



**SOUTH
KESTEVEN
DISTRICT
COUNCIL**

Cabinet

Tuesday, 10 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 determine the future delivery model for the Council's leisure service following the conclusion of the leisure options appraisal.

Recommendations

That Cabinet:

1. Approves the Council entering into a new leisure delivery contract with LeisureSK Ltd. for a maximum of ten years from 1 April 2025.
2. Terminates the current contract with LeisureSK Ltd. by giving the required six months' notice effective from 30 September 2024.
3. Approves a new operating model for the delivery of the leisure services, based on an agency model with LeisureSK Ltd. acting as an agent for the Council in respect of the leisure services only.
4. Subject to recommendations 1 to 3 being approved Cabinet is asked to request that appropriate governance arrangements are established to oversee the future contract arrangement between the Council and LeisureSK Ltd in order to provide the Council with a suitable level of control and assurance.
5. Explores the opportunity to expedite the transition to the new arrangement to ensure best value for money.

Decision Information

Is this a Key Decision?	Yes. Any decision is not subject to call-in, the Chairman of the Council agreed on 28 July 2024 that call-in need not apply to this decision, the notice is contained at https://moderngov.southkesteven.gov.uk/ecCatDisplay.aspx?sched=doc&cat=13925
Does the report contain any exempt or confidential information not for publication?	Appendices 1, 2 and 3 to this report are not for publication by virtue of paragraph 3 of Part 1 of Schedule 12A of the Local Government Act – financial information As this exempt information was not originally included on the Forward Plan, an Urgent Private Meeting notice was published on 15 August 2024 at the following web address - https://moderngov.southkesteven.gov.uk/ecCatDisplay.aspx?sched=doc&cat=13925
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

- 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 leisure activities and engage LeisureSK Ltd to provide these services 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 which 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 arrangement 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 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.
- 1.14 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.
- 1.15 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: Graham Watts, Assistant Director – Governance and Public Protection and 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 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 31st 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 Cabinet held on 18 January 2024 a series of tasks were identified in relation to the Council's leisure service, one of which was to accelerate the options appraisal for the future delivery model of the Council's leisure services. Cabinet requested that this should be undertaken in the shortest of timescales.
- 2.5 Subsequently four options were identified for the future delivery of the Council's Leisure Service, these being:
- Insourcing the leisure service
 - Entering a further contract arrangement with LeisureSK Ltd
 - Securing a contract with an external provider
 - Entering an Agency Arrangement with LeisureSK Ltd

Leisure Centre Maintenance:

- 2.6 A major consideration when assessing the various advantages and disadvantages of the leisure management options is the age and condition of the three leisure facilities, and the level of necessary repairs and maintenance identified from the leisure centre condition surveys.
- 2.7 The building condition surveys were undertaken in financial year 2022/23 to identify the anticipated spend required to maintain them over a 30-year period. The items identified were categorised A to D, those being rated D being either a health and safety issue or requiring urgent attention, through to those rated A which were non-urgent repairs, for example redecoration works.
- 2.8 **Exempt Appendix One** provides detail on the spend profile for the Council's leisure facilities, including the Stadium at Grantham. The costs identified are for category C and D items only and relate to works which if not completed would pose a significant compliance issue or risk the ongoing operation of the leisure centres. The figures do not include any provision to enhance the leisure facilities, or the grant funded energy works which are currently being progressed.
- 2.9 Any future contract arrangement would need to set out the respective repairs and maintenance responsibilities of the Council and the contractor. This would include provision for loss of income claims should the Council fail to satisfy its maintenance obligations or should repairs not be undertaken in timely manner.

Insourcing:

- 2.10 A costing exercise was undertaken to identify the likely financial impact of an insourced leisure service using the projected outturn management fee for financial year 2023/24 and the actual expenditure which was incurred. This was then overlayed with the associated savings and additional costs resulting from in-house delivery. As demonstrated in **Exempt Appendix Two** the most significant impact would be the resulting business rate liability and increased salary and pension costs.
- 2.11 Given the significant cost implications the option to insource the Council's leisure service was discounted.

New Contract Arrangement with LeisureSK Ltd:

- 2.12 As there is no provision to extend the current contract arrangements with LeisureSK Ltd a new contract arrangement would need to be in place for 1 January 2026. A new contract would need to be developed clearly identifying the Council's expectations for the service and the leases in relation to the three leisure facilities would also need to be refreshed.
- 2.13 A further contract arrangement with LeisureSK Ltd does afford the Council some advantages in terms of ongoing flexibility, especially in relation to the timing and prioritisation of repairs and maintenance. LeisureSK Ltd would continue to receive business rate relief and the staff would remain on their current terms and conditions.
- 2.14 However, the Council would remain liable for a management fee payment which represents the difference in the expenditure incurred by LeisureSK Ltd and the income it has been able to generate. This would include substantial amounts of VAT which the company are unable to recover, therefore increasing the management fee payable by the Council.
- 2.15 The Council has taken advice from external tax consultants which has 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.

