

**Mini Audit Review:
The Assigning of Parent Company Guarantees and Other
Types of Securities to Council Contracts**

1 Introduction

- 1.1 At the Finance & Audit Scrutiny Committee meeting of 3 January 2018, following their consideration of a report on Newbold Comyn Golf Course to Executive the next day, Members asked for an urgent review of the assigning of parent company guarantees (PCGs) to Council contracts. The review has been extended to cover all types of securities as the processes for setting these up and monitoring them are the same. It would therefore be negligent, and ultimately unhelpful, not to include all types of securities within the review.

2 Scope and Objectives

- 2.1 The review is concerned with assessing the effectiveness or otherwise of the Council's arrangements for assigning securities to contracts with particular emphasis on parent company guarantees.
- 2.2 The review took the form of a systems-based examination of the Council's overall arrangements and did not focus on the Golf Contract specifically. The review is more concerned with ascertaining whether the problems encountered are systemic and could therefore have applied to other contracts. It is also focused on identifying improvements in arrangements to mitigate the occurrence of such problems in the future.

3 Background

- 3.1 A report was issued by the Deputy Chief Executive (AJ) to Executive on 4 January 2018 detailing problems with the Golf Contract at Newbold Comyn Golf Course and the issues resulting from this. The report advised that the contractor, Mack Trading, had recently ceased its operation at the golf course and wanted to withdraw from the contract that it had with the Council. In order to do this, a negotiated settlement was being sought. The report set out a number of options and presented various recommendations for dealing with the situation.
- 3.2 Discussions on the report revealed that, although there was a PCG within the contract, this could not be invoked as it became clear that the parent company of Mack Trading had changed its company structure as to render the security useless. (This was done shortly after the contract was let.)

4 Securities in Contracts: General Principles

- 4.1 From this point onwards, for the purposes of readability, the term "security" will be used to cover all types of guarantees and bonds within contracts. The terms will be explained in this section.

- 4.2 It is important to be clear on the nature and purpose of securities in contracts.
- 4.3 The issue of securities in contracts is a complicated one and it is essential that legal advice be sought at an early stage of the procurement process. Although the application is complex, the principle is straightforward: A security is a promise by one party to compensate another for the loss suffered as a consequence of a specific event. The trigger event can be anything defined by the parties, including a breach of contract, a party's fault or negligence or a specific action. A security operates as a transfer of risks between the parties, and changes what they would otherwise be liable for or entitled to under a normal damage claim.
- 4.4 Bonds and guarantees are forms of security that accompany contractual obligations. 'Secondary obligation bonds' are the most common form of contract security in the UK. They normally comprise guarantees, including parent company guarantees, or conditional bonds, and the bond provider is only liable where a breach of contract has occurred; for example, where the contractor is in breach of contract. A performance bond places an obligation on the provider of the bond (usually a bank or insurer) to pay the buyer a sum of money if the seller fails to perform the contract.
- 4.5 As an illustration of the complexity involved, there are various types of PCG:
- Pure Guarantee – A guarantee in which the parent company guarantees that its subsidiary will perform its obligations under the contract.
 - Guarantee and Right to Perform – This PCG not only guarantees performance of the specialist contractor's work but also obliges the guarantor to make good any default of the contractor.
 - Guarantee and Indemnity – In contrast to the Guarantee and Right to Perform, a guarantee including an indemnity will make the guarantor liable for any and all damages no matter how questionable.
- 4.6 For both the contracting body and the contractor there are various advantages and disadvantages to each of the different types of security that are available.
- 4.7 From the perspective of the contracting body one of the advantages of a PCG is that it helps to maintain a relationship between the Council and the guarantor. With a bond, on the other hand, both the contractor and the Council are subject to the requirements of the bank and what its standard terms are (which are often non-negotiable). With a guarantee the Council can set the terms it wants.
- 4.8 Service contracts tend to be longer term, including some that are 10-15 years, whereas construction contracts tend to be shorter term, for just a few years to deliver fixed milestones. This means that companies in service contracts want to keep their costs lower which leads to them

preferring to use PCGs, whereas companies in construction contracts are predisposed to using bank securities.

