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MAXIMISING FINANCIAL RETURNS – WHEN YOU MUST, AND WHEN YOU MUSTN'T

Some issues concerning state aid, land valuation and the use of powers for commercial purposes

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Introduction

1. Continuing financial stringency, and the government's stated objective that local authorities should become self-financing, places authorities under pressure to find new income streams, and to realise the value of assets. There is also a desire for revenue-raising activity to be conducted in a tax efficient manner, which may be seen as pointing towards the use of particular legal structures. Requests for advice show that there continues to be considerable uncertainty about the legal parameters within which authorities have to operate.

2. Likewise, land disposals, whether or not forming part of development agreements, continue to generate significant debate and dispute – partly in relation to the procurement law status of development agreements (not the subject of this paper), and partly in relation to the question of what authorities have to do to fulfil "best consideration" and similar duties in domestic and EU law.

3. The aim of this paper is to draw together some of the legal threads that run through these topics, and to review some recent caselaw.

The use of powers for commercial purposes

Background

4. Until relatively recently, local authorities had no general power to act for a commercial purpose. There was for the most part no express prohibition on doing so either, but it would in practice be difficult in many cases to point to the requisite source of power.

5. In particular:

   (i) Even where an authority had an express power to undertake a particular activity or provide a particular service, the general position was that there was taken to be no power to charge for doing so, unless that was itself expressly authorised: see *McCarthy & Stone (Developments) Ltd v Richmond upon Thames LBC* [1992] 2 AC 48.

   (ii) Although section 111 of the Local Government Act 1972 allowed authorities to do anything calculated to facilitate, or conducive or incidental, to the discharge of their functions, there were significant obstacles to the use of this power for commercial purposes. Anything that was merely "incidental to the incidental" would not be

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permitted, and mere money-raising was not likely to be regarded as incidental or conducive to substantive functions.

(iii) The well-being power, contained in section 2 of the Local Government Act 2000, was subject to the limitation, in s 3(2), that it did not enable an authority to "raise money (whether by precepts, borrowing *or otherwise*)" (emphasis supplied). Even if the activity could be characterised as money-saving, rather than money-raising, the Court of Appeal held in *R (Risk Management Partners Ltd) v Brent LBC* [2010] LGR 99 that the mere fact that savings could be applied to various beneficial activities did not mean that the making of such savings itself constituted the promotion or improvement of economic, social or environmental well-being.

(iv) The power to supply goods and services under s 1 of the Local Authorities (Goods and Services) Act 1970 ("LAGSA 1970") was often a valuable weapon in the armoury of powers. But it too was subject to particular restrictions, most notably that the recipient itself had to be a "public body" as defined by the 1970 Act or in a designation order made under it.

6. A more general trading power was introduced by section 95 of the Local Government Act 2003, read with the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2004, and the Local Government (Best Value Authorities) (Power to Trade) (Wales) Order 2006. But, whilst a significant innovation, this was limited to doing for a commercial purpose things which the authority was already authorised to do for the purposes of its "ordinary" (i.e. other) functions. That limitation was capable of causing significant doubt about the proper scope of the power. The power conferred under s 95 also had to be exercised "through a company" – of which more below.

The general power of competence

7. The general power of competence (GEPOC) conferred by the Localism Act 2011 was a radical departure from what had gone before. For those authorities to which it applies, it gives a general power to "do anything that individuals generally may do". By section 1(4)(b), that explicitly includes power to do any such thing "for a commercial purpose or otherwise for a charge".

8. Section 4(1) of the Localism Act provides that GEPOC confers power to do things for a commercial purpose only if they are things which the authority may, in the exercise of GEPOC, do *otherwise* than for a commercial purpose. But it is hard to imagine that there will be many cases in which this will make a practical difference.

9. The use of GEPOC for commercial purposes is, however, subject to three critical constraints. The first is that, under s 2 of the Act, so-called pre-commencement restrictions and limitations govern the use of GEPOC as well. This makes it necessary to consider on a case by case basis what other, potentially overlapping statutory powers exist, and whether they contain any such restrictions or limitations (as opposed to merely not being broad enough to extend to particular situations – see *R (Khan) v Oxfordshire CC* [2004] LGR 257. This is not the subject of the present paper.

