



Nottingham City Council

Report in the Public Interest concerning the Council's governance arrangements for
Robin Hood Energy Ltd

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Summary

We are issuing this report as a Report in the Public Interest under section 24 and Schedule 7 of the Local Audit and Accountability Act 2014. The Council is required to publish this report as soon as practicable, consider it at a meeting held in public within one month of the date of publication and provide a publicly available written response to us.

The Council set up Robin Hood Energy (RHE) in 2015 as a wholly owned not-for-profit subsidiary, in order to tackle fuel poverty in the City of Nottingham and provide a realistic alternative to the 'big 6' energy suppliers. As part of this, it aimed to provide better terms to users of pre-payment meters, who are more likely to be below the poverty line and cannot access the variety of discount arrangements offered to other customers of the big six suppliers. As expected, the Company made losses in its early years but reported a small profit of £202,000 in 2017/18 (although this was subsequently amended to a loss of £1.6m as a result of a prior period adjustment as part of the 2018/19 audit). In 2018/19, it made a large loss of £23.1m, giving it cumulative losses to 31 March 2019 of £34.4m. These losses were caused by a number of factors including:

- Volatility in wholesale energy markets which impacted on all energy retailers
- Price cap changes by the regulator, Ofgem
- The need to increase the provision for doubtful debts by £2.6m (more than trebling it) following an increase in debtors, implementation of a new accounting standard and continuing difficulties in collecting old debt in the year, which was partly due to insourcing a previously outsourced debt management service.

Despite having concerns about the quality of the financial information being produced by the Company, its deteriorating financial performance and therefore its ability to make repayments, the Council decided to make significant additional loans to the Company on several occasions during 2018/19 and 2019/20. Had it not done so, the Company would have immediately failed, and the Council would have lost most of the value of its existing stake in it, with £47.4m at risk at the time when the largest loan was requested in October 2019. The Council faced a choice between two highly undesirable alternatives, a scenario brought about in large part by its own inadequacies in holding the Company to account.

This position stemmed from a range of factors:

- The setting up and operation of an energy company is hugely ambitious, given the highly complex, highly competitive and highly regulated markets in which energy companies operate, and the impact which external global factors can have on pricing. Some aspects of RHE – particularly its focus on low tariffs and poorer customers – further increased these risks.
- The governance arrangements which the Council has had in place were not strong enough, particularly given the nature of the Company and its markets:
 - o There was an insufficient appreciation within the Council (as a corporate body) of the huge risks involved in ownership of, and investment in, RHE
 - o There was insufficient understanding within the Council of RHE's financial position, partly due to delays in the provision of information by RHE and the quality and accuracy of that information
 - o There was insufficient sector (or general commercial) expertise at non-executive Board level

- There was a lack of clarity in relation to roles within the governance structure
 - The arrangements did not establish an appropriate and consistent balance between holding to account and allowing the Company freedom to manage, and this worsened as levels of trust decreased and the financial position deteriorated.
- Overall, the governance arrangements were overshadowed by the Council's determination that the Company should be a success, and this led to institutional blindness within the Council as whole to the escalating risks involved, which were ultimately very significant risks to public money. Where concerns were raised by some individuals, these concerns were downplayed and the resulting actions insufficient.

Improvements have been made to the governance arrangements over the past year, but have been too late to protect the Council's finances. These have included the setting up of an internal RHE Steering Group, chaired by the Council's Chief Executive, an officer Shareholder Board and more recently the bi-monthly Companies Governance Sub-Committee, chaired by the Leader of the Council, with the latter two developments covering all the Council's companies.

Because of the poor financial performance and prospects of RHE, and hence the reduced likelihood of loans being repaid and any future realisation of the value of its £7.5m shareholding, the Council has had to impair (reduce the value of) these loans and the shareholding in its accounts. It has also had to increase the value of the liability disclosed in its accounts for the Parent Company Guarantees, totalling £15m, which it has entered into with RHE's suppliers, because the risk of them being 'called in' has increased.

The Council has now amended its 2018/19 accounts to reflect what amounts to a 'loss' of £24.4m. This will have a direct impact on the Council's financial reserves and leave it with a need for more challenging savings plans. A further loss of over £8m will be incurred in the 2019/20 accounts, while depending on decisions which have yet to be taken about the future of the Company, it is likely that a further significant loss will be incurred in 2020/21. Despite the escalating situation, the Council's Leadership has only very recently reacted vigorously to the situation and moved away from what had felt to be a determination to continue at any cost. This is not how local authorities should look after large amounts of public money.

The Council has a controlling interest in a range of companies and other organisations. While it has been working to improve the governance arrangements across these companies, and make them more consistent, this progress has been very slow and its benefits are not yet being reflected. The Council needs to ensure that lessons are learned from the experience of RHE and further improvements made across all the Group. Some of these companies are successful and appear well-run, but this does not eliminate the need for strong governance arrangements within the Council.

The Council also needs to reflect on the RHE experience in relation to its overall governance arrangements, and ensure that sufficient effective safeguards are built into these to ensure that policy initiatives are appropriately challenged and risks properly understood and managed, in the context of the Council's overall strong ambitions for the City of Nottingham.

Recommendations

This report makes a number of recommendations for the Council to address. A Strategic Review is already underway to determine the future of RHE, and the most important steps for the Council to take now involve applying the lessons from RHE across the wider group. In this regard, we would particularly highlight recommendations 2 and 3 in relation to the composition of company boards, recommendation 8 in relation to further strengthening monitoring arrangements and recommendation 12 in relation to applying the lessons to the Council's overall governance.

R1. Using the current Strategic Review and other appropriate advice to assist with decision-making, the Council should urgently determine the future of RHE, with options properly evaluated and risks properly assessed. This assessment should also take into account the context of the Council's current financial position.

R2. The Council should review its overall approach to using councillors on the boards of its subsidiary companies and other similar organisations. This should be informed by a full understanding of the role of and legal requirements for company Board members.

- R3. *Where it continues to use councillors in such roles, it should ensure that the non-executives (including councillors) on the relevant board have, in aggregate, the required knowledge and experience to challenge management. This is of particular importance where the company is operating in a specialised sector which is outside the normal experience of councillors.*
- R4. *Where councillors are used in such roles, the Council should ensure that the councillors are provided with sufficient and appropriate training which is updated periodically.*
- R5. *The Council should ensure that all elements of its governance structure, including the shareholder role, are properly defined and that those definitions are effectively communicated to the necessary individuals.*
- R6. *When allocating roles on Council-owned organisations to individual councillors, the Council should ensure that the scope for conflicts of interest is minimised, with a clear divide between those in such roles and those responsible for holding them to account or overseeing them.*
- R7. *The Council should ensure that risks relating to its companies are considered for inclusion in its overall risk management processes, with appropriate escalation and reporting, rather than being seen in isolation.*
- R8. *As the new arrangements for monitoring companies are rolled out alongside the Companies Governance Sub-Committee, the Council should ensure that financial information is provided in accordance with its requirements and is fully understood by the Sub-Committee and others involved in holding the companies to account, and that robust action, with the oversight of the s151 officer, is taken if suitable information is not provided.*
- R9. *Within the new arrangements involving the Companies Governance Sub-committee, the Council needs to ensure that responsibilities for scrutiny and risk management are given sufficient prominence, including giving the Audit Committee explicit responsibility for scrutiny of governance and risk management across the group.*
- R10. *In addition to those referred to in recommendations above, the Council should apply the lessons from RHE in a further review of its company governance arrangements, in particular to ensure that risks are appropriately flagged and managed, as well as successfully implementing the more robust monitoring agreed by the Companies Governance Executive Sub-Committee.*
- R11. *As part of this review, the Council should consider the appropriateness of the definition of the shareholder role adopted in the 2019 report and give it an emphasis on protection of the Council's financial interests alongside other elements.*
- R12. *The Council should use the experience of owning RHE to consider whether there are any lessons for its wider governance, particularly in relation to the 'checks and balances' which need to be in place, including the need for a stronger monitoring and scrutiny function and moving to a culture in which challenge of political priorities and how they are being implemented is seen as a positive.*
- R13. *The Council should ensure that it reflects the financial pressures arising from RHE alongside those from covid-19, demand-led services and other areas to produce balanced and achievable financial plans for the current year and for the medium-term, without disproportionate, unsustainable reliance on one-off measures.*

Introduction

We are issuing this report as a Report in the Public Interest under section 24 and Schedule 7 of the Local Audit and Accountability Act 2014. The Council is required to publish the report as soon as is practicable, consider it at a meeting held in public within one month of the date of publication and provide a publicly available written response to us.

