCR might seek to argue that the extent of the controls exercisable by HC were such that the board members of the ALO as a charitable entity (“charity trustees” within the meaning of the Scottish charities legislation) could not reasonably be said to have the degree of independence required of charity trustees;
  - HM Revenue & Customs might take the stance that the payments by HC to the Trust were of the nature of grants/subsidies rather than consideration for the provision of services, and therefore did not support the proposition that a supply of services by the ALO to HC for VAT purposes was involved;
  - an organisation (whether private sector, third sector or public sector) involved in the provision of services of a nature akin to those included in any potential transfer might argue that unlawful state aid was being

provided by HC to the ALO (or some other party might raise the issue with the European Commission);

- a business involved in providing services of the nature covered by the service level agreements (dealing with services provided by HC to the ALO e.g. cleaning, catering services etc) might argue that the ALO should have given them the opportunity to tender for provision of those services.

## **EU Procurement**

- 3.3 The starting-point, in considering the issues relating to procurement, is that it is essential from the point of view of the VAT treatment that the arrangements under which payments are made by HC to the ALO are structured in such a way as to support the proposition that a supply of services by the ALO to HC is involved. That, however, would normally mean that HC, as a “contracting authority” (within the meaning of EU procurement law) would require to follow EU procurement requirements in commissioning those services – and that, in turn, would carry with it the need to pursue an open and transparent procurement process i.e. such that other bodies would require to be given the opportunity to submit bids for providing the services.
- 3.4 The analysis of the arrangements as involving a supply of services to HC is slightly complicated by the nature of certain activities where payment for services comes partly from HC and partly from members of the public; that would fall within the category of a “services concession” under EU law. The grant of a services concession is not currently subject to the detailed regime which currently applies to services contracts – but there is a requirement to follow the more general principles of equal treatment, non-discrimination, and transparency set by EU procurement law if that concession would likely be of interest to providers from outside the UK; and that, at the very least, would imply some form of exposure to the market and a need to ensure a degree of advertising which was sufficient to enable open competition. We fully accept that any approach which might involve the ALO bidding against other players would be unacceptable from HC’s perspective, as being contrary to the underlying ethos and intent of the overall proposal.

## **Key principles**

- 3.5 The principles established through the *Teckal* case – which allow a contracting authority to enter into arrangements for the supply of services by a body controlled by that authority, providing certain requirements are met - provide a reasonably robust solution to the procurement issues outlined above.
- 3.6 Structuring the ALO as a vehicle in terms of which HC is the sole member and appoints all members of the board of directors (to satisfy the criteria laid down in *Teckal*), would, in our opinion, provide a sound basis for not following EU procurement requirements in relation to the services supplied by the ALO to HC. That may also help to reduce any risk of challenge under

procurement principles, in relation to the supply of services by HC to the ALO.

### ***Teckal* principles**

- 3.7 The general thrust of the *Teckal* decision was that a contracting authority would not require to observe EU procurement requirements if:
- the services were being supplied by a body over which the contracting authority was able to exercise the same control as it could over one of its own departments; and
  - the other body carried out the essential part of its activities with that contracting authority.
- 3.8 While those principles were set by reference to arrangements involving the supply of services to the contracting authority, it is considered (and this is supported by subsequent case law) that they would apply equally to arrangements which fell within the category of a services concession – and accordingly, the fact that the arrangements could be regarded as having the character of a services concession (given that the ALO would continue to receive a significant part of the payments for certain of the services from the public, rather than from the contracting authority) rather than a services contract, would not cause a difficulty.
- 3.9 The criterion set out in the first bullet above might be seen as running counter to the requirements associated with charitable status – and with particular reference to the duty which the Scottish charities legislation imposes on the directors of a charitable company to exercise independent judgement, and in a manner which gives priority to the interests of the charity as compared with the interests of the body (in this case, the body would be HC) which appointed them to the board (or approved their appointment). Against that, if HC was the sole member of the ALO, there would be a number of elements which would support the proposition that HC would have the “power of decisive influence over both strategic objectives and significant decisions of [the] company” required by the European case law, to satisfy this strand of the *Teckal* test – and accordingly allowing a strong case to be made that the arrangements satisfied the tests in *Teckal*. Burness has been directly involved in most of the transfers of leisure operations in Scotland to offshoot vehicles over recent years - and we are able to confirm that in each of those cases, the decision was taken to pursue a model which reflected the principles outlined above *Teckal* –compliant; there was a further instance where the local authority altered the structure of an existing leisure trust to make it *Teckal* - compliant. We are also able to confirm that charitable status was achieved (or, in relation to that last example, maintained) in each of those instances.