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10. The second constraint is that, by virtue of s 4(3), things cannot be done for a commercial purpose under GEPOC in relation to a person if some other statutory provision *requires* the authority to do those things in relation to that person. In effect, if the authority is under a statutory duty to provide X with a service, it cannot circumvent that duty by purporting to be providing the service on a commercial basis and charging accordingly. Any power to charge will have to be found elsewhere (and in the case of a statutory duty will generally be limited to charging on a cost recovery basis, if such a power exists at all).

11. The third constraint is the one that will be the focus of this paper. Section 4(2) provides that:

> "Where, in exercise of the general power, a local authority does things for a commercial purpose, the authority must do them through a company."

12. It will be seen that this echoes the requirement that trading under s 95 of the 2003 Act has to be done through a company. It is in fact very difficult to imagine any case in which an authority having the GEPOC power would find it made any positive practical difference to rely upon the s 95 power instead.

13. The language of acting "through" a company is somewhat loose. The legal concept of X acting "through" Y would normally be that Y entered into some transaction as X's agent. In the present context, however, it is reasonably clear that this is not what is meant. Rather, the authority will act through a company if it forms or participates in a company which does things (as principal) for a commercial purpose. In the *Durham Company* case, discussed in more detail below, Warren J said at [60] that, for the purposes of GEPOC, the doing of the thing in question by a company is seen as the provision of the relevant service by the authority itself.

14. The purpose of the requirement to act through a company is also tolerably clear, namely that local authorities, if permitted to trade, should have to do so on a level playing field, and should not be able to enjoy advantages such as having their trading profits escape from the same tax consequences as would apply to a normal private company. In the House of Commons Public Bill Committee on the Localism Bill, on 1 February 2011, the Minister said that the most significant reason for the requirement was that local authorities "should trade on an equal footing with the commercial sector", and that taxation was a particular issue in this respect. In a letter dated 21 March 2011 to the Chair of the Communities and Local Government Select Committee (published as HC931), the Secretary of State said that the rationale of the requirement to act through a company was that "local authorities should not be able to use their public status to gain commercial advantage over the private sector."

15. It therefore becomes essential for an authority that relies upon GEPOC to identify when it is acting for a commercial purpose. If it is so acting, then the authority will need to make use of a company. If the authority is not acting for a commercial purpose, then there will

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be no requirement[1] to use a company – but it will then follow from s 3 of the Localism Act that, if GEPOC is being relied upon in order to make charges for a service provided, the income from charges does not exceed the costs of providing the service, "taking one financial year with another".

When is something done "for a commercial purpose"?

16. The concept of a commercial purpose is not defined by the Localism Act (or by the 2003 Act). However, the ordinary and natural meaning of the phrase connotes the pursuit of financial gain. For most practical purposes steps undertaken for a commercial purpose can be equated with activities that are pursued with a view to profit, or steps taken as part of an activity that is pursued with a view to profit.

17. This is consistent with what is said in paragraph 65 of the statutory guidance[2] on the s 95 trading power: "If a trading company is established for commercial purposes, then necessarily it will seek to make a profit."

18. So far, so good. If an authority engages in an activity which is calculated to make money, and does so because it wants to make money, there can be little doubt that it is acting for a commercial purpose. Whether the activity *in fact* succeeds in generating a profit should be nothing to the point. Equally, the mere fact that an activity turns out to generate a net surplus does not mean that it was done for a commercial purpose.

19. The harder questions arise if the nature of what the authority is doing, and its motives for doing it, do not entirely march in step. What if the authority is doing something that is objectively calculated to make a profit, but that is not the reason why it is doing it? For example, what is the position if the authority advances funds to a start-up company, on terms that the authority will receive a share of the company's profits, but the authority's motives are those of regeneration and the creation of employment, rather than the desire to receive such profits? The authority may indeed be constrained, subject to any relevant state aid exemptions, from providing assistance to commercial undertakings on "soft" terms that do not allow for a commercial return.

20. "Purpose" is not necessarily to be equated with motive. For example, in *Ashton v Inland Revenue Commissioner* [1975] 1 WLR 1615 it was held that the "purpose" of an arrangement depended not upon the subjective motive for which it was made, but rather upon its intended effect, as ascertained from its terms and nature[3]. In *Hayes v Willoughby* [2013] 1 WLR 935 at [9], the Supreme Court endorsed the general proposition that "the purpose of a transaction is the result which it is capable of producing and is intended to produce", whilst confirming that this is only a partial definition, and that the concept is a "protean" one whose meaning must depend on the context in which it is used.