Background

The Council set up Robin Hood Energy (RHE) in 2015 as a wholly owned not-for-profit subsidiary, in order to tackle fuel poverty in the City of Nottingham and provide a realistic alternative to the 'big 6' energy suppliers. As part of this, it aimed to provide better terms to users of pre-payment meters, who are more likely to be in poverty but do not receive a good deal from the regular commercial suppliers.

The original business case which led to the setting up of RHE stated that the company would require an investment of £8.1m and would stand cumulated losses of £3.8m before moving into profit in year 4 (2018/19). It envisaged that the Company would need to attract significant external investment as it grew.

While the policy focus was primarily on serving the people of Nottingham, we understand it was always clear that in order to be competitive, and to provide a realistic alternative to the 'big 6', the Company would need to operate on a more national basis. In early 2017, RHE entered into a partnership with EBICO, another not-for-profit energy supplier operating across the country with similar aims to RHE, while it has also entered into deals with various 'white label' companies, many of which are linked to specific local authorities. RHE also grew its customer base by focusing on 'void switchers' (arranging supplier switches in vacant properties), both directly and through the white label companies.

As a result, RHE has grown at a rapid rate in terms of turnover and meter points served (Table 1) but has been far less successful in terms of its profit and loss position, with cumulative losses of £34.4m to 31 March 2019, the most recent date for which audited accounts are available.

Table 1
Robin Hood Energy financial results

	2015/16	2016/17	2017/18*	2018/19
Turnover	£4.6m	£25.9m	£69.0m	£97.9m
Profit(loss)	(£2.5m)	(£7.2m)	(£1.6m)	(£23.1m)
Meter points			168,000	220,000

* The accounts for 2017/18 were restated following the 2018/19 audit, converting the previously reported profit of £202k to a £1.6m loss.

Table 2 below demonstrates how the Council's financial commitments to RHE have grown since its inception, with the gross liability at 31 March 2020, including guarantees, being £59.6m. In effect, the Council had invested £43m of public funds into RHE, and risked a further £16.5m in the form of guarantees.

Table 2
Council liabilities in respect of RHE (gross values, £m)

	31/3/16	31/3/17	31/3/18	31/3/19	31/3/20
Shareholding	0**	0**	7.5	7.5	7.5
Loans	2.3	9.5	11.7	20.2	31.8
Prepayments	0	0	0	3.9	3.9
Parent company guarantees	0	7.0	12.0	12.0	16.5
Pensions guarantee	0	0.7	0.7	0.7	0
Total*	2.3	17.2	31.9	44.3	59.6

* In addition, the Council provided uncapped letters of comfort in respect of 31 March 2016 to 2018, and a letter capped at £12.5m for 31 March 2019.

** The Council held a single £1 share on 31/3/16 and 31/3/17.

Scope

The events described in this report are complex and involve a wide range of individuals in various roles across the Council and the Company. While we have legal powers to comment on RHE as a 'connected entity' of the Council, our focus has been primarily on the Council and its own governance arrangements in relation to RHE. The Company became operational in 2015, well before we were appointed as the Council's external auditors, and we have not sought to assess the original decisions to set the Company up, including the compilation of the business case. Inevitably, though, some of the risks that we comment on were inherent to the original decision-making.

Summary of events

While our findings are focused particularly on the Council's governance arrangements, in order to understand our concerns about governance, it is necessary to understand the sequence of events in the Council's relationship with the Company over the past two years, and the key points are set out below.

We were appointed as the Council's external auditors with effect from April 2018. Shortly after that, the Company celebrated its first profit, having made a reported surplus of £202k in 2017/18 (although this was subsequently amended to a loss of £1.6m as a result of a prior period restatement agreed in the 2018/19 audit). The Company was securing growth through the acquisition of 'white label' companies, often linked to other local authorities, through which it sold energy in various parts of the country. To finance this growth, RHE negotiated with the Council to convert £7.5m of debt to equity shareholding in January 2018, giving it a more favourable balance sheet position and meaning that it no longer had to pay principle and interest on the debt, but taking it beyond the assumptions set out in the original business plan.

Since that time, the relationship between the Council and RHE has been under increasing strain, due to:

- the Council not authorising RHE to proceed with two proposed acquisitions in January 2018 and January 2019, which the Company maintained would have helped to cushion the impact of market pressures and hence to improve its financial position but for which Council officers maintain they were not provided with adequate formal proposals and business cases, and in the context of the Company not having provided the Council with up-to-date and reliable management accounts
- an at times rapid and unpredicted deterioration in the Company's financial position in terms of both profit and loss and cash. We appreciate that 2018/19 was a particularly difficult year for all energy suppliers due to market and regulatory

changes, but the Council was not properly sighted on the impact of this on RHE's performance or the security of its own loans and investments.

- issues arising from the audit of the Company's 2018/19 accounts, which led to tension over the request by RHE for an uncapped 'letter of comfort' from the Council as well as significantly delaying the production of the Council's final Statement of Accounts for 2018/19, which have necessitated a large number of amendments in respect of accounting for its relationship with RHE.

Additional loan – Dec 2018

In late 2018, RHE approached the Council for an additional £5m loan, in two tranches, to assist with its cash position over the winter. This was discussed at a meeting between RHE executives and relevant Council officers on 11 December 2018. At that time, the Council had the preliminary findings from PwC from a review of RHE's finances, and these flagged up significant concerns with the Company's financial performance in the first 6 months of 2018/19, its underlying cash position and the quality of its financial forecasts. The notes of the meeting record that the PwC views were discussed and recognised as early feedback, with a need for more input from RHE officers. They also record that the loan was agreed, subject to the need for a formal Council decision. The Strategic Director of Finance expressed concerns at that time about the risks involved in making the loan and the inadequacy of information provided by the Company. She was also clear that the normal level of assurance could not be provided from due diligence work because of the short timescales necessary and the continuing difficulties encountered in obtaining the necessary information from RHE. These concerns are well-documented in the decision-making report.

The notes also refer to the Council's concerns about the governance of RHE, and an action is noted for the Council's Director of Legal and Governance to carry out a review of it. It is not clear that this requirement was ever communicated to the Director of Legal and Governance and no specific review of RHE governance was carried out, although he was already involved in work to review company governance across the Council (as described later in this report). It would appear, though, that the fact that an RHE-specific review was not carried out at this stage was one of several missed opportunities to address the significant issues.

Overdraft facility – Jan 2019

In addition to the need for the new loan outlined above, the Company was seeking to agree an overdraft facility with its bank, but negotiations collapsed because the Council could not provide a copy of a particular document to be shared with the bank: as part of its due diligence process, the bank requested a copy of the record of the portfolio-holder decision to enter into parent company guarantees. As the report and the decisions made were exempt from publication by virtue of Paragraph 3 of Schedule 12A of the Local Government Act 1972, disclosure of those reports to Lloyds and their legal advisors would have given them more information than warranted to enable Lloyds to make a decision over a £3m overdraft. In that context the bank's legal advisors were offered a redacted version of the report. That was not acceptable to the bank.

