



**SOUTH
KESTEVEN
DISTRICT
COUNCIL**

Culture and Leisure Overview and Scrutiny Committee

Tuesday, 3 September 2024

Report of Councillor Paul Stokes,
Deputy Leader of the Council, Cabinet
Member for Leisure and Culture

Conclusion of Leisure Options Appraisal

Report Author

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Purpose of Report

To consider information relating to the conclusion of the leisure options appraisal and provide a recommendation to Cabinet on the preferred option.

Recommendations

In consideration of the information presented within this report the Culture and Leisure Overview and Scrutiny Committee is requested to:

- 1. Recommend to Cabinet that the Council enter into a new leisure delivery contract with LeisureSK Ltd for a maximum of ten years from 1 April 2025.**
- 2. Recommend to Cabinet that the current contract with LeisureSK Ltd should be terminated giving the required six month's notice effective from 30 September 2024.**
- 3. Recommend to Cabinet that the new operating model for the delivery of the leisure services will be based on an agency model with LeisureSK Ltd acting as an agent for the Council in respect of leisure services only.**

Decision Information

Does the report contain any exempt or confidential information not for publication?	Appendix One is not for publication by virtue of paragraph 3 of Part 1 of Schedule 12A of the Local Government Act – financial information
What are the relevant corporate priorities?	Connecting Communities Effective Council
Which wards are impacted?	All Wards

1. Implications

Taking into consideration implications relating to finance and procurement, legal and governance, risk and mitigation, health and safety, diversity and inclusion, safeguarding, staffing, community safety, mental health and wellbeing and the impact on the Council's declaration of a climate change emergency, the following implications have been identified:

Finance and Procurement

- 1.1 The provision of leisure is a discretionary service for the Council with the cost of providing the service, together with the costs associated with maintaining three aging leisure facilities, representing a significant ongoing financial liability.
- 1.2 Given the Council's wider financial pressures it is vital that any new arrangement post the end of the current contract with LeisureSK Ltd represents an affordable position for the Council within its Medium-Term Financial Strategy.
- 1.3 The Council's current contract with LeisureSK Ltd commenced on 1 January 2021. The contract terms provide that the Council is responsible for a management fee payment which represents the difference in the expenditure incurred by the company and the income it has been able to generate.
- 1.4 The decision to enter the current contract arrangement with LeisureSK Ltd was identified as being the most tax efficient model at that time. It also allowed the Council to respond to the challenges presented by the impact of Covid-19 on the leisure market.
- 1.5 Whilst this arrangement has provided the Council with flexibility in terms of how the centres are operated, it has not been without its challenges in relation to the higher than budgeted for utility costs, and costs associated with irrecoverable VAT. In financial year 2023/24 this resulted in the Council having to provide an additional management fee payment in order for the company to meet its financial liabilities.

- 1.6 The leisure options appraisal which has been undertaken has identified an option for the Council to enter an agency arrangement with LeisureSK Ltd. Under such an arrangement the Council would become the principal supplier of the leisure facilities and engage LeisureSK Ltd to provide leisure activity on its behalf as its agent.
- 1.7 As income would be collected by LeisureSK Ltd on behalf of the Council, the Council would then receive the gross income collected by LeisureSK Ltd in respect of leisure specific activity. This would then enable the previously irrecoverable VAT to be reclaimed by LeisureSK Ltd and would have a positive impact on the profit and loss projections of the company which would be reflected in any future management fee.
- 1.8 The Council has an option to terminate the current arrangement with LeisureSK Ltd with the provision of six months' notice. Should the Council decide that an agency arrangement is the future model to be adopted, an early termination of the current arrangement could facilitate a new contract incorporating agency principles to commence with effect from 1 April 2025. This would align with the start of the new tax year and allow the Council to benefit from the resulting savings earlier than the natural end of the contract.
- 1.9 If the proposal to move to an agency arrangement with LeisureSK Ltd is approved, then the Council will need to undertake detailed analysis on how to structure the arrangement in the most tax efficient way. This will include identifying within the contract which services the Council will provide as the principal and where it would be more tax efficient for LeisureSK Ltd to continue to provide the services which are either taxable or exempt from VAT. In assessing this the Council will need to look at the wider implications in terms of its own partial exemption for VAT purposes.
- 1.10 The Council will also need to identify and develop the accounting processes necessary to account for the leisure income and associated expenditure.
- 1.11 It will also be necessary for the Council to identify and establish governance arrangements which provide the Council with assurance that LeisureSK Ltd are maximising income opportunities and controlling expenditure. It will also be prudent to ensure that the contract and company documentation provide the Council with an appropriate level of control over the company's decision-making processes.