### **Reverse *Teckal***

- 3.10 Having regard to the rationale for the *Teckal* exemption - that is, that the contractual relationship with a separate legal entity is viewed, from the perspective of the public procurement rules, as being an in-house



administrative arrangement - it would appear to us to be logical for the ALO to be entitled to access services from HC (that is, as part of the in-house administrative arrangement) without the necessity of a procurement process. While there is no case law which has specifically examined this approach, the fundamental principle underlying the *Teckal* judgement (and subsequent case law) of “self-supply” does, in our view, mean that HC and any off-shoot of HC which meets the *Teckal* exemption can reasonably be regarded as a single entity for the purposes of procurement .

- 3.11 We would recommend, however, that the service level agreements (or equivalent) relating to the provision of services by HC to the ALO should include provision for periodic review (including renegotiation of pricing) and the option for the ALO to terminate any strand of the services if agreement cannot be reached at any review date. Leaving aside the element of uncertainty under procurement law as outlined above, that approach reflects the fact that in an arrangement of this kind the Office of the Scottish Charity Regulator, in seeking to ensure that the ALO as a charity would obtain best value in relation to its use of charitable funds, would want to ensure that the ALO would not be tied into a long-term arrangement without the scope for assessing on a periodic basis the value for money of the services supplied by HC.

### **Summary**

- 3.12 Accordingly, while it is impossible to state the legal position with absolute certainty given the considerations outlined in paragraph 3.1 and the element of discretion which is available to the Office of the Scottish Charity Regulator and HMRC Charities in respect of charitable status, we can confirm that the approach which HC has outlined to date - involving HC as sole member of the company and with all directors being appointed by HC - represents in our opinion a reasonable basis on which to proceed from the perspective of procurement law.

## 4 STATE AIDS

- 4.1 Concerns with regard to state aid relate, broadly speaking, to the principle that, under EU law, it is illegitimate for a party which operates in a commercial marketplace to receive any financial or other advantage from the state or from state resources, on the basis that this distorts competition within the EU. Where state aid is held to be unlawful (and there are a number of complex frameworks, block exemptions and the like to be considered, as well as difficult matters of interpretation in relation to state aid principles), the European Commission can order the relevant public sector body to claw back the financial support which it has given. The points noted in paragraph 3.1 should be borne in mind in considering the high-level analysis set out below.

### **Services of General Economic Interest (SGEI)**

- 4.2 We consider that the most promising route for resolving state aid concerns in the present context would be to make use of the EU principles established through the *Altmark* case and the further development by the European Commission of principles round the concept of “services of general economic interest” following upon the decision in *Altmark*. In addition to producing a more robust position from the point of view of state aid principles, use of the EU principles established through the *Altmark* case reflects the underlying nature of the services which are involved and is compatible with retaining the preferred VAT treatment.

### ***Altmark* principles**

- 4.3 The judgement in the *Altmark* case expressly recognised that a contracting authority could pay compensation in recognition of the supply by another body of services of public benefit (in the EU technical language, “services of general economic interest”), providing the contracting authority was satisfied that the level of compensation was set at a level which allowed only for cost recovery (plus a reasonable level of profit) and various other requirements were met. Further, compensation of that kind would, providing the detailed criteria were met, be taken to fall outwith the category of state aid.
- 4.4 Applying those principles to this project, the concept is that HC, through a services agreement, would impose public service obligations on the ALO (an act of “entrustment”, within the meaning of the European legal principles). The EU principles explicitly allow for flexibility in defining what can be regarded as services of general economic interest. The nature and extent of the public service obligations would require to be clearly defined in the services agreement. The payments by HC to the ALO under the services agreement would be structured in such a way as to ensure that the level of the payments did not exceed what was necessary to provide those services (plus a reasonable profit margin). In order to comply with the other criteria laid down in *Altmark*, the services agreement would require to set out a monitoring framework, and with appropriate provisions for restricting the

level of future payments and/or clawback where appropriate – so as to avoid “over-compensation”, within the meaning of the *Altmark* judgement.