[1] One not entirely straightforward question is whether the authority may nonetheless *choose* to carry out such non-commercial activities as a participant in a company, rather than directly.
[2] *General Power for Local Authorities to Trade in Function Related Activities through a Company* (DPM, July 2004).
[3]

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21. Does the particular statutory context of s 4 of the Localism Act indicate a subjective or an objective test of purpose? It seems unlikely that a test which looks only at subjective motivation could be correct. If the statutory objective is indeed that the trading activities of local authorities should be undertaken on an equal footing with those of private sector concerns, that suggests that the issue should be whether the authority is acting as a commercial undertaking would do, regardless of its reasons for doing so.

22. On the other hand, it is possible that it is too narrow an approach to ask simply whether the activity in which the authority is engaged is in its nature a commercial, profit-making activity. The legislation has after all used the word "purpose", and has not chosen to refer (for example) simply to activities of a commercial nature.

23. Thus it may be that a more flexible test needs to be applied – to ask whether the authority's intentions should, objectively, be characterised as "commercial" when all the circumstances of the case are considered, and not just the narrow question of whether the activity in question is one calculated to generate a profit. On that footing, the way in which an authority goes about deciding whether and on what terms to conclude a particular transaction might be part of what needed to be looked at to determine the proper characterisation of its purpose.

24. Whilst there is caselaw that discusses what is "commercial" in other contexts, it is unlikely to be of great assistance here. In some of those contexts specific definitions apply; in others the word "commercial" is not linked to the concept of "purpose" as here. Until very recently, there has been no caselaw discussing the "commercial purpose" provisions either of the Localism Act or of the Local Government Act 2003 in any detail. However, it is now necessary to take account of the decision of Warren J in the Upper Tribunal in *R (The Durham Company Ltd) v HMRC and HM Treasury* [2016] UKUT 417 (TCC). The issue in *Durham Company* was whether the tax authorities were acting lawfully in treating local authorities as able to carry out trade waste collection services without charging VAT. That depended upon whether the authorities engaged in that activity "as public authorities", which under the relevant caselaw depended in turn upon whether the authority in pursuing the activity was acting under a special legal regime, or was engaging in an activity equally open to a private sector operator under essentially the same legal conditions. Warren J held that the provision of waste collection services pursuant to the duty in s 45 of the Environmental Protection Act 1990 (which was what the authorities whose position was in evidence said that they were doing) was an activity undertaken as a public authority, but it was the claimant's contention that this was not the power that was being exercised. By this route the tribunal became engaged in consideration of whether there was any other power under which a local authority could engage in the collection of trade waste, and specifically whether it could do so under s 95 of the 2003 Act or s 1 of the Localism Act (GEPOC).

25. Warren J held that, because collection under EPA s45 was in the nature of a duty (cf. paragraph [ ] above), that was not an activity which could be undertaken pursuant to s 95, nor under GEPOC by way of charging for something done with a non-commercial purpose. For the same reason, he doubted (at [61]) that it could be done under GEPOC on a commercial basis either. However, he preferred (at [97]) not to decide that point. It was by this means that Warren J came to consider (at [63]) whether a local authority providing a trade waste collection service was acting for a commercial purpose, so that it could not

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do so other than through a company (which would certainly have to charge VAT in the normal way). It is questionable how far it was really necessary for the judge to go into this question to decide the case before him, and indeed what he says about it is expressed in somewhat provisional terms ("not immediately obvious", "well arguable" etc). It is also unclear how much argument was directed to this point, or whether Warren J was shown any of the background to the statutory requirement to act through a company (see paragraph 14 above).

26. For these reasons, what is said at [63] of *Durham Company* needs to be treated with a degree of caution. Nonetheless, it is the only judicial discussion so far of what is meant by a "commercial purpose" within the meaning of the Localism Act, and may be influential accordingly.