- 4.9 It is favourable for contracting bodies to require PCGs from their contractors as the PCG requires the parent company to step in and perform if the contractor defaults rather than just pay a fixed sum of money. Also, there is no cap or limit on PCGs as there are for bonds.
- 4.10 Bank securities are more costly as a percentage of the bond value has to be paid by the contractor to the bank indemnifying the contract. In addition, there are restrictions on the level of security that can be provided.
- 4.11 It is worth pointing out that a guarantee or bond is not needed for every contract; it will depend on the value and risk. In addition, although the Council has a template guarantee, it is based on the leisure contract and may be too stringent for lower-risk contracts.
- 4.12 As stated previously the issue of securities within contracts is a complex one and procurement and legal advice should be sought by services at an early stage of the procurement process. Where a security is required, the Council's Legal advisors should be involved in drafting them so that they can be drafted according to the needs of the particular contract.

5 Findings

- 5.1 Although at the time of completing this report the position across the Council had not been fully established, it is clear that very few of Warwick District Council's contracts have PCGs or any other types of security assigned to them.
- 5.2 With just three, Cultural Services appears to have the most PCGs within its current set of contracts. These comprise:
 - Leisure Services contract – with Everyone Active
 - Leisure Centre Construction contract – Spellers
 - Golf contract – Mack Trading
- 5.3 With the exception of its forthcoming Housing & Void Repairs Contract with Axis Europe, which is being assigned a PCG, Asset Management (previously 'Property Services' and now part of the Chief Executive's Office) doesn't appear to have assigned any forms of security to any of its contracts. This includes the contract to carry out Electrical Maintenance & Repairs to Appliances and Installations.
- 5.4 Neighbourhood Services is inclined to use bonds for its large contracts such as Waste Collection, Street Cleansing and Grounds Maintenance.
- 5.5 Housing Services does not appear to have assigned any forms of security to any of its contracts, understandably in most cases by virtue of being relatively small in value.

- 5.6 Other services tend to have relatively small value contracts that are below the threshold (albeit unspecified) for requiring securities to be attached to them.
- 5.7 Although there is an expectation by the Procurement Manager that PCGs will be considered for larger-value contracts, written guidance on the topic of securities within contracts – e.g. when and how they should be included – was found to be somewhat limited.
- 5.8 For example, although there is guidance to services on the application of bonds within the Council's 'Guide to Risk Management', there is no mention of PCGs within the document.
- 5.9 In a similar vein, although there is reference to PCGs in the supplementary guidance document, 'Financial Vetting of Suppliers Guidance', the references – in the context of the tenderer being able to demonstrate sufficient financial strength – are fleeting. No guidance is provided on when PCGs should be considered and how they should be applied.
- 5.10 Furthermore, there is no overall guidance on the different types of securities that are available, when they should be considered and which ones are the most suitable for particular types of contracts. This has led to tenderers controlling the form of security that is provided.
- 5.11 In terms of the procedure for assigning a security to a contract, tenderers have, traditionally, offered a security of their own choice and the Council has responded to that. The Council has been acting reactively, therefore, not proactively.
- 5.12 For example, in the case of the Golf contract the tenderers were asked in the tender documentation what type of security they would like to provide. In the case of the successful tenderer, M T, the company said that it would provide a parent company guarantee.
- 5.13 With the aid of the Council's Procurement Service and the County Council's legal service the Council is now moving to a situation where the Council decides what it wants and instructs the tenderer accordingly.
- 5.14 Again, however, there is no written guidance governing this and so the application of this approach may be inconsistent across the Council's services.
- 5.15 As a result of contacting services across the organisation as part of this audit to determine what securities are in place, it is clear that not all managers have an awareness of the position regarding their contracts. Some managers did have a handle on the position regarding their contracts but in several cases the information wasn't readily known. Not all were able to confirm the situation in time for this report. Contract managers should have a ready appreciation of such matters or be able to ascertain the position fairly promptly.