- 4.5 The essential principle underlying the concept of services of general economic interest (as that expression is understood in the context of EU law) is that it may be legitimate, notwithstanding wider principles of EU competition law, for financial support to be provided by the state (or out of state resources) to bodies (whether public or private undertakings) to cover some or all of the specific costs resulting from public service obligations which have been entrusted to them. In the context of the present proposals, the public service obligations would manifest themselves at a practical level in specific obligations imposed on the ALO to provide sports/leisure activities and cultural events etc to members of the general public; the services provided by the ALO would, on that basis, be regarded (in EU parlance) as falling within the category of “services of general economic interest”.
- 4.6 In its judgement in the case of *Altmark*, the Court of Justice held that public service compensation (i.e. financial support provided from state resources to support the delivery of services of general economic interest) would not constitute state aid provided that certain conditions were met; the four conditions (all of which would require to be satisfied) referred to in the court judgement can be summarised as follows:-
- the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined;
  - the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner;
  - the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant receipts and a reasonable profit;
  - where the undertaking which is to discharge the public service obligations is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing the services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking would have incurred.
- 4.7 The European Commission has issued guidance and a formal Decision and Framework relating to the application of funding for services of general economic interest. There are a number of specific requirements - and it would be appropriate for the services agreement to be drafted to take account of the requirements specified in the case, Decision and Framework, to provide greatest support for HC’s position in arguing that either there was no state aid, or that the aid was compatible with the EC Treaty by virtue of the Decision /Framework.

- 4.8 In considering the issues associated with state aid, it is also important to have regard to any other financial advantages (beyond the cash payments flowing from HC to the ALO) that may be conferred on the ALO. One obvious example would be the grant of leases/licences to the ALO at a peppercorn rent/fee. In our view, the most appropriate approach to the issue of the peppercorn rent/licence fee is to state explicitly in the services agreement that this forms part of the compensation/consideration for the provision of services of general economic interest under the services agreement; it is essential, of course, that the value of this benefit should be taken into account in determining whether or not there is over-compensation (see above).
- 4.9 It should also be noted that the Transparency Directive came into force in the UK on 22 September 2009. The directive obliges bodies engaged in both commercial activities and in receipt of public funding for SGEIs to ensure that their management accounts are sufficiently separate to distinguish between the publicly supported activities and the purely commercial activities. We would not anticipate that the Transparency Directive would affect an ALO established by HC - on the basis that it is unlikely to have any unsupported commercial activities. However, if HC established a subsidiary company of the ALO to carry out commercial activities, then an assessment would require to be undertaken to determine whether the Transparency Directive did apply or if any exemption was available; even if the Transparency Directive did apply, the accounting arrangements would in any event have to distinguish the commercial activities for other reasons so the impact of the Transparency Directive would be unlikely to be significant.
- 4.10 Finally, the European Commission carried out a consultation exercise in 2010 in relation to the rules relating to SGEI. The consultation process ended in September 2010, but [as yet no announcements have been made in relation to the outcome of that consultation or any steps that may be taken in the light of representations made in the course of the consultation.]

### **Summary**

- 4.11 In summary, providing (a) the services agreement is structured in a manner which reflects the considerations outlined above (and of course Burness is in a position to make use of the templates which we established through a significant number of previous instances where this approach was adopted, in the context of leisure trusts and the like) and (b) the level of payments under the services agreement is similarly in line with these principles, we consider - subject to paragraphs 3.1 and 4.10 - that the risk of a successful challenge to the arrangements by reference to state aid principles is low.