27. Warren J's consideration of the issue includes the following points:

    (i) It is a question of fact, in any particular case, whether the authority is carrying out the relevant activities for a commercial purpose or otherwise than for a commercial purpose – this must be correct;

    (ii) The purpose of providing a service is not necessarily commercial just because a charge is made for it – again, that is clearly correct;

    (iii) If the intention is for any charge only to cover costs, rather than to make a profit, that will be an important factor in determining whether there is a commercial purpose – this too must be right;

    (iv) The purpose of providing the service is not necessarily commercial even though the charge is set out so as to make a surplus or profit, nor because the authority is carrying out certain activities (e.g. advertising, and negotiating contracts with customers) in the same way as a private sector operator. Here the judgment enters into more controversial territory. Warren J said this:

> "A local authority has wide social responsibilities which a private sector operator does not, responsibilities which include statutory duties. Its purpose in providing a particular service may be to fulfil those responsibilities. The service is not, in those circumstances, a commercial purpose. It is not immediately obvious to me that, if the local authority is empowered and chooses to provide those services in a way which is designed to make a profit, the purpose of the provision then becomes a commercial purpose. It is well-arguable that the local authority's purpose in providing the service . . . is not a commercial purpose even though its objective in adopting the method which it does for effecting its purpose is to make a profit."

28. Two comments may be made about this passage. First, Warren J is speaking of a case in which the authority provides a service to fulfil its "social responsibilities". It is not entirely clear whether he intends to confine this to a case in which the authority has relevant statutory duties to discharge, although that seems not to be the true reading of what he says. Secondly, the judge's dicta tend to suggest that he would only regard an authority

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as acting for a commercial purpose if its sole or predominant reason for becoming involved in the relevant activity at all is to make money, and not just because the activity is in fact money-making in nature (even if the authority has deliberately chosen to organise its participation in a way that makes money rather than one that does not).

29. The *Durham Company* judgment therefore supports both a more subjective, and a narrower, approach to the question of when a commercial purpose exists than has been advocated in the earlier analysis in this paper. The extent to which weight can really be placed upon the decision is questionable. Nonetheless, it may potentially be relied upon by authorities which are anxious not to have to act through a company in particular circumstances, and which have objectives beyond the mere making of money.

30. Whatever the position in relation to the test for commercial activity, the fact that the focus is on profit does not necessarily mean that profits have to be immediately on the agenda before the authority can be acting for a commercial purpose. For instance, an activity that is intended to trade for profit on the market in due course is likely to be one carried on for a commercial purpose, even though it will not initially be profit-making, and may involve offering services at or below cost price in order to become established.

31. What about the things that the authority may do to support its company, such as the provision of loans or guarantees, or the provision of accommodation or services? In one sense, such measures serve the same commercial purpose as the actual trading of the company. However, it is suggested that it cannot be right to say that all such activities must themselves be undertaken through a company.

Potential alternatives to GEPOC

32. It is important to be clear that neither the Localism Act nor, for that matter, s 95 of the Local Government Act 2003 imposes any *general* obligation to act through a company when an authority is acting for a commercial purpose. The requirements to act through a company that they impose are limited to cases in which the power being exercised is, respectively, GEPOC or s 95 of the 2003 Act. If the authority can find some other source of power to pursue the relevant commercial purpose, it remains free to do so directly and in its own right (illogical though this may seem in light of the apparent purpose of the mandatory use of a company in the 2003 and 2011 Acts). Thus, for example, there is no need to involve a company when supplying services under LAGSA 1970, however commercial the basis upon which that is done.

33. But, as already noted, an authority's general powers may not often assist it to engage in commercial activity.

34. Also worthy of attention is the power of investment under s 12 of the Local Government Act 2003. By its very nature investment is something done for a commercial purpose, and there is no need for the use of a company when s 12 is the power relied upon. An authority is permitted to invest not only for the purposes of the prudent management of its financial affairs, but also "for any purpose relevant to its functions under any enactment". So some regeneration activities might fall within the ambit of s 12, even though they are calculated to produce a profit.

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The disposal of land

Powers of disposal and "best consideration"-type requirements in domestic law

35. A local authority's primary power to dispose of land is to be found in section 123 of the Local Government Act 1972. The rule under s 123(2) is that disposal otherwise than on a short (less than 7 years) tenancy requires the consent of the Secretary of State if it is:

> "for a consideration less than the best that can reasonably be obtained"

36. The current general consents allow an authority to dispose of land under s 123 at up to £2 million below its valuation if the purpose of the disposal is to further the economic, social or environmental well-being of the area.