- 5.16 information on whether contracts contains securities and the type of security assigned is not currently held on contract registers so contract managers must rely on their memories, or an interrogation of the contract documentation, to determine the position for the contracts that they are responsible for.
- 5.17 As a general point, it must be stressed that improvements are continually being made to procurement practices and the Council continues to learn from problems. Very shortly the strategic element of the Council's Procurement support is to be provided by the County's Procurement Service. This will provide an opportunity for greater uniformity across the two authorities. Uniformity of approach should certainly lead to more efficient arrangements in terms of the legal support that the County provides as the County's legal service will have a greater appreciation of procurement and contractual processes and there will not be the need to "reinvent the wheel".
- 5.18 For example, Warwickshire County Council Legal now has a template PCG that can, where applicable, be used for appropriate contracts and issued with the Invitation to Tender documents.
- 5.19 In the future when Warwickshire County Council's Procurement service provides Warwick District Council's Strategic Procurement function the Council will have the same tender documents as the County Council so there will be uniformity and standardisation.
- 5.20 Other approaches that the County utilises may also come in to force at the Council when the County takes over the strategic procurement function. For example, the County subscribes to "Credit Safe" which provides alerts to members in respect of drops in credit status.
- 5.21 There is also a new company-checking service at Companies House that the Council could consider using which provides notifications of when routine documents for companies are filed. This will enable, for example, the Council to monitor whether a company's ownership structure has changed. Each company has to file an annual confirmation statement that sets out who their shareholders are. Again, the County Council use this and it may be beneficial for the Council to do likewise.
- 5.22 For the Council to benefit properly from these facilities it may be appropriate for a designated officer within Finance to be assigned responsibility. Currently, the support that Finance provides on contracts – e.g. carrying out pre-contract credit checks on tenderers and post tender monitoring of the financial performance of contractors – is informal and unstructured.

6 Conclusions

- 6.1 There are weaknesses in procedures concerning the setting-up and monitoring of securities assigned to contracts. The Golf Contract was an example of those weaknesses and the impact that can have.

- 6.2 The situation highlights weaknesses in contract management, perhaps evinced by some managers not having an appreciation of whether their contracts contained securities.
- 6.3 Revised arrangements should be focused on:
- Identifying the most appropriate form of security.
 - Establishing the security effectually within the contract.
 - Monitoring the contract effectively, including monitoring the financial position of the contractor and, where applicable, its parent company.
 - Enhanced contract management generally.
- 6.4 This will require greater and improved staff training, improved procedures and documentation, greater expertise in the carrying out of financial checks and financial monitoring as well as greater consultation throughout between the contracting service, the Procurement Service and the legal service.
- 6.5 The provision of a strategic procurement service by the County should lead to a more standardised approach to contracts as the County also provides the legal support. Equally, however, there could be problems in communication with services. Hopefully, the continuation of a procurement presence at the District will mitigate this as will good procedures together with a resolve by all parties to make the arrangement work.

7 Recommendations

- 7.1 Guidance on the use of PCGs and other types of securities should be reviewed with a view to ensuring that it is appropriate and sufficient to assist services during the procurement process, in particular when compiling the Invitation to Tender documentation and when establishing contracts with successful tenders.
- 7.2 More specifically, guidance on the use of PCGs and other types of securities should be incorporated within the documentation provided by the Procurement Team to aid services during the procurement process.
- 7.3 Because of its importance to the Council, driven by such factors as the reputation of the Council and the sums involved, contract management training should be run at regular intervals for relevant employees and not just as one-offs. Staff should be trained not only in the Council's practices and procedures but also provided with general contract management training on such matters as the different types of securities that are available and the basis for selection.
- 7.4 There should be due emphasis within contract management training programmes on the importance of monitoring the delivery of contracts after they have been established.

- 7.5 Contract registers should record, for each contract, whether the contract has had a security assigned to it and, if so, what form of security is in place. Any other relevant information pertaining to securities should also be recorded on the contract registers.
- 7.6 Finance should establish a designated officer within its service that is able to provide an appropriate level of financial input on contracts. This officer should, for example, be trained to carry out financial checks e.g. perform credit checks on tenderers, pre-contract, and monitor the financial performance of contractors, after the contract has commenced. Such support should be systematic and proactive, not needing to be requested by the contracting service. (This facility, had it been in place, would have identified the problem with the parent company of Mack Trading, enabling the Council to have taken remedial action before it was too late.)
- 7.7 After the reorganisation of the Procurement function, the County's Procurement Team should be asked to assess the Council's procurement arrangements, including the guidance currently provided to services when procuring services and entering into contracts with a view to bringing practices at the Council in line with those at the County. This is particularly the case in respect of legal documentation.
- 7.8 The Council should consider the commissioning of a wider review by a specialist of its contract management arrangements to ensure that it is meeting best practice in its arrangements. This should take place after the reorganisation of the Procurement function, and after the 'internal' review recommended in 7.7 above, so that the new arrangements with the County form part of the review.

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