Agenda Item

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Shetland Islands Council

Harbour Board	**26 November 2014**
Policy & Resources Committee	**26 November 2014**

Sella Ness Port Operation – Financial Modelling	
F-074-F	
Report Presented by Executive Manager – Finance	**Corporate Services**

1.0 Summary

1.1 As part of the work undertaken on the Long Term Financial Plan, a specific piece of financial modelling has been completed to estimate future surpluses from the Sella Ness Port (the "Port") operation.

1.2 The initial results estimate that if the Port is managed carefully from a financial point of view, it would make a net contribution to the Council's Reserve Fund over the period 2014-2050.

1.3 However, based on an initial comparison between the likely future surpluses generated from retaining the Port, and the cash flows that could be generated if the Port was sold with the proceeds invested with fund managers, the latter option represents a better financial outcome for the Council.

2.0 Decision Required

2.1 That the Harbour Board RECOMMENDS that the Policy & Resources Committee RESOLVES to approve that a further report be presented in 2015 upon completion of the additional work required in order to provide the Council with updated and more robust financial modelling.

3.0 Detail

3.1 The Medium Term Financial Plan was independently reviewed during 2013 by SOLACE Enterprises. One recommendation that came out of this work was that the Council should undertake a Long Term Financial Planning exercise. Over the past 12 months the Finance Service has been leading on preparing this piece of work which will be presented to Council on 3 December 2014.

3.2 One important strand of the work was to undertake a financial modeling exercise on the future cash-flows of the Port in order to determine the level of surplus that it could contribute to funding Council services in the future.

3.3 It is not possible to place significant reliance on a forecast of future revenues up to 2050 as a result of the number of variables and external factors that could impact upon it. However the exercise provides an indication of the likely future direction of the Port if it continues to operate as it currently does into the future. It also highlights the financial risks around continuing to operate the Port.

3.4 The model has been reviewed by SOLACE Enterprises Ltd which has confirmed that the model is competent. The model has also been reviewed by officials at Scottish Government who also commented that the model was technically sound. However, a key piece of feedback from the Scottish Government was that the income data entered into the model relies on information from BP and it would be beneficial to contract a private oil and gas analyst to provide an independent view on future throughput projections for the Sullom Voe Terminal (SVT).

3.5 This work has been commissioned, and upon its completion the future throughput projections will be worked through the financial model.

The Approach

3.6 The financial model covers the period 2014-2050, which matches what the industry has indicated is the remaining lifetime of SVT.

3.7 There are a number of key assumptions in the financial modelling as set out below –

- The Port and associated assets remain 100% owned and operated by Shetland Islands Council;
- Jetties 1-4 remain a BP funded assets;
- Assumes that BP continues to require a 24 hour a day, 7 day a week operation for the remaining life of the Port, and therefore staffing levels remain at the same level;
- The terms and conditions of the Sullom Voe Agreement remain unchanged;
- Harbour dues are increased by inflation each year;
- All capital investment estimated to 2050 is fully included in the model;
- Employee costs and operating costs are inflated annually;
- Used BP estimates for tanker numbers up to 2025/26 and then a straight line reduction each year until there are none in 2050;
- Decommissioning of the Port will cost the Council £13 million.

3.8 The financial model was prepared in Spring 2014 and has been discussed with the oil industry formally at a Sullom Voe Association meeting in May 2014.

3.9 The model has subsequently been externally reviewed, but will require to be fully updated once the independent throughput projections have been obtained.

3.10 SOLACE Enterprises Ltd also undertook a review of different options for the Port based on the financial model – attached at Appendix 1.

3.11 After this initial report had been produced, the Executive Manager – Finance explained that in the event of an outright sale, the proceeds would be invested with fund managers and the Council would use the 7.3% average annual investment return to supplement service expenditure. As a result SOLACE Enterprises Ltd produced a second supplementary report – attached at Appendix 2.

3.12 In addition the financial modelling exercise, Finance Services commissioned SOLACE Enterprises Ltd to undertake a company valuation exercise to determine what a fair value sales price would be for the Port. The calculation was based on the cash flows in the financial model, and are therefore subject to change if the independent throughput projections differ significantly from those provided by BP.

3.13 The assumption made on the sales option is that the proceeds would be invested with the Council's fund managers, and the Council would seek to make an annual return.

The findings

3.14 SOLACE Enterprises Ltd estimate that the Port has a sales value of £71.7m based on the information in the financial model.

3.15 The table sets out the future cash flows (in today's prices) available to fund services in the period to 2050 under the financial model for continuing to operate the Port and under the scenario of selling the Port and investing the sales proceeds with fund managers.

	Financial Model – Continue operating Port in current format	**Sell the Port and invest the proceeds**
Total Net Positive Cash Flows (NPV) to 2050	£101.8 million	£197.9 million
Annual average amount	£2.8 million	£5.3 million

3.16 Further work is required to refine the assumptions and update throughput projections, but the difference in future available cash between the two scenarios is £96.1 million.

3.17 Expressed another way, it will cost the Council £2.5m per year for the next 37 years for the right to operate the Port, as opposed to selling it.

3.18 Therefore, it would take a significant change in assumptions for the exercise to show that retaining the Port is the most financially beneficial approach that the Council could take.

The Conclusions

3.19 The initial conclusions from this first piece of work is that it would be financially beneficial for the Council to sell the Port if it could achieve the fair value valuation.