Instead, the Council agreed to provide a short-term additional loan of £3m, due originally to be repaid within 3 months, although this expectation was not formally documented and appears not to have been communicated to RHE executives. In the event, this loan has not been repaid, and was converted to a long-term loan as a result of a decision of the Council's Executive Board in December 2019.

Proposed acquisition – Jan 2019

RHE entered into negotiations to acquire Our Power, an energy supplier with around 31,000 customers which collapsed in January 2019. RHE negotiated a purchase price of £1 but in order to be able to forward purchase energy for the increased customer base, RHE sought an additional Parent Company Guarantee (PCG) of £3m from the Council. The Council initially approved the acquisition, but subsequently, on the advice of the Strategic Director of Finance, rejected it because it believed that insufficient justification had been provided for the acquisition – indeed no formal written proposal was ever presented to the Council - and that the associated risks were too high. Our Power therefore went into the Supplier of Last Resort (SoLR) process instead.

This was the second occasion on which the Council had not authorised an acquisition which the Board of RHE supported, with the first having been a smaller opportunity in January 2018. The fact that the Our Power proposal was the second such example significantly worsened the relationship between the Council and RHE, putting strain on the governance arrangements. We understand that there were also disagreements in relation to proposals to secure additional external investment.

RHE 2018/19 audit – May 2019 onwards

The next significant events were related to the audit of RHE's 2018/19 accounts. The Company was due to produce draft accounts in May 2019 to form the basis of the Council's group accounts, with the audit of RHE then due to be completed in time for the final version of the Council's accounts, due to be signed off by us by 31 July 2019. Draft accounts were duly produced, showing a loss of £11.4m. RHE executives made clear to us and to Council officers that they did not wish this loss to be overtly referenced in the Council's accounts, because they did not want the market to be aware until later in the calendar year when, they hoped, the Company's performance would have improved. The Company would still be able to meet its own statutory deadline for filing its accounts of 31 December 2019. While we understand the reasoning, this discussion provides a good example of the potential conflicts between the commercial imperatives of running a company in a highly competitive market and the accountability requirements from being owned and funded by a public body.

In the event, difficulties in the audit process meant that the audit of RHE took around 10 months to complete, and to avoid being fined for late filing of its accounts at Companies House, RHE took a decision on 24 December 2019 to shorten its accounting period by one day, which automatically gave it another 3 months from that date to file its accounts.

During the lengthy period of the audit (May 2019 to March 2020), the relationship between the Company and the Council deteriorated, with the Company's request to the Council for an uncapped 'letter of comfort' being the main focus of the conflict. Where companies' auditors have concerns about whether a company has sufficient cash to meet its ongoing liabilities (ie about whether or not it is a 'going concern'), it is normal for them to ask the company to obtain some form of letter of comfort or even Deed of Guarantee from a parent organisation, in order for the directors to be able to prepare the accounts on a going concern basis, with this judgement having a significant impact on the valuation of the company's balance sheet. The Council had provided the Company with an uncapped letter in previous years, meaning that the Council was in effect agreeing to meet any liabilities the Company incurred. We expressed concerns about whether this was appropriate, especially given the Company's deteriorating cashflow position, and there was a process of negotiation between the Council and the Company about what level of financial support would be sufficient to allow the Company to be signed off as a going concern, and also whether the letter of comfort could be issued as a legally binding Deed of Guarantee.

Throughout this time, the Company was accusing the Council of delaying the audit by not providing the letter of comfort while the Council was not prepared to provide a letter of comfort because the Company had not provided it with appropriate cashflow forecasts to enable the Council to properly consider the level of financial support requested. In turn, the Company asked for a copy of the PwC report to feed into its considerations, and there were delays in this being provided to the Company. Amongst other occasions, this disagreement was demonstrated in successive meetings of the Council's Audit Committee in the Autumn of 2019, including a meeting at which the Committee had requested the Chief Executive and Managing Director of RHE to attend and explain the reasons for the delay in the finalisation of RHE's accounts.

In reality, issues concerning the letter of comfort did not lead to the delays in the audit – BDO made clear to us that there were a range of outstanding audit queries throughout this time waiting to be resolved between themselves and the Company.

BDO also had their own concerns about the robustness of the Company's cashflow forecasts, and took the unusual step of writing personally to each individual member of the Board on 2 December 2019 setting out their requirements in relation to the assessment of going concern and expressing concern about the delays in providing the information requested. The letter concluded by reminding each director of their statutory responsibilities as a director and suggested that they should take legal advice. This action by the auditor is very rare in the context of a local authority company and reflects poorly on the Company's governance and in turn on the Council's governance arrangements for the company.

Renewables Obligation – October 2019

A very significant cashflow crisis occurred in October 2019. As part of the regulatory regime established by Ofgem, energy companies which do not obtain green energy directly have to either trade their obligations with a green energy supplier or pass on to Ofgem, for redistribution, the premium which customers pay to them as part of their tariffs. This arrangement is known as ROCs (Renewable Energy Obligation Certificate) and for 2018/19 for RHE amounted to £9.5m.

ROCs payments had to be made to Ofgem within 6 months of RHE's financial year end. RHE's management were aware over the summer of 2019 that, although the majority of the cash for paying the ROCs had already been received from customers, it had been absorbed into the Company's wider cash position and was not available to make the payment. The need to make the significant payment was discussed by the Board, and hence known by councillors and the shareholder representative, but the Board was told by RHE executives that they intended to negotiate an instalment payment plan with Ofgem, and provided assurances that there was no cause for concern. This view was based on informal discussions with Ofgem and an understanding that other suppliers had been granted payment arrangements. Despite its potential magnitude, there is no evidence that this issue was flagged as a major concern within the Council by the shareholder representative or anyone else.

In the event, Ofgem were not willing to accept a payment plan and issued a statutory notice on 1 October threatening RHE ultimately with the loss of its licence if the ROCs payment was not made in full within 30 days. At this point, RHE approached the Council to ask for an urgent loan of £9.5m to enable it to make the payment.

This sudden request put Council officers in a very difficult position, and we had a number of discussions with officers at the time as to whether or not making the additional loan was sufficiently rational as to be lawful. At the time, the Council had not received management accounts from RHE for several months, the 2018/19 audit of RHE was still in progress and a number of significant issues were coming out of it about the company's finances. There was a significant risk that the Council was simply investing more public money into a failing company, but there was insufficient time to carry out meaningful due diligence research into RHE's finances.

However, the alternative was that, if the ROCs payment were not made, suppliers and customers would lose faith in RHE, with the result that rapid failure of the company could follow, and the Council would lose the value of its holdings in RHE and have to pay out on the Parent Company Guarantees, with a total potential loss highlighted by the Strategic Director of Finance of £47.4m.

As part of discussions, RHE provided the Council with an update on its financial position, in order to provide assurance that the risk of making the further loan was limited. This presentation stated that RHE was expected to make a profit of £3m in 2019/20 and provided a cashflow forecast which suggested that the £9.5m could be repaid in full by 31 March 2020, although this was the base case and there was a 'worst case' included which did not include repayments in this timescale.

In the event, officers determined that the loan could be made lawfully, because minimising the risk of immediate failure of the company was a reasonable, if unfortunate, justification. We did not disagree with this view. The additional £9.5m was provided to RHE at a market rate of interest, with payment of principal due to be made in its entirety by 31 March 2020. In the event, no principal repayments were made by that date because the Company did not have the cash available, and the forecast profit for 2019/20 has since become a £12m loss.