Completed by: Alison Hall-Wright, Deputy s151 Officer

Procurement

- 1.12 The 2015 Public Contract Regulations provide that the Council can directly award a further contract to LeisureSK Ltd, either with or without an agency agreement

being in place. For this to be a compliant award of contract the company must be under the direct control of the Council and more than 80% of the activities undertaken by the company must be directly on behalf of the Council.

Completed by: Helen Baldwin (Procurement Lead)

Legal and Governance

- 1.13 It is within the remit of the Culture and Leisure Overview and Scrutiny Committee to work alongside with Cabinet Members to assist in the development of policies and to scrutinise decisions made in respect of the Council's leisure service. This includes the decision on the future leisure management model to be adopted.
- 1.14 As detailed within this report, work has been undertaken to identify the options available to the Council in relation to the future management of its leisure service. In assessing the options, the Council has sought advice from specialist tax advisers in relation to the potential adoption of an agency agreement. Should this option be progressed specialist legal advice will also be required to develop a new contract, leisure specification and leases for the leisure facilities.
- 1.15 The contract will need to identify the future relationship between the Council and LeisureSK Ltd ensuring this is based on agency agreement principles. It is also recommended that the company's Articles of Association are reviewed to identify whether any changes will be required to support the agency arrangement.
- 1.16 It is currently within the remit of the Culture and Leisure Overview and Scrutiny Committee to review and approve the LeisureSK Ltd Business Plan on an annual basis. Should the Council enter an agency arrangement with LeisureSK Ltd it would be prudent for the Council to review its governance arrangements to ensure that there are mechanisms in place which allow the Council to assess and, if necessary, challenge the financial information provided, as well as being able to have a level of influence over the company's decision making.
- 1.17 The terms and conditions of the Council's current contract with LeisureSK Ltd provides for an early termination of the arrangement with the provision of six months' notice.

Completed by: James Welbourn, Democratic Services Manager and Deputy Monitoring Officer

2. Background to the Report

- 2.1. The Council's Corporate Plan (2024 – 2027) contains a vision for South Kesteven to be 'A thriving District to live in, work and visit'. This is underpinned by a commitment to invest in a sustainable leisure and cultural offer, and to provide excellent value for money and financially sustainable services.

- 2.2. The Council's leisure contract arrangement with LeisureSK Ltd commenced on 1 January 2021, the contract term being for an initial two years with the potential to extend for a further three years.
- 2.3. The contract has now been extended by the maximum period allowed and a new arrangement will need to be in place by 31 December 2025. In line with the contract terms and conditions the contract can be terminated earlier should the Council provide six months' notice of its intention to do so.
- 2.4. At a meeting of the Culture and Leisure Overview and Scrutiny Committee held on 18th June 2024 (**See Background Papers**), Members received a report which provided an update on the series of tasks requested by Cabinet in relation to LeisureSK Ltd. This included an update on the work being undertaken on a leisure management options appraisal with a view to identifying the optimum model for the future delivery of the Council's leisure service.
- 2.5. As previously reported four options were identified, these being:
- Insourcing the leisure service
 - A further contract arrangement with LeisureSK Ltd
 - Securing a contract with an external provider
 - Entering an Agency Agreement with LeisureSK Ltd

Insourcing

- 2.6. The option to deliver the management of the Council's three leisure centres in-house has been investigated to establish the potential financial impact. As reported previously it has been identified there would be a significant increase in the cost of providing the leisure service in-house which is primarily due to the increased salary and pension costs, and the Council being liable for the full payment of business rates. Therefore, this option was previously discounted, and work on the leisure options appraisal continued focussing on the remaining three options.