3.20 Further work is required to sharpen the financial modelling so that there is better quality information on which Members can make a decision about the future of the Port

3.21 The sensitivity analysis undertaken on the Port financial modelling highlights the high level of volatility in this industry, with small changes in assumptions leading to significant changes in future net cash flows.

3.22 The modelling highlights the level of financial risk associated with the ongoing running of the Port as a result of the size of the future cash flows that were modelled in relation to the size of the Council's net general fund budget of around £110 million. The total cash flows in the model total £1.36 billion which is 12 times the entire annual budget of the Council. Therefore relatively minor variations against the assumptions in the model could have a big impact on the general fund which relies on the Port's forecast surpluses.

3.23 Further information on risk is set out in the risk management section of the report.

4.0 Implications

Strategic

4.1 Delivery On Corporate Priorities
The decision over the future of the Port will have significant financial implications and have a bearing on future funding levels available to fund services in line with corporate priorities.

4.2 Community /Stakeholder Issues – The Council has had initial discussions on the model with the oil industry, Scottish Government and shortly the UK Government. Further engagement will be necessary once the financial model has been updated early in 2015.

4.3 Policy And/Or Delegated Authority
The Harbour Board has responsibility for providing strategic oversight in relation to all aspects of the Council's harbour undertaking. The Policy and Resources Committee has delegated authority for securing the control and proper management of the financial affairs of the Council.

4.4 Risk Management
There are no risks arising directly from this report, but the early work undertaken highlights a number of risks around this exercise and also around the Council's operation of the Port.

The financial modelling exercise

4.4.1 The obvious risk is around the imperfect information that will be available to Council when it takes a decision whether to retain the Port, and in what form, or sell the Port.

4.4.2 If the Council decided to sell the Port it is possible that the actual performance of the Port could be better than forecast meaning that a) the Council could have achieved a higher sales value and b) the Council may have been financially better off by retaining the Port.

4.4.3 If the Council decided to keep the Port based on the financial modelling exercise, the actual performance of the Port could be significantly poorer than forecast, meaning the Council was worse off as a result of maintaining ownership of it.

Key Financial Risks arising from operating the Port

4.4.4 Throughput – the single biggest factor in the financial model is the amount of income that the Port will generate from the Council based on the Port's throughput. This is a volatile source of income as a result of the numerous factors that influence it, none of which the Council has any ability to control at all. For example, oil prices, the rate at which new technology is developed to make extraction profitable, the potential for increased FPSO to market transfers thereby avoiding the SVT will all impact on throughput levels.

4.4.5 Operating model – the Port's operating model requires a 24/7 operation using specialist staff. This is expensive and has the potential to become more so in future if staff need to be brought into Shetland to provide the service.

4.4.6 Capital investment required – significant sums of capital investment are required in order to keep the Port operational into the future. However, because of the uncertainty around future profitability, there is no guarantee that an investment return will be made on any capital expenditure.

4.4.7 Losses in the later years of operation – the model indicates that the Port will operate at a loss in later years as reducing throughput and tanker movements mean the falling income is insufficient to cover the fixed costs of operating the Port. It is unclear how significant these losses might be so the Council carries a risk that they may be greater than have been budgeted for.

4.4.8 Reinstatement Costs – again the model estimates what the costs of reinstatement of the site might be for the Council, but again there is a lack of clarity around this, which presents the financial risk that the costs might be higher than budgeted for in the model.

4.4.9 Litigation – if operational accidents occur there is a potential for the Council to suffer financial loss as a result of litigation.

Key Non-Financial Risks arising from operating the Port

4.4.10 Environmental – if an environmental accident occurred the Council could be held responsible, both legally and with the public, for damaging Shetland's natural environment.

4.4.11 Workforce issues – there are a number of workforce issues regarding the Port such as terms and conditions of staff, succession planning and industrial action issues. Also, due to the nature of the work, there is the potential for serious injury or death of staff employed by the Council.

4.5 Equalities, Health And Human Rights – None.

4.6 Environmental – None.

Resources

4.7 Financial - There are no direct financial implications arising from this report for noting. However, upon completion of further work in early 2015, the Council will have sufficient information to start to form a view on the approach that it wishes to take with regard to the future of the Port. There will be significant financial implications as a result of any decision owing to the large amounts involved.

One key point that should be made is that the Port does not exist to provide services to the public. It should therefore not be treated like any other Council service like the ferries service. Instead it should be treated as a business with its sole purpose being to make an investment return for its owners – the Council. Therefore any decision as to whether to retain or sell the Port or whether to make future investment of capital should all be based on the principles of profitability.

The cost of the SOLACE consultancy was £9,174 for the 2 reports. This was met from within the 2014-15 Finance Service budget.

4.8 Legal – None arising directly from this report.

4.9 Human Resources – None.

4.10 Assets And Property – None.

5.0 Conclusions

5.1 Early indications suggest that the Council would be financially better off in the future if it were to sell the Port at fair value rather than continue to operate it into the future.

5.2 This course of action would also reduce the amount of financial and non-financial risk that the Council faces currently by operating the Port.

5.3 Further work is required to ensure that any future decision made by the Council is based on the most robust evidence available. Therefore a further report will come forward in 2015 which will include updated and more robust financial modelling.

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List of Appendices
Appendix 1 – Review of Sullom Voe Financial Projections & Options – An independent appraisal by SOLACE

Appendix 2 – Practical Considerations of Status Quo v Sale Option for Sullom Voe – A brief supplementary report by SOLACE Enterprises