As part of the discussions on this crisis, the Council's Strategic Director of Finance commissioned PwC to carry out further investigations into RHE's finances. To strengthen governance arrangements within the Company, the Council arranged for one of its own solicitors to take up the Company Secretary role for RHE, and for its own Committee Services team to start minuting Board meetings. The shareholder representative was removed from the role by the Chief Executive and the role was given instead to the Corporate Director of Development and Growth.

It was because of this crisis that we took our initial formal audit action as set out in the Annex to this report, resulting in us making formal recommendations to the Council and discussing our concerns with the Council's Executive Board on 17 December 2019. Even at this stage, it did not appear that the Council fully recognised the magnitude of the risks that it was facing.

Additional loan request Nov/Dec 2019

Having categorically assured the Council in negotiations in October 2019 that there would not be any need for further cash injections, the Company again approached the Council on 12 November 2019, only three weeks after the Executive Board had granted the ROCs loan, with a further urgent request for an additional loan of £4.5m. This raised the same issues in terms of lawfulness as did the previous request, but by this time the Council had received PwC's report commissioned as a result of the previous loan request. This concluded that:

- RHE would require further cash support from the Council in future;
- the Company's cashflow forecasts had a number of assumptions and sensitivities within it totalling between £18 and 22m, amounting to around 20% of RHE's annual turnover;
- a detailed review of the debt position of the Company was required;
- a shortfall in income collection following the insourcing of the previously outsourced debt collection function had led to the deteriorating cash flow position of the Company;
- the current quality of financial planning and reporting and control at RHE was not giving the Council adequate foresight of underperformance in relation to financial results.

Following further discussions, it was determined that the immediate need for the loan could be avoided if the Council agreed to increase the percentage coverage of losses under the Parent Company Guarantees from 80% to 100%, thus increasing the Council's maximum exposure by £3m (from £12m to £15m). However, due to the uncertainties felt to be within RHE's cashflow forecasts, the Strategic Director of Finance obtained delegated authority from Executive Board on 17 December for an additional loan of £2.7m, to be drawn down if needed. This loan was provided to the Company in February 2020, in addition to the increased PCG coverage.

Recent events

In December 2019, the Board of RHE decided to suspend the Company's Chief Executive and its Managing Director of Finance. The Board, with assistance from the Council, secured an interim Chief Executive and an interim Director of Finance, initially for a period of three months but this has been extended. At the same time, the Council secured the services of a specialist energy consultant – who has held senior positions in major energy suppliers – to act as a retained advisor.

The audit of RHE's 2018/19 accounts was eventually finalised on 24 March 2020, with the loss of £11.4m reported in the initial draft accounts in May 2019 (and used in the draft of the Council's accounts) having increased to £23.1m. The original draft was predicated on a positive outcome to discussions on a number of accounting issues totalling £7m in value. The Council provided a letter of comfort capped to a value of £12.5m, based on the expected ROCs payment due in September 2020, and taking into account the cashflow forecasts prepared by the new interim management, which Council officers considered to be more robust and understandable.

The audit report included a 'material uncertainty' on going concern, drawing the reader's attention to the disclosure notes in the accounts around the existence of the 'letter of comfort' and the fact that RHE is only a going concern because of the Council's financial support.

Following the confirmation of RHE's financial results for 2018/19, the Council commissioned different consultants to explore options for the future of the Company, including seeking bids from the market. This process is still in progress: the Council is not committed to disposal, but obtaining information as to the current value of the Company in the market is clearly helpful in discussions about its future.

As we have previously made clear, the Council is entitled to make the policy choices that it has made in relation to RHE, and it is not for us as auditors to substitute our judgement for that of elected councillors. However, as with all the legal powers which local authorities are given, the power to invest in companies needs to be exercised reasonably, balancing the costs and risks against the benefits to local people and the local area. While we appreciate that the policy objectives of RHE, particularly those around tackling fuel poverty, are laudable, we question whether the costs already incurred and the continuing risks of the Council's involvement in RHE can now be seen as reasonable.

R1. Using the current Strategic Review and other appropriate advice to assist with decision-making, the Council should urgently determine the future of RHE, with options properly evaluated and risks properly assessed. This assessment should also take into account the context of the Council's current financial position.

The Council's governance arrangements for RHE

While we acknowledge the clear improvements made over the past year or so, overall, the Council's governance arrangements for RHE were not strong enough, especially given the specialist nature of the Company and the challenging and highly regulated markets in which it operated. In particular:

- There was an insufficient appreciation within the Council (as a corporate body) of the huge risks involved in ownership of, and investment in, RHE
- There was insufficient understanding within the Council of RHE's financial position, due to delays in provision and the quality and comprehensibility of the information provided
- There was insufficient sector (or general commercial) expertise at non-executive Board level
- There was a lack of clarity in relation to roles within the governance structure
- The arrangements did not establish an appropriate and consistent balance between holding to account and allowing the Company freedom to manage, and this worsened as levels of trust decreased.

Overall, the governance arrangements were overshadowed by the Council's determination that the Company had to be a success, and this led to institutional blindness in the Council as a whole to the escalating risks involved and to very significant risks to Nottingham taxpayers' money. The Strategic Director of Finance gave formal advice on numerous occasions, but this was not sufficiently heeded.

Roles and responsibilities

RHE Board

The governance arrangements for RHE were not dissimilar to those in operation in the Council's other companies. The Board of RHE was set up to be chaired by a councillor and with other councillors on the Board ensuring a councillor majority, but with no opposition councillors. Indeed for a fair proportion of its life, councillors have been the only non-executive Board members. For some of RHE's existence, but not recently, the Council's former portfolio holders for energy have been on the Board and the portfolio holder was chair until 2017. The Leader of the Council was also on the board from May 2016 to December 2018.

Between October 2017 and July 2019, the Chief Executive of EBICO also sat on RHE's Board, bringing additional expertise independent of the executive directors. Since he left the Board, there has been no-one with energy expertise to challenge the executives, although as noted above, a special advisor was brought in from December 2019 onwards, but is not a Board member. Longer ago, there was also a different special advisor in place between July 2016 and July 2017.

Overall, we do not think that the composition of RHE's Board has been conducive to good governance. A company operating in a highly competitive, highly regulated market needs non-executive members who understand that environment. It is clear that councillors who have been on the Board of RHE have taken their roles seriously and sought to understand that environment, but this is no substitute for having gained direct experience in that or a similar environment. While they were equipped to challenge the executives on more generic issues, it was not reasonable, given their backgrounds, to rely on them to be able to provide sufficient scrutiny of the operation of the Company, or to understand its finances. The availability of special advisors during 2016/17 did help to mitigate this, as has that since December 2019.

There were also risks in having the Chief Executive of EBICO on the Board, given that EBICO are in effect a customer of RHE, and at times the interests of RHE and EBICO would not be the same, although we have no evidence that this led to any specific issues.

The previous inclusion of the Council's successive executive councillors with the energy portfolio on the Board brought advantages in that the portfolio holder would be expected to understand more than other members about energy-related issues, and it provided a direct link from the leading group of members into RHE, as did the inclusion at certain times of the Leader and/or Deputy Leader of the Council. This helped ensure that the Council's policy priorities were being pursued and that the Company's aims were congruent with those of the Council. However, the strength of this linkage may also be a contributory factor in why governance and financial risks appeared to be given less of an emphasis. The Company became a de-facto extension of the Council.