New Contract Arrangement with LeisureSK Ltd

- 2.7. There remains an option for the Council and LeisureSK Ltd to enter a new contract, on a similar basis to the current arrangements, to commence from 1 January 2026. The company would continue to benefit from discretionary business rate relief and the staff would remain on their current terms and conditions. However, the Council would remain liable for a management fee

payment which represents the difference in expenditure incurred and the income the company has been able to generate.

- 2.8. The Council has received advice from external tax consultants who have confirmed that, whilst the current arrangement with LeisureSK Ltd was the most tax efficient at the time, this is no longer the case. Furthermore, under a new contract arrangement with LeisureSK Ltd on similar terms and conditions, there is no way the impact of irrecoverable VAT can be mitigated.
- 2.9. As the costs associated with irrecoverable VAT are significant, the Council would need to meet these ongoing costs through the management fee provided. Therefore, the option to enter a new contract arrangement with LeisureSK Ltd on the same terms and conditions as the current contract is not recommended.

Securing a Contract with an External Provider

- 2.10. The option to secure an external provider through a competitive tender process has been investigated, and as previously reported a soft market test has been undertaken to establish interest from the leisure operator market.
- 2.11. Whilst the soft market test confirmed there could be interest from the market in an external contract arrangement, the responses identified that contractors would be unlikely to take on a significant level of risk. This, together with the age and condition of the leisure centres is likely to result in contractors pricing risk into the management fee, ultimately resulting in higher costs for the Council. In addition, whilst contractors are comfortable to take the risk on utility consumption, they have indicated that the risk on utility tariff increases would need to remain with the Council.
- 2.12. A major consideration when assessing the benefits of procuring an external contract arrangement is the age and condition of the Council's three leisure centres. As detailed in the report presented to the Culture and Leisure Overview and Scrutiny Committee on 18 June 2024, the condition surveys undertaken by the Council have identified the anticipated spend on the leisure centres over a 30-year period. The Council are currently completing the repairs that have been categorised as health and safety items or those requiring urgent attention, but corporate spend on building maintenance needs to be balanced across the whole of the Council's assets and estate.
- 2.13. Under an external contract arrangement, the Council would be contractually bound to undertake the items of repairs and maintenance assigned to them under the contract within prescribed timeframes. If, due to wider financial pressures, the Council were not able to undertake works in line with the contract terms and conditions this could result in the Council being liable for further costs in relation to loss of income or contract variation claims.

- 2.14. Intelligence from the leisure market also indicates that, due to the number of opportunities available, contractors can decide which opportunities to bid for typically prioritising those which will provide the maximum return. Some of the more successful procurements have involved significant sums of investment being provided to refurbish facilities as part of the tender opportunity. Due to the financial pressures the Council is facing it is not currently possible to provide any capital investment as part of a procurement opportunity. In addition to the age and condition of the leisure facilities, this may make the contract opportunity less attractive.
- 2.15. In consideration of the above information there is a significant risk that an external procurement will not deliver significant interest from the leisure market. Furthermore, if a contractor was secured it is likely that the management fee requested would include a level of risk in line with the age and condition of the leisure facilities. Therefore, an external contract arrangement may not deliver the most advantageous financial outcome for the Council.