37. One case in which the s 123 disposal power will not apply is that of "HRA land", i.e. that held under Part II of the Housing Act 1985. In such cases disposal requires the general or specific consent of the Secretary of State under s 32 of the 1985 Act. There is no distinct statutory requirement to obtain best consideration, although valuation of the land may be relevant to whether it is possible to rely upon one of the general consents, or to whether the Secretary of State would be willing to grant a specific consent.

38. Also, if the land is held for planning purposes, the power of disposal is to be found in section 233 of the Town and Country Planning Act 1990. This provision appears at first sight to be very like s 123, in that it requires, by s 233(3), the consent of the Secretary of State if the disposal is not by way of a short tenancy and is for a consideration less than the best that can reasonably be obtained (and in this instance there are no general consents in force).

39. However, there are subtle differences between s 233 and s 123. In particular, whereas the latter is simply expressed so as to permit disposal "in any manner [the authority] wish", the former expressly provides, by s 233(1), that the authority may dispose of the land "to such person, in such manner and subject to such conditions" as appear to the authority expedient to secure the best use of the land, or the construction or carrying out of any buildings or works needed for the proper planning of the area. See below for the potential consequences of this difference in wording.

40. There are two particular respects in which it may be necessary for the authority to maximise its financial returns from the disposal of land, and which may not be immediately obvious.

41. First, the best consideration reasonably obtainable for a disposal of land is that which could be obtained for an unrestricted disposal. If the authority wishes to impose (for example) covenants as to the future use of the land which will drive down its value below what could otherwise be obtained, it will need the consent of the Secretary of State to do so.

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42. It is in this respect that a disposal under TCPA s 233 may be different from one under s 123. Although concerned with slightly differently worded Scottish legislation, the decision of the House of Lords in *Standard Commercial Property Services Ltd v Glasgow CC* 2007 SCLR 93 indicates that in this context the "best terms" for the disposal may allow for consideration of planning benefits and gains, and thus not require a disposal to be on a strictly commercial basis.

43. Secondly, it is now well established that, whilst the consideration for this purpose may be kind and not just in cash, it has to be consideration that has a commercial or monetary value to the authority, and does not include something that may be beneficial in other ways, such as the creation of employment opportunities: see *R v Pembrokeshire CC ex p. Coker* [1999] 4 All ER 1007, and *R v Hackney LBC ex p. Lemon Land Ltd* [2001] LGR 555.

44. The question of what exactly can be "counted" under this approach was examined relatively recently by Mitting J in *R (London Jewish Girls High Ltd) v Barnet LBC* [2013] PTSR 1357. He held that two elements of what the purchaser in that case would provide or do had to be excluded from consideration. One was the making of certain payments under a section 106 agreement, the point being that the purpose of those payments was to offset costs that the authority would incur as a result of the development, and did not therefore represent a net financial benefit to it. The other excluded element was the creation of affordable housing units as such. However, the creation of nomination rights in favour of the authority was something that could be taken into account.

45. This "money or money's worth" test means that, if authorities dispose of land as part of a transaction with a party selected through a tendering process (whether or not a fully regulated procurement), they need to consider carefully the award criteria to be applied. Whilst those criteria need not be limited to price alone (see the discussion of the *Faraday* case below), criteria which have no bearing upon the best consideration for the disposal may, in the absence of consent, be of questionable legality. In particular, in cases where the authority is procuring a development agreement as a public works contract, there may be an issue as to the use of design quality criteria, unless (see above) the disposal is of land held for planning purposes, or any resulting loss of value will be within the headroom permitted by the general consents. In other cases, and if a specific consent is not to be sought, the authority may need to rely upon the planning process to ensure that the design of the development is satisfactory.

