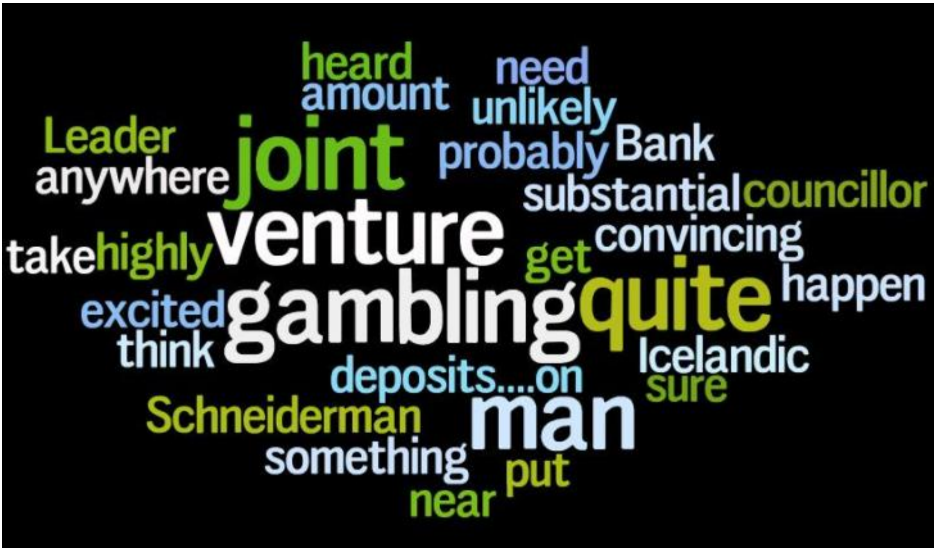
Barnet UNISON

How Joint Venture Companies Work



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Barnet UNISON has asked APSE to prepare a short paper on Joint Venture Companies (JV) to aid understanding of how the proposed JV for the DRS contract will work. A recent statement, suggesting that the JV will **not** increase risk to the Council has led to some confusion. It is worth considering therefore how the model works.

The purpose of any company is to limit the risk to investors so that they do not become liable for more than the amount of money they have put into the company. Investment can be in cash, kind or by guarantee but both reward, in the form of a share of the profit, and liability in the event of losses, relate directly to investment, as does the level of ownership that each investor is said to have. Where an investor pus up **100%** of the share capital or is the sole guarantor, that investor will be entitled to **100%** of any profit that is not reinvested in the company – it also takes **100%** of the risk up to the level of its investment or guarantee. In such a case, the company is **100%** owned by the investor.

In a Joint Venture Company ownership is **shared** – usually by two or more corporate bodies, i.e. companies or corporate public bodies such as Councils. The respective level of ownership reflects the respective level of investment or guarantee. For example, one of the partners might have a **75%** share in the company and the other a **25%** share. In this case the one with the **75%** share takes **75%** of the risk and can expect to receive **75%** of any distributed profits.

Reasons for creating JV arrangements will vary from case to case but it is usually the ability to **share risk** that is the underlying motive. Other advantages, such the sharing of technical or commercial expertise or combining access to market, are all important but could be achieved in ways that would not require giving up part of the profit.
Local Government Joint Ventures are also vehicles for risk sharing. A perceived ability to retain a degree of control by having a presence on the board is also often cited as a reason for preferring the model over a straight contract. Profit sharing can also be an attraction but as this is the other side of the coin from risk sharing, it only really makes sense where the expected profit is to come from trading outside of the contract with the Council itself. It is difficult to see why a Council would take any of the commercial risk involved in trading with itself – particularly where so called ‘risk transfer’ has been cited as one of the

main reasons for contracting out.

The **Southwest One partnership** between Somerset County Council, Avon and Somerset Police, Taunton Deane Borough Council and IBM is a good example of how a JV is used as a vehicle to spread risk and share profit. In this case IBM is the predominant partner and it is IBM's services that are provided through the JV Company.

The public authorities are currently the only customers of Southwest One and because the venture has **not** been **successful** in terms of other trading, have not received the financial benefit originally expected. This benefit would be partly profit share but also lower fees arising from the ability to share overheads and spread the cost of investment across a wider customer base. IBM is still providing services to its JV partners but **savings** have been **far lower** than expected because the company is not as profitable as expected and because a lower than expected volume of work has prevented optimisation of costs through economies of scale. The overall impact is that whilst IBM, as the major shareholder, will carry the bulk of the financial loss, the County Council is far worse off than it expected to be.

Notwithstanding the outcome of a **legal battle** that has now commenced between the County Council and the JV that it partly owns, SouthWest One clearly demonstrates the need to **consider** the potential **for loss** as well as gain when evaluating a proposal to create a JV.

Barnet has stated that it will be investing no more than a **nominal** amount **(£1)** in the proposed JV. Given that the level of ownership and therefore share of any profit is directly related to the level of investment or guarantee, this suggests that whilst the Council will in this way minimise risk to itself, it will also **minimise benefit**. In fact, a company in which the Council has such a minor stake could not be properly considered to be a Joint Venture. This suggests either that the JV proposal is **not** genuine or that the Council has **not provided** full information about the nature of its proposed stake, e.g. that its investment is to be in kind or by guarantee, rather than cash.

Clarification should be sought on this point but perhaps more important will be to understand how far savings in relation to the service to the Council are predicated on the success and profitability of trading with other customers. The private partner may well, as the Council states, **underwrite** the service to the Council but this is **not** the same as **guaranteeing savings** that depend on the success of trading activity where the risk is, by definition, shared.

Decision makers in Barnet would be well advised to look closely at the Southwest One example to fully understand the need to consider the disadvantages as well as the advantages of the JV approach. Ultimately, a decision to go ahead must be based on a sound business case that takes account of the commercial reality that drives propositions of this kind. The bidders are motivated primarily by the need to make a profit. The fact that **they are proposing** a JV in itself suggests that they see a need to share risks associated with some element of the contract. If, as with Southwest One, this element is the link between the success of external trading and the generation of savings on work carried out for Barnet, the risk that these **savings** may **not materialise** must be **fully** explored and **fully** explained to elected members, before an informed decision can be taken.

Five key Joint Venture Questions

1. If the Council has no more than a nominal share and takes no risk please explain how the Council can expect to receive more than a nominal share of the rewards?
2. What level of additional benefit is now expected to flow from a JV over and above any expected savings from a straight contract with the private partner to justify taking this additional risk?
3. What level of **additional** procurement cost has been identified to put in place a JV?
4. Can a JV be concluded within the **existing estimated time frame** for the DRS procurement?
5. In the case of DRS there is **no business case supporting the use of a JV arrangement** and elected members have had no opportunity to consider the many options available. Given this, can you describe in broad terms what is meant by a JV in the context of DRS, i.e. **what legal** form will it take, **what level** of Council ownership/investment/guarantee will there be?

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