Shetland Islands Council

Practical Considerations of Status Quo v Sale Options for Sullom Voe

A Brief Supplementary Report by

SOLACE ENTERPRISES

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Likely "Real World" Decision Making when Considering Retention v Sale

OVERVIEW

1. This report is supplementary to our recent analysis on the various financial outcomes for the Port at Sullom Voe.

2. It arises from discussions and subsequent emails with the Chief Financial Officer of the Council.

3. The original main report presented the results of potential options on a commercial basis. This used the concept of Net Present Value (NPV) and Discounted Cash Flows (DCF) to arrive at a value for each option presented at today's values. The advantage of this approach is it allows options to be considered on a consistent basis so the most financially advantageous decision can be selected.

4. While the approach is robust, sound and in line with commercial investment appraisal techniques, it does not take a "real world" view of how the various returns will be invested in Shetland Islands Council (SIC).

5. Therefore, we have undertaken some additional work to establish the financial outcomes of comparing the Status Quo v Sale options based on how surpluses will be invested by SIC.

6. Two specific aspects have been brought into the overall financial picture:-

    - **Status Quo Option**: Assume surpluses from the Harbour Account are spent in full in the year in which they are generated; and

    - **Sale Option**: If the Port is sold for c£72m, proceeds would be invested with fund managers to generate an average return on capital of 7.3%. Of the 7.3% generated each year, 2.5% is set aside for inflation, and the balance (equivalent of 4.8% return on capital each year) would be spent. Also, the Council wouldn't spend any of the c£72m sale proceeds.

7. The revised modelling work uses a slightly higher discount rate of 7.3% (in line with the return on capital rate) and 2.5% for real terms calculations.

STATUS QUO OPTION: SURPLUSES SPENT IN FULL

8. A revised Appendix B model has been produced showing the NPV position if all surpluses generated are spent in the year they are earned (this includes "spend" on the creation of an Equalisation Account). On this basis, a negative NPV of £14.5m arises (see worksheet "Sullom Voe Model"). The NPV represents the discounted value of cash deficits arising from 2039/40 onwards totalling £154.1m.

9. In terms of the funding position (see worksheet "Cash Funding" in Appendix B), it's effectively neutral for the Council. No interest is receivable as surpluses are spent as they are earned. No interest is payable as it is assumed the Equalisation Reserve will be utilised to finance deficits in later years. In reality, the situation is more complex, but a simple position is outlined here for ease of calculation.

10. Cash Investment in Council services is £101.8m over the period in real terms (includes adjustments for future deficits funded from the Equalisation Account).

11. A list of assumptions is also contained in the "Cash Funding" worksheet along with calculations of the investment in Council services (expressed in cash and real terms).

SALE OPTION: PROCEEDS RETAINED BUT 4.8% NET FUNDS MANAGER RETURN SPENT

12. A revised Appendix F model highlights if the Port is sold for £71.7m and proceeds are invested with fund managers to generate an average return on capital of 7.3%. Of the 7.3% generated each year, 2.5% is set aside for inflation cover, and the balance - equivalent of 4.8% return on capital each year – is spent on Council services. Moreover, the Council wouldn't spend any of the £71.7m in capital – in other words it is retained in real terms value.

13. In contrast to the status quo, a positive NPV is generated of £12.2m. This approach also allows for a real terms investment of £126.2m in Council services while retaining the real terms value of the original sales proceeds (£71.7m).

14. Again, worksheets "Sullom Voe Model" and "Cash Funding" contain the relevant detail and assumptions made.

CONCLUSION

15. These latest calculations take the previous financial outcomes and consider the results in the context of the "real world" workings of the Council.

16. On the basis of likely reality and on purely financial terms - selling Sullom Voe, investing the proceeds and spending the net investment return (after inflation proofing) on Council services, results in a better financial outcome than retaining the Port and spending all annual surpluses on services.

17. As the Council intends to use an Equalisation Reserve to provide for future deficits, the cash impact is neutral on the status quo basis over the period.

18. In contrast, the sale option is able to fund Council services in real terms of

£126.2M over 37 years (against £101.8m for the status quo) while retaining a real terms cash balance of £71.7m throughout (the original value of the sale proceeds).