More generally, it is not seen as good practice for councillors to be on the boards of local authority companies, with other mechanisms used to ensure that the company meets the Council's policy objectives. This reflects the above issues in relation to the expertise and experience of many councillors, and the potential for conflicts of interest between the councillors' commitment to the interests of the company, which has to override other interests when they are on company 'business', and their wider responsibilities as councillors. Having councillors on company boards can lead to a failure to properly separate the two sets of interest – of the company and of the Council – and it appears that this occurred in relation to the expectation that the Council would continue to fund RHE indefinitely.

While there is no evidence of such conflicts leading to any impropriety in relation to those councillors on the RHE Board, the difficult relationship between the Council and the Company, and the decisions faced in respect of increased council funding for the company during 2019, put the councillors into difficult situations.

As a minimum, the Council needs to consider the appropriateness of being as reliant as it is on councillors sitting on the boards of its companies and ensure that the boards have an appropriate level of sector-specific and commercial knowledge and experience; there may be some companies for which a higher proportion of councillors can still achieve this, although such arrangements still present risks around potential conflicts of interest. For a Company operating in a very specialised and regulated market like RHE, the proportion of outsiders with experience clearly needs to be higher.

The Council has offered training to its members who serve on the boards of its companies, but we were told that further training was needed. Overall, the Council needs to be aware that being on the board of a company, and especially one operating in a complex and highly-regulated market, with a turnover of around £100m and outside the Council's normal course of business, is a significant role which requires particular skills, experience and training.

R2. The Council should review its overall approach to using councillors on the boards of its subsidiary companies and other similar organisations. This should be informed by a full understanding of the role of and legal requirements for company Board members.

R3. Where it continues to use councillors in such roles, it should ensure that the non-executives (including councillors) on the relevant board have, in aggregate, the required knowledge and experience to challenge management. This is of particular importance where the company is operating in a specialised sector which is outside the normal experience of councillors.

R4. Where councillors are used in such roles, the Council should ensure that the councillors are provided with sufficient and appropriate training which is updated periodically.

Shareholder representative

For each company, the Council designated one of its senior officers as 'shareholder representative', with the intention that this individual ensured that the Council's (as shareholder) best interests were served and protected. For RHE, the shareholder representative was the Corporate Director Commercial and Operations, until October 2019 when he was replaced by the Corporate Director for Development and Growth. The role of the shareholder representative was not formally defined but was understood to require a balance between ensuring that the Council's policy aims were being achieved through the Company and also ensuring that the Council's financial stake in the Company was secure. It required effective two-way communication, and in relation to protection of the Council's interests required concerns to be raised with other senior Council officers, such as the Executive Director for Finance and the Council's Director of Law and Governance.

In practice, the shareholder representative role does not appear to have operated as the focus of the relationship between the Council and the Company. For example, when requests for financial assistance were made, these were made through an approach from RHE executives to the Council's Strategic Director of Finance, who then brought in other officers as appropriate – we would have expected the shareholder representative to be the primary focus for such requests and for him to discuss them with other Council officers. Conversely, we would have expected the shareholder representative to be the one applying pressure to the Company to provide appropriate financial information to the Council, but the Strategic Director of Finance in practice took the lead on this.

On the face of it, this may not appear to have significant practical consequences. However, not having a shareholder representative acting as a clear focal point for the relationship it is part of an overall situation in which the distinction between the Council and the Company was very blurred, with multiple communication channels (including those between councillors on the Board and the Council leadership, company MD to Council Strategic Director of Finance etc) and no clear overall mechanism for holding the Company to account. A properly defined shareholder representative role should have been the focus for that relationship and the channel through which the Company was held to account.

As the focus of the relationship, the shareholder representative role is ideally placed to be the Council's 'eyes and ears' in the strategic management of the Company, and in particular to highlight emerging risks (to the Council), referring these to other appropriate Council officers such as the Strategic Director of Finance and the Monitoring Officer, and ensuring that the Company is addressing these risks. The scale of the financial risks which emerged in relation to RHE, and the speed at which they emerged, suggests that the shareholder representative role did not fulfil this purpose.

Irrespective of the lack of clear definition of the shareholder representative role, we would expect any senior local government officer to recognise the very significant risks to public money which RHE came to represent, and to ensure that they were highlighted and to champion mitigation of those risks. We are not suggesting that the shareholder representative failed to identify the risks at all, but he appears to have not attached sufficient seriousness to them and to have prioritised instead the element of the role which was aimed at ensuring the success of the Company in accordance with political priorities. Arguably, this may be part of a more general tendency, which we ask the Council to reflect on later in this report, for legitimate challenge of political priorities to be viewed as inappropriate.

R5 The Council should ensure that all elements of its governance structure for companies, including the shareholder role, are properly defined and that those definitions are effectively communicated to the necessary individuals and are adhered to.

Shareholder meetings

In addition to RHE Board meetings, shareholder meetings were also held. These comprised a mix of Council officers and RHE Board members and were intended to ensure that a wider range of Council officers and members were aware of the issues being faced by RHE and the associated decisions. However, these meetings ceased formally in March 2019 in anticipation of the new arrangements being put in place following a review of company governance across the Council – but in the event the replacement member forum was not put into place properly for around 9 months. This should, however, have been mitigated by the existence of the shareholder role and the fortnightly meetings of the Steering Group.

Linkages between the Company and leading councillors and senior officers also existed through less formal means, with a range of ad hoc meetings taking place. These were strengthened in February 2019, when the Council's Chief Executive started leading a more frequent RHE steering group. When Cllr Mellen became Leader in May 2019, he and the Chief Executive agreed these meeting should be continued and they would alternate fortnightly meetings of officers and then member meetings with the Leader chairing the latter. Over time these meetings have merged into one the RHE Steering Group, solely chaired by the Leader.

For many councils, shareholder meetings are the key means through which subsidiary companies are monitored and overseen, particularly given that, as noted above, the inclusion of councillors directly on the boards of companies is not seen as good practice.

Audit Committee

We had specific concerns about the role of the Council's Audit Committee in relation to RHE, during 2019 in particular. As the member body responsible for oversight of governance, it should have been better sighted on the developing issues in relation to RHE. The Committee had previously identified the need to improve arrangements for the governance of companies in general, leading to the developments later in this report, and we are aware that some of its members did have concerns about RHE. However, the Committee did not pursue those concerns until we started reporting the emerging outcomes from our 2018/19 audit and the delays in RHE's audit.

An additional complication was that the then Chair of the Board of RHE was also the Chair of the Audit Committee from May 2019, leading to a very clear conflict of interest which took some time to resolve. With the Audit Committee in effect being part of the mechanism for holding RHE to account, at least in relation to governance, it was inappropriate for the Chair of the Board to also be Chair of that Committee. This was dealt with by the individual declaring an interest in the relevant items at Audit Committee, and handing the chair over to his deputy, although shortly after this, he ceased to be chair of the RHE Board. We are not suggesting that there was any actual impropriety on the part of the individual concerned but the arrangement potentially put him in a difficult position.

R6. When allocating roles on Council-owned organisations to individual councillors, the Council should ensure that the scope for conflicts of interest is minimised, with a clear divide between those in such roles and those responsible for holding them to account or overseeing them.

Overall governance

A successful relationship between a local authority and its subsidiary companies relies on achieving an appropriate balance between the authority on the one hand being sufficiently involved to hold the company to account and on the other hand giving it freedom to manage itself. Where the balance lies will vary between companies and over time, depending on the nature of the company and its performance, but this has to be in a clear framework and to be linked to the governance roles and structures that are put in place. Ordinarily, a council would set the overall aims of a company and approve its business plan and significant variations from it, and then monitor performance against this business plan by means of an agreed framework.

As part of an overall review of company governance arrangements (see later section of this report) instituted at the request of the Audit Committee in July 2017, the Council established a set of governance principles, reported 18 months later in February 2019, which sought to establish the framework for achieving this balance. The length of time taken to undertake this review and implement the improvements represents an important missed opportunity to address the governance of both RHE and other Council companies.