Securing a Contract with an External Provider:

- 2.16 The main advantages of securing an external contract are the ability to fix the management fee payment for the duration of the contract, although this would be increased on an annual basis by RPI, and the ability to pass a level of risk to a contractor.

- 2.17 The option to secure an external provider through a competitive tender process has been investigated and a soft market test undertaken to establish potential interest from the leisure market. The main feedback received was:
- Operators wanted a shared approach to maintenance risks, with the Council retaining responsibility for major lifecycle and structural aspects.
 - Recommending use of the Sport England utility benchmarking process with the operator taking the risk on utility consumption and the Council retaining the risk on tariff increases.
 - Operators suggested a minimum contract term of ten years with the potential to extend for a further five years, although some contractors were open to longer term contracts.
- 2.18 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 an element of risk into the management fee required.
- 2.19 Under an external contract arrangement, the Council would be contractually bound to undertake the items of repairs and maintenance assigned to them within prescribed timeframes. If, due to wider financial pressures, the Council were unable to undertake these works this could result in the Council being liable for further costs in relation to loss of income claims.
- 2.20 Intelligence from the leisure market confirms that there are a significant number of procurement opportunities and therefore contractors can choose which ones to bid for, typically prioritising those which will return the maximum level of 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 this is not currently possible. In addition to the age and condition of the leisure facilities this may make the contract opportunity less attractive.
- 2.21 In consideration of the above information there is a substantial risk that a procurement to secure an external contractor will not deliver significant interest from the leisure market. In addition, if a contractor was secured it is likely that the resulting management fee would include a level of risk in line with the age and condition of the leisure centres. The risk on utility tariff rises would need to remain with the Council which could also lead to additional costs being incurred. For these reasons an external procurement may not deliver the most financially advantageous outcome for the Council.

Agency Arrangement with LeisureSK Ltd:

- 2.22 There is an opportunity to engage LeisureSK Ltd under a new contract arrangement which incorporates agency principles. Under such an arrangement the Council would become the 'Principal' provider of the leisure services with LeisureSK Ltd acting as the Council's 'Agent'.
- 2.23 In considering this option the Council commissioned advice from external tax consultants to establish the implications and points to consider. The resulting report is attached at **Exempt Appendix Three**.
- 2.24 The advice received has confirmed that an agency arrangement would be a compliant and legitimate option 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 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 in the current financial year.
- 2.25 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.
- 2.26 This VAT ruling only applies to leisure services provided by a Council. However, if a local authority trading company were to act as the Council's agent in collecting the income from the leisure facilities, the same ruling can be applied therefore allowing full recovery of the VAT costs which were previously irrecoverable.
- 2.27 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).
- 2.28 **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

2.29 For an agency agreement 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.

2.30 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.

- 2.31 To satisfy the tests set by HMRC the contract and business arrangements between the Council and LeisureSK Ltd will 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.
- 2.32 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 its expenditure incurred in generating the income on a monthly basis. 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.
- 2.33 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.
- 2.34 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.
- 2.35 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 employed by LeisureSK Ltd. In addition, the company's branding, signage and uniforms would remain the same.
- 2.36 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.
- 2.37 The changes for the Council are more significant as it will 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 will 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.

- 2.38 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 above the Council does have an option 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.
- 2.39 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 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. For example, the timing of repairs and maintenance works, or the opening hours of the facilities could be amended without the need for negotiations with an external company or contract variations.
- 3.3 Under an agency arrangement LeisureSK Ltd would still benefit from 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 findings of the 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 financial 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 an earlier termination of a longer-term contract would still be possible with the provision of six months' notice.
- 5.3 An earlier termination of the current contract arrangements and move to an agency arrangement would allow the Council to access the full amount of savings in financial year 2025/26 rather than waiting until the expiry of the current contract on 31 December 2025.
- 5.4 In order to provide an appropriate level of assurance and control over the operation and financial performance of LeisureSK Ltd it is recommended that the governance arrangements are reviewed and enhanced.
- 5.5 Recommendation number 5 has been added at the request of the Culture and Leisure Overview and Scrutiny Committee following debate at the meeting which was held on 3 September 2024. The Members of the Committee endorsed the transition to an agency arrangement with LeisureSK Ltd.

6. Consultation

- 6.1 Members of the Culture and Leisure Overview and Scrutiny Committee have previously received reports providing an update on progress with the leisure options appraisal at the meetings held on 18 June 2024 and 3 September 2024. At the meeting held on 3 September 2024 the Members present endorsed the adoption of an agency agreement with LeisureSK Ltd but requested that Cabinet consider an earlier adoption of the arrangement, acknowledging that further savings would be achieved if this could be implemented in a shorter timeframe.

7. Background Papers

- 7.1 Report on Progress on Actions Requested by Cabinet dated 18 June 2024 available [here](#).

8. Appendices

- 8.1 **Exempt Appendix One** – Condition Survey Repair and Maintenance Costings
- 8.2 **Exempt Appendix Two** – In-house Leisure Costings

8.3 **Exempt Appendix Three** – Report on Agency Structure for Leisure Management