Agency Arrangement with LeisureSK Ltd

- 2.16. As reported previously there is an opportunity for the Council to engage LeisureSK Ltd as its agent under a new contract arrangement. Under such an arrangement the Council would become the 'Principal' provider of the leisure services with LeisureSK Ltd becoming the Council's 'Agent'.
- 2.17. The Council has commissioned advice from external tax consultants on the implications and points to consider on the management and operation of leisure facilities under an agency model. The resulting report is attached at **Exempt Appendix One**.
- 2.18. The advice received has confirmed that an agency arrangement is a compliant and legitimate model for the Council to adopt. In addition, this would allow the Council to benefit from the most tax efficient arrangements available and would reduce the operating costs of LeisureSK Ltd in relation to irrecoverable VAT. In financial year 2023/24 the amount of VAT which was irrecoverable was £341,788 and this is forecast to be £354,186 for the current financial year 2024/25.
- 2.19. The opportunity to consider an agency arrangement was established as a result of the loss of a tribunal case between HMRC and Chelmsford City Council (known as the Chelmsford Ruling). This set a precedent that, where a Council provides leisure services these can be treated as non-business income for VAT purposes, and therefore the associated VAT costs can be recovered in full.
- 2.20. This VAT ruling only applies to leisure services provided by a Council. However, if a local authority trading company were to act as a Council's agent in collecting the income from the leisure facilities, the same ruling can be applied therefore allowing full recovery of VAT costs.

- 2.21. It has been confirmed that non-business income applies to the supply of leisure activity including sports lettings, bookings, equipment hire and tuition. However non-sports supplies such as catering, clothing or equipment sales, vending sales, and general room lettings are classified as business activities (although room lettings and catering concessions would remain exempt from VAT as they currently are).
- 2.22. **Table One** below demonstrates the impact of the Chelmsford Ruling on how income streams would be treated for tax purposes in comparison to the previous arrangements.

Table One – Comparison of New and Previous VAT rulings		
Income Stream	New rules	Previous rules
Admissions (casual sports sessions)	Non-business	Taxable
Sports Membership	Non-business	Taxable
Facility Hire - Sports (block booked)	Non-business	Exempt
Facility Hire – Sports (not block booked)	Non-business	Taxable
Baths/Shower/Lockers	Non-business	Taxable
Courses (including gym induction sessions)	Non-business	Exempt
Courses (schools with own instructor)	Non-business	Taxable
Hire of sports equipment	Non-business	Taxable
Creche	Non-business	Non-business
Parties (sports)	Non-business	Taxable
Parties (non-sports)	Taxable	Taxable
Sale of equipment	Taxable	Taxable
General lettings	Exempt	Exempt
General lettings (if Council has opted to tax)	Taxable	Taxable
Catering concessions	Exempt	Exempt
Catering concessions (if Council has opted to tax)	Taxable	Taxable
Catering sales in-house	Taxable	Taxable
Courses (non-sport)	Exempt	Exempt
Soft Play	Taxable	Taxable

- 2.23. For an agency arrangement between the Council and LeisureSK Ltd to be accepted by HMRC, the Council would need to prove that it has control of the company as its agent in line with the six tests set out by HMRC to establish whether a true agency relationship for goods and services exists. These are:
- **Title** – If the agent is selling goods on behalf of the principal, ownership (or title) must remain with the principal and the agent should never assume ownership of the principal's goods.

- **Identity** – the services bought and sold by the agent on behalf of the principal must be identifiable
- **Value** – the principal must know the exact value at which goods or services have been bought or sold on its behalf
- **Separation** – the value of the agent's service must be separately identifiable from the main supply and should generally be known to the principal
- **No change** – the agent's intervention cannot alter or change the direction of the main supply between buyer and seller
- **Nature and value** – agents generally cannot alter the nature or value of supplies which they arrange on behalf of the principal.

- 2.24. HMRC has acknowledged that where an organisation has chosen to conduct its business using an agency arrangement, if the terms of the agreement are set out and agreed by both parties and applied consistently, then this is a compliant and legitimate arrangement.
- 2.25. To satisfy the tests set out by HMRC, the contractual and business arrangements between the Council and LeisureSK Ltd would need to be established, documented and consistently applied to align with agency principles. This includes the contract between the Council and LeisureSK Ltd, all correspondence between the two organisations, and the handling of income and expenditure. All documentation must be available for HMRC to review should they request to do so.
- 2.26. Under an agency arrangement leisure related income from the leisure centres would still be collected by LeisureSK Ltd but on behalf of the Council. LeisureSK Ltd would then retain the income and invoice the Council for the associated expenditure incurred monthly. If the income generated exceeded the expenditure this would be released to the Council, and if expenditure exceeded the income then the Council would need to top this up via a management fee payment.
- 2.27. Income from non-leisure supplies which are either taxable or VAT exempt, such as catering and retail goods, could continue to be made by LeisureSK Ltd who would then need to account for VAT appropriately.
- 2.28. A contract between the Council and LeisureSK Ltd incorporating agency principles would need to set out the process by which LeisureSK Ltd will communicate and transfer the income it has collected as the Council's agent. The Council would need to establish robust processes in order to receive and assess the financial information received from LeisureSK Ltd and would also need to satisfy itself that income generating opportunities were being maximised and expenditure being effectively controlled.