In the case of RHE, there had always been a closer relationship between the Council and the Company, given the composition of the latter's Board and the transfer of existing Council employees to the Company. Inclusion of councillors as the main non-executives on RHE's board mitigated against the healthy levels of separation which are normally seen between authorities and their companies. In turn, the lack of separation meant that more consistent strategic performance management arrangements were not put in place. This lack of an overall framework was a key omission in the Council's governance arrangements for the Company, and the delays in putting the framework in place reflect the low priority given to achieving healthy governance arrangements at that time.

During 2019, the performance of RHE in any case meant that more direct Council involvement was justified. This was achieved to an extent through the Chief Executive's Steering Group, supported by an increased number of ad hoc meetings. Some efforts were made to 'reset' the relationship between the Council and the Company but these were not sustained, partly because of delays in RHE providing information on its financial performance, tension around the 'letter of comfort' and the very significant urgent additional funding requirements in October and November 2019.

Overall, many aspects of the governance arrangements which the Council put in place were not dissimilar to those put in place for many local-authority controlled companies both in Nottingham and elsewhere, but there were crucial differences:

- the number of councillors on RHE's board (all from the ruling group)
- the lack of an established overall monitoring framework

- the limited clarity and robustness of the shareholder role.

The key point in relation to RHE, though, is that its complex nature meant that it needed much stronger governance arrangements. Many local authority companies are set up simply to do through a different vehicle things which the Council already does – for example grounds maintenance or, in Nottingham’s case, processing benefits claims. The skills to provide such services already exist in house and the markets for the services are, generally, far less complex and less competitive. It is not difficult for such companies to co-exist alongside a local authority with its public accountability and arrangements for safeguarding public money.

This cannot, however, be said for an energy company with a turnover of £100m. The next section of this report considers the risks that were inherent in the operation of RHE and the Council’s arrangements for managing them.

Management of risk

From a Council perspective, there have always existed a wide range of risks in relation to RHE, from the point of view of both achievement of its policy aims and also protection of the Council’s stake in the Company. It was always a high-risk project, in that it:

- sought to compete against established suppliers in a highly competitive market which was also susceptible to significant impacts arising from global economic and political events
- was conceived as offering low prices, thus requiring very tight control of costs and highly-effective purchasing of energy, in a complex market involving significant hedging, if it was ever to break even
- again because of its policy aims, had an inbuilt tension in relation to debt collection, with the normal debt collection policies of energy companies being seen as inappropriate as a means of tackling fuel poverty – but thus putting RHE at a competitive disadvantage. Similar competitive disadvantages arose because of the policy decision to implement the Warm Homes discount early.
- its target customer group were typically people who may need telephone support rather than web, and who were also more likely to be pre-payment meters or paying on receipt of a bill (rather than through regular direct debit), so that the ‘costs to serve’ were harder to keep low, and debt harder to control.
- was operating in a highly regulated market, where the energy regulator Ofgem has significant powers to revoke licences, set price caps and administer fines for breaches
- was set up as an ‘offshoot’ of the Council, using some key former Council staff, which meant it was culturally different to its competitors – perhaps an advantage in terms of its policy aims but a disadvantage in terms of effective competition. There were also related issues regarding the grading of posts within the Company.
- continued, as a local authority controlled company, to be bound by the additional governance and accountability requirements which rightly apply where public money is used, which may again have placed it at a disadvantage against its competitors.

Given these risks, it was vital that RHE had effective risk management arrangements in place and that, in turn, the Council had assurance that risks were being managed and that it managed the risks it faced itself as a result of owning the Company. Managing these risks was in itself made more difficult by the fact that RHE was operating in an environment of which local government officers had little knowledge and could not be expected to have such knowledge and experience. The level of the risks faced by the Council only increased as RHE expanded and the Council’s stake in it increased. A key additional factor in managing these risks is that the financial risks ultimately fall on the people of the City of Nottingham, but RHE’s customer base was national, albeit with preferential tariffs or discounts for Nottingham residents.

Overall, it appears that these risks have not been widely understood and managed within the Council as a whole, so that it did not perceive any prior warning of the significant deterioration in RHE’s financial performance in 2019. Some of this deterioration was due to external factors, such as changes to the price cap regime and fluctuations in wholesale energy markets, but such risks should always have been identified and mitigated or planned for as far as reasonably possible. Other factors, such as the deteriorating debt position, and hence cashflow, should also have been a major focus of attention for

those holding RHE to account, as well as to its management. While such issues have been discussed by RHE's Board, it is not clear that the Company's management were adequately challenged and held to account in that forum.

One specific opportunity which occurred for the Council to understand better, and mitigate, the risks it was taking occurred in the summer of 2018. Consultants, with significant energy sector experience, were commissioned by the Corporate Director Commercial and Operations on behalf of RHE, Bristol Energy, Nottingham City Council and Bristol City Council. This work was to assess the benefits which could be gained from closer working, and possible merger, between RHE and Bristol Energy, another local-authority owned energy supplier operating on a smaller scale than RHE. The report was considered largely by the shareholder representative and officers from Bristol City Council. However, other senior council officers were completely unaware of the report or indeed of the possible merger, and none of the messages within the report were shared among other Council officers, including with the Strategic Director of Finance.

This is significant because the report, produced by industry specialists, included findings which echo our views. Overall, it concluded that 'RHE's business model leaves it exposed to high costs and bad debt. Although the costs are being well managed and service levels are typical for the industry, the bad debt provision should be regularly reviewed, and the company needs to be confident around its appraisal of the risk related to its debt position.' It went on to suggest that RHE needed to:

- review its debt position and reassess the adequacy of the related provision
- tighten up financial reporting, including recognition of revenue
- increase the amount of energy expertise within RHE

In relation to RHE's future prospects, the report noted that:

'RHE has developed expertise in the low income and Social Housing Market. There are 5 million homes in social housing in Britain so there is plenty of market to win yet. This Business Model does have higher costs and although RHE have successfully broken even quite quickly, increased regulatory burdens from Smart, Price Caps, WHD (Warm Homes Discount) and ECO (Energy Company Obligation) will all add pressures to the business'.

It did also comment that RHE's basic operating model can be profitable and can deliver its objectives.

While the report resulted from an initial exploratory assignment and its conclusions should not be overplayed, we remain of the view, shared with current senior management of the Council, that this report was one of a number of missed opportunities to highlight risks identified in relation to RHE which subsequently had significant consequences.

R7. The Council should ensure that risks relating to its companies are considered for inclusion in its overall risk management processes, with appropriate escalation and reporting, rather than being seen in isolation.

Financial information

It has been a persistent concern for the Council's Strategic Director of Finance that the Council has not been provided with adequate financial information, and the information it has had has not been prompt. This was in part because the information, in the form of management accounts, was not being produced within the Company either, we understand due to staffing issues. We are aware that the Strategic Director of Finance raised her concerns over the lack of financial information persistently, but did not feel supported by the shareholder representative.

The low quality of financial information was also highlighted to the Council in at least two consultancy reports:

- As noted above, in the summer of 2018, one energy specialist consultancy reported as part of their report on a possible merger between RHE and Bristol Energy (another local authority owned energy company) that financial reporting needed to be improved, alongside a series of other improvements to RHE.
- In the autumns of 2018 and 2019, PwC reported as part of their assignments commissioned by the Strategic Director of Finance that the current quality of financial planning and reporting and control at RHE was not giving the Council adequate foresight of underperformance in relation to financial results.