46. The duty under s 123 is to achieve a particular outcome (the best consideration reasonably obtainable), rather than to follow any particular process: see *R (Salford Estates (no 2) Ltd v Salford CC* [2011] LGR 982. However, this proposition needs to be correctly understood in a number of respects:

    (i) It does not prevent the authority's decision-making process from being challenged on normal *Wednesbury* grounds, as recently illustrated by *R (Galaxy Land Ltd) v Durham CC* [2015] EWHC 16 (Admin). The authority there had failed to take account of relevant considerations by reason of defects in the officers' report upon which the decision was based, including a misapprehension that the value of the authority's land was diminished by being subject to "ransom";

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(ii) Conversely, where the authority has made judgments about the right way to obtain best consideration for the disposal, then the court will not interfere with those judgments unless they are flawed on *Wednesbury* grounds. Again, there is a recent illustration of this, in the decision of Holgate J in *R (Faraday Development Ltd) v West Berkshire Council* [2016] EWHC 2166 (Admin)[4]. In circumstances where the ultimate value of the respective tenders for the development agreement, under which disposals would occur, would depend upon future events and was necessarily a matter of prediction rather than precise calculation, it was for the authority to judge whether it needed to probe further the financial information with which it had been supplied. Only if its decision not to do so was one which no reasonable authority would have reached, would the court interfere;

(iii) Whilst there is no absolute requirement to conduct an open tendering exercise, or to go out to the open market in some other way, there may be cases in which that is the only way to ensure that the best consideration reasonably obtainable is secured. This is especially likely to be so if it is otherwise difficult to obtain an accurate valuation of the land, and if there is no valid reason to suppose that the marketing exercise would itself (e.g. through reasons of delay) lead to a less beneficial outcome than disposal by some other means. The point about the potential need to go to market is made in *Salford*, by reference to the earlier judgment in *Tomkins v Commissioner for the New Towns* [1989] 1 EGLR 24. It is frequently assumed, but in fact a misconception, that a sale at a price supported by a valuation necessarily means that best consideration is being secured.

47. The other point that emerges strongly from the *Faraday* decision, albeit not new to that case, is that doing what is reasonable to obtain best consideration does not always mean simply performing a calculation of the price being offered. In circumstances where the value obtained by the authority depended crucially upon the delivery of the development, it was held by Holgate J that the authority was entitled, in selecting the tender that it accepted, to focus heavily upon the experience and expertise of the developers concerned.

State aid

48. The disposal of publicly owned land to an undertaking operating in the market place may, if it is at an undervalue, amount to a form of state aid – a selective advantage conferred from state resources. Such aid is only unlawful if it threatens to distort competition, and has the potential to affect trade between member states, but these hurdles are generally set at a low level.

49. Important in this respect is the Commission communication on state aid elements in sales of land and buildings by public authorities (97/C 209/03). The communication effectively

[4] Permission to appeal is being sought in this case, but only on the question of whether the authority's agreement with the developer amounted to a public works contract, not on the s 123 issue. The judgment contains a review of some of the s 123 caselaw, at [131].

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offers two routes which, if followed, will automatically mean (or at any rate lead to the Commission assuming) that there is no notifiable state aid.

50. The first route is a sale following "a sufficiently well-publicised, open and unconditional bidding procedure, comparable to an auction". Presumably this requires the outcome of the procedure to be based fundamentally upon the price offered.

51. The second route is that the sale price does not diverge by more than 5% from an independent valuation carried out prior to the sale negotiations.

52. Failure to follow either of these routes should not automatically mean that the terms of a disposal *do* constitute state aid, but it may well place the authority on the back foot in any challenge.

53. The following points should be borne in mind in considering the relationship between state aid rules and domestic best consideration requirements:

    (i) Special obligations imposed upon the disposal of the land (e.g. use requirements) will, if they operate equally as between potential purchasers, not create a state aid problem, even though they might mean that best consideration was not being obtained;

    (ii) Ministerial consent is no answer to a complaint of unlawful state aid;

    (iii) Non-monetary receipts or obligations might be relevant to the state aid picture, even if not counting as consideration under s 123. The ultimate question is whether the purchaser has got more than it paid for;

    (iv) A prior valuation should involve state aid issues, but (as explained above) it is not necessarily conclusive in relation to best consideration;

    (v) The question of whether there is state aid is an objective one, not one to be judged on a *Wednesbury* basis. However, especially in more complex transactions, the application of the "market economy investor" test may mean that the authority has in effect a certain margin of appreciation: cf. the recent consideration of other state aid issues in a local authority context, in *R (Sky Blue Sports & Leisure Ltd) v Coventry CC* [2016] EWCA Civ 453.

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