- 2.29. The impact of adopting an agency arrangement with LeisureSK Ltd would be very limited from a customer perspective and no changes would be necessary in relation to the employment terms and conditions of the leisure centre staff, who would remain under the employment of LeisureSK Ltd. In addition, the company's branding, uniforms and signage would remain the same.
- 2.30. However, the agency arrangement would need to be recognised within all commercial documentation including invoices and purchase orders, with information being clearly displayed that LeisureSK Ltd were acting on the Council's behalf.
- 2.31. The changes for the Council are more significant as it would need to ensure that back-office procedures are established to effectively account for the income generated from the leisure centres and the expenditure incurred. It would also be necessary to establish appropriate governance arrangements and processes to enable the Council to assess the financial and operational performance of LeisureSK Ltd and provide a check and challenge to the information provided by the company.
- 2.32. The Council could adopt an agency arrangement on the expiry of the current contract, the new arrangement commencing from 1 January 2026. However, as detailed in paragraph 2.3 the Council does have an option to provide six months' notice to terminate the current contract. If notice was provided no later than 30 September 2024 this could facilitate a new contract, to include agency principles, to commence from 1 April 2025 in line with the start of the new financial year.
- 2.33. There is no legal requirement to seek HMRC approval before adopting an agency arrangement whether this is implemented at the start of a new contract or as a change in an existing contract agreement.

3. Key Considerations

- 3.1. The options appraisal has identified that the option to enter an agency arrangement with LeisureSK Ltd would provide the most financially advantageous position for the Council. This arrangement would also allow for greater transparency on the operation of LeisureSK Ltd as income would be collected on the Council's behalf and the Council would be entitled to receive a full breakdown of the expenditure incurred in generating the income.
- 3.2. A new contract with LeisureSK Ltd would provide the Council with ongoing flexibility in terms of operating the leisure facilities and the timeline for any repairs and maintenance. For example, opening hours could be amended without the need for negotiations with an external company resulting in contract variations.
- 3.3. Under an agency arrangement LeisureSK Ltd would still benefit from discretionary Business Rate relief.

- 3.4. Intelligence from the leisure market suggests that many local authorities who currently operate leisure services through a local authority trading company are investigating the option to move to an agency type arrangement. In addition, many external leisure operators are also looking at the model with a view to amending their current and future contract arrangements with local authorities.

4. Other Options Considered

- 4.1. This report provides information on the conclusion of an options appraisal which has been undertaken to determine the future delivery model of the Council's leisure service.

5. Reasons for the Recommendations

- 5.1. The leisure options appraisal has identified an option to enter an agency arrangement with LeisureSK Ltd. This option would allow the Council to benefit from the most tax efficient arrangement available and provide a significant level of savings on an ongoing annual basis.
- 5.2. A contract duration of ten years would allow LeisureSK Ltd to plan its activity and financial projections over a longer period of time. To protect the Council's interests it is recommended that a clause be included to provide for an earlier termination with the provision of six months' notice.
- 5.3. An earlier termination of the current contract arrangements and move to an agency arrangement from 1 April 2025 would allow the Council to benefit from an increased level of savings in financial year 2025/26.

6. Background Papers

- 6.1. Report on Progress on Actions Requested by Cabinet dated 18th June 2024
<https://moderngov.southkesteven.gov.uk/ieListDocuments.aspx?CId=727&MId=4568&Ver=4>

7. Appendices

- 7.1. **Exempt Appendix One** – PS Tax Report on an Agency Structure for Leisure Management