This reflects the views of the Strategic Director of Finance and our experience of observing the unreliability and apparent 'optimism bias' within RHE's financial reporting and forecasts. While we recognise that recent years, and particularly 2018/19, have been difficult for all energy companies, the rapid deterioration in RHE's profit and loss and cashflow positions and the huge differences between predictions and outturn have been notable. Examples include:

- Within three weeks of being granted the additional £9.5m loan, RHE had to approach the Council again to request a further loan, despite having provided assurance that no further lending would be needed.
- The expected £3m profit for 2019/20 which RHE included in its presentation to the Council in October 2019 had become an expected £10.5m loss by late January 2020 (with the interim management in place)
- The cashflow forecast from October 2019 which predicted that the £9.5m loan could be repaid in full by 31 March 2020 was overoptimistic, as no principle repayments could actually be afforded within that timescale, although we note that the latter was foreseen in the 'worst case'.
- The Company said in November 2019 that it would not need any additional loans for the foreseeable future if the extended PCG coverage was agreed, yet the £2.7m loan which was approved at the time as a contingency (in effect without being requested by the Company) did have to be drawn down in February 2020 as the cash position deteriorated.

While the production of financial forecasts is a matter for the company and not the Council, it is vital for the Council's management of risks that the Council is presented with forecasts which it can understand and can rely on in order to advise members on appropriate action. This is the point which PwC were making in their report. The Council's governance arrangements, with their lack of clarity about roles and responsibilities and reporting lines, did not ensure that financial forecasts were appropriately challenged and understood. Such challenge appears to have been seen as a challenge of the legitimate policy objectives behind the company, rather than part of a healthy culture and governance systems in which challenge is welcomed and due regard is given the safeguarding public money, in this case that of Nottingham taxpayers.

The new arrangements being implemented by the Companies Governance Sub-Committee require the routine provision of financial information by all the Council's companies and are a positive development. What matters is not only that this information is provided, but that it is of an appropriate quality and is properly understood by Sub-Committee members and others charged with holding them to account, and that where information is not provided or is not understandable, robust action is taken to remedy the situation. We understand that this is starting to happen.

R8. As the new arrangements for monitoring companies are rolled out alongside the Companies Governance Sub-Committee, the Council should ensure that financial information is provided in accordance with its requirements and is fully understood by the Sub-Committee and others involved in holding the companies to account, and that robust action is taken, with the oversight of the s151 officer, if suitable information is not provided.

The council's governance arrangements for its other companies

In addition to RHE, the Council has controlling interests in a number of other companies and other organisations, giving it a much more complex group structure than most local authorities. The reasons for holding these companies vary, as does their lifespan. Nottingham City Transport has, for example, been a Council-controlled company for many years, having previously been part of the Council. Others have been set up more recently for specific purposes, including, in some cases, income-generation as part of the Council's 'commercialisation' agenda. The Council acquired an additional group company, Thomas Bow City Asphalt, in December 2019, and is considering setting up more.

Some of these companies are successful and appear well run, but this does not remove the need to the Council to have effective governance arrangements in place for them or to ensure that the lessons from RHE are applied more widely.

In July 2017, the Audit Committee recognised that improvement was needed in the Council's overall governance arrangements for its companies, and requested that officers should to identify best practice in local authority company governance with a view to proposing a framework for City Council owned companies. The scope of this work was confirmed in September 2017 and the outcome was reported in April 2018. It highlighted areas of good practice which were absent in Nottingham's arrangements. The Council recognised that it needed to strengthen the governance arrangements in place across its companies and further work was then undertaken and reported in February 2019. As a result:

- **A set of Company Governance Principles were agreed.**
- The principles set out that the companies would be provided with the necessary freedoms to achieve their commercial and operational objectives, while the Council would retain controls to enable it to protect its investment and ensure that objectives were met. It included expectations on information flow between the bodies and the need to enforce protocols so that decisions taken were for the benefit of the company and the Council group.
- **A new committee was proposed to provide member oversight**
- The Executive Board Companies and Commercial Committee was proposed. The board would have the following functions.
 - o To give direction to the Shareholder Board on the vision and ambition of the Council with reference to its commercial activities
 - o To review the implementation of the Council's commercial approach including its group companies in relation to development of the companies and the group
 - o To evaluate the impact of group companies and commercial activities on the achievement of the Council's strategic objectives
 - o To approve the Shareholder Board work programme
 - o To approve group company structure proposals and other formal structures to protect the legal and commercial interests of the Council as shareholder
 - o To review, by exception, outcomes achieved and delivered against the company governance principles and approve measures taken by the Shareholder Board to enable any deficiencies identified to be remedied.
- **A new officer board was also proposed**
- The Shareholder Board would include the Chief Executive, the Strategic Director of Finance, the Monitoring Officer and the Corporate Director of Commercial and Operations. The role of this board is to ensure that the Council's strategic objectives are met across the group and support the development of the group in line with the Council's regulations and ambitions.

However, progress in implementing the new arrangements has been mixed, with a significant delay in particular to the setting up of the new member forum.

The first meeting of the new officer Shareholder Board occurred in May 2019 and this has continued to meet on a monthly basis. The anticipated Companies and Commercial Committee has been replaced by a sub-Committee of Executive Board, the Companies Governance Executive Sub-Committee, which eventually had its first scene-setting meeting in January 2020 and its second meeting in May 2020 (with the delay being mainly due to Covid-19). The terms of reference of this sub-Committee, while focussing on the achievement of the Council's strategic objectives for its group, include responsibility:

- *'To approve group company structure proposals and other formal structures to protect the legal and commercial interests of the Council as shareholder....*
- *'To review, by exception, outcomes achieved and delivery against the Nottingham City council company governance principles and approve measures taken to enable any deficiencies identified to be remedied.'*

While it is early days in the operation of the Sub-Committee, and we see it as a positive step, we are concerned that, like other aspects of the governance arrangements, its effectiveness may suffer as a result of playing a dual role – as an executive function driving forward policy initiatives through the companies and as a scrutiny or monitoring function in safeguarding the Council's interests. It is vital that this latter part of the role receives due emphasis.

We understand that the original proposals for the sub-Committee envisaged the inclusion of a suitably experienced and skilled independent member but no-one was appointed. Such an appointment could have greatly strengthened to operation of the Sub-Committee by bringing in particular skills and experience.

The review of the Council's company governance arrangements proposed (in April 2019) for the first time a definition of the shareholder role:

'Their role will be to engage monthly (or more frequently as required) with the Company to ensure that it meets the Council's strategic objectives and

- receives from the group and
- provides to the group support towards development in line with the Council's policies and ambitions.'

It is noticeable that this definition does not include any element of safeguarding the Council's interests, but in other authorities with subsidiary companies this is a key element of the shareholder role. Given the example of RHE, where arrangements clearly did not ensure the Council's interests were adequately protected, the Council needs to consider whether the shareholder role should, going forward, be clearly seen to encompass first-line protection of the Council's investment in the relevant Company.

We have not assessed the governance arrangements for all of the Council's companies as part of our work, although we did assess them for a sample of organisations as part of our 2018/19 'value for money' work. For those we considered, we found that the governance arrangements were loose, with key information apparently not held by the Council and lack of evidence of effective monitoring of the companies. Recent proposals to the Executive Sub-Committee however, suggest that much more rigorous monitoring is starting to emerge, and this needs driving through.

We also noted that, of the seven group companies, only two posted an operating profit during 2018/19, and these were small, and more companies have been given significant additional loans by the Council, the ones other than RHE being:

- Nottingham City Homes £19.8m in 2018/19 – also £6.6m in 2019/20
- Enviroenergy £12m in 2018/19, nil in 2019/20
- Nottingham Ice Centre nil in 2018/19, £4.5m in 2019/20

In the light of our findings in respect of RHE, and the financial pressures which the Council is currently experiencing which mean it cannot afford any repetition of the RHE scenario, and recognising our view that some of the circumstances around RHE are unique, the Council needs to re-review its overall company governance arrangements robustly, ensure that the improved monitoring proposed to the sub-Committee is implemented and embedded and that other aspects of the arrangements are strengthened where appropriate.

R9 Within the new arrangements involving the Companies Governance Sub-committee, the Council needs to ensure that responsibilities for scrutiny and risk management are given sufficient prominence, including giving the Audit Committee explicit responsibility for scrutiny of governance and risk management across the group.

R10. In addition to those referred to in recommendations above, the Council should formally establish the lessons from its involvement with RHE and ensure these are addressed in a further review of its company governance arrangements, in particular to ensure that risks are appropriately flagged and managed, as well as successfully implementing the more robust monitoring agreed by the Companies Governance Executive Sub-Committee.

R11. As part of this review, the Council should consider the appropriateness of the definition of the shareholder role adopted in the 2019 report and give it an emphasis on protection of the Council's financial interests alongside other elements.

Wider governance issues

The Council's overall governance arrangements have not been within the scope of our work. Based on the situation we have described in relation to RHE, however, we would suggest that the Council needs to reflect on its overall governance arrangements, which are based on the 'strong leader and cabinet' model set out in the Local Government Act 2000, as amended, and associated guidance. The period during which RHE has existed has been characterised by very strong (in its general sense) and ambitious leadership within the Council, and this has enabled many successful policy initiatives to be driven through. However, in such a leadership model, it is vital that there are also sufficient checks and balances in place and in particular that risks are appropriately recognised and managed, that there is an effective scrutiny function and that challenge of political priorities by both members and officers is seen as a positive. This has not been the case in relation to RHE. We suggest therefore that the Council uses this opportunity to consider whether its overall governance arrangements continue to serve it well.

R12: The Council should use the experience of owning RHE to consider whether there are any lessons for its wider governance, particularly in relation to the 'checks and balances' which need to be in place, including the need for a stronger monitoring and scrutiny function and moving to a culture where challenge of policy priorities and how they are being implemented is seen as a positive.

Impact on the Council's financial position

RHE has impacted on the Council's financial position in two ways:

- Through lending large and increasing amounts of cash to RHE, the Council has had less cash available to it for other purposes, or alternatively has had to borrow more – although this has had only limited impact as the Council has ready access to additional PWLB borrowing where prudent
- Much more significantly, the impairments which the Council has now had to make to the values in its balance sheet relating to its equity investment, loans and other interests in RHE mean that it has significantly depleted its useable reserves, which means that those reserves are no longer available to be used to support Council services. The need to make significant savings in the running of services, either through service cuts or increased efficiencies, has thus been significantly increased directly as a result of the financial performance of RHE.

Accounting standards, which the Council is legally obliged to follow, require that the Council values assets such as loans made and equity investments taking into account not the original costs of the assets but the likelihood of them being repaid. Following the finalisation of the audit of RHE's 2018/19 accounts, which disclosed a loss of £23.1m for the year, almost 25% of turnover, and taking into account RHE's updated forecasts for 2019/20, the Council has reassessed the likelihood of repayment in accordance with appropriate accounting guidance and as a result its own revised accounts now include impairments of £10.5m on the £20.2m of loans and £7.5m on the £7.5m equity. This has effectively reduced the Council's reserves by £18m. At the same time, the Council has increased the liability value in respect of the Parent Company Guarantees which it has provided in respect of RHE, because there is an increasing likelihood of these being 'called in' by suppliers, and this has reduced the Council's reserves by a further £6.4m.

A further impairment of £7.9m has been required in 2019/20 to reflect the continuing deterioration in RHE's finances. It is also likely that there will be a further cost in 2020/21 once the future direction of the Company has been determined.

This has occurred at a time when the Council's finances are already under pressure as a result of the additional costs and lost income due to Covid-19. The Council has some hard choices to make and cannot afford to become involved in further risky initiatives without very robust risk management arrangements in place.

R13: The Council should ensure that it reflects the financial pressures arising from RHE alongside those from covid-19, demand-led services and other areas to produce balanced and achievable financial plans for the current year and for the medium-term, without disproportionate, unsustainable reliance on one-off measures.

Annex - Previous audit action

We were appointed as the Council's auditors with effect from April 2018. Towards the end of 2018 and throughout 2019, we had a range of concerns about the arrangements the Council had put in place in relation to its interests in RHE and, specifically, in the arrangements for managing the significant financial risks which the Council was taking though that involvement. As noted above, our audit of the Council's 2018/19 accounts was significantly delayed because RHE's own auditors, BDO, were unable to give their opinion on the Company's accounts, which are consolidated into the Council's accounts and therefore impact on our audit responsibilities.

We expressed our concerns in the latter half of 2019 to senior officers and to the Council's Audit Committee, but these discussions were not in public because we were concerned that any public discussion of our views on the levels of risk that the Council was taking, linked to the Company's financial position, could in itself lead to a rapid deterioration of the Company's position (eg through trade credit facilities being withdrawn, loss of customers and even possible regulator action), which could have led to an uncontrolled collapse of the company and rapid crystallisation of the Council's financial risks.

Following the provision of the urgent additional financing to RHE in October to enable it to make its Renewable Energy Commitments payment to Ofgem, we decided that it was appropriate for us to make formal recommendations to the Council to draw attention to the level of risk faced and encourage it to take further action to manage those risks. Ordinarily, we would have made Statutory Recommendations under Section 24 (check) and Schedule 7 of the Local Audit and Accountability Act 2014, which have to be considered by the Council in a public meeting and to which a public response is required from the Council. We determined, however, that it was not in the public interest at that time for such consideration to be made public, and we therefore agreed with the Council that it would treat our recommendations as if they were Statutory Recommendations with the exception of meeting the publicity requirements.

In a letter to the Leader of the Council dated 2 December 2019, we stated that:

As your external auditors, we have become increasingly concerned about the overall increase in the level of risk to which the Council is exposed and the rationality, and therefore lawfulness, of decisions to provide additional financial support. These decisions have had to be made in short timescales and in the absence of a sound understanding of the Company's financial performance and forecasts. This has meant that the only justification for providing the additional support has been in order to prevent an uncontrolled failure of the Company and hence to protect the Council's existing loans and guarantees. If the Council is to provide any further support to the Company, it needs to do so not just to protect the existing investment but also in the light of a rounded assessment of the Council's policy objectives for the Company, the prospects for the Company and the level of risk which the Council believes is appropriate to take in the light of the policy objectives. Continuing with the sole aim of protecting the Council's existing loans and guarantees is not a rational position other than in the very short term.

And made the following recommendation:

The Council should, taking account of all relevant information including the analysis provided by PwC, determine a clear direction for its future relationship with Robin Hood Energy, including:

- *reconsidering or reaffirming the Council's policy objectives in relation to its interests in RHE*
- *ensuring that the level of financial risk the Council is carrying is consistent with the policy objectives and with the Council's fiduciary duty to local taxpayers*
- *implementing, in the light of these decisions on policy and risk, measures to reduce the level of risk to the Council, which could range from retaining the current level of financial involvement with the company but with much stronger monitoring and governance arrangements through to full disposal of the Council's interests or a controlled winding up of the Company.*

The Council considered the recommendation at the private meeting of Executive Board on 17 December 2019. We were not provided with a formal written response to the recommendations, but the minutes of the meeting record that it was resolved to:

(1) Note the recommendations made by the NCC external auditor.

(2) Note the position of RHE's external auditor

(7) To approve the necessary actions to respond to NCC's External Auditor recommendation;

(8) To approve a full options appraisal regarding the future structure of the Company;
