# Shetland Inter Island Transport Study

## Financial Review

On behalf of **Shetland Islands Council**

Project Ref: 35580 | Rev: SC | Date: February 2016

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# Document Control Sheet

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| | Name | Position | Signature | Date |
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| **For and on behalf of Peter Brett Associates LLP** | | | | |

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| 1 | 16/02/2016 | SIC Comments | Dr Scott Leitham | Stephen Canning | Stephen Canning |
| | | | | | |

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# 1 Introduction

1.1.1 This paper provides an overview of the financial issues surrounding the provision of inter-island ferry and air services by Shetland Islands Council ("the Council"). It:

- outlines the recent financial history of the Council since the mid-1970s when oil-related income created a material change in the Council’s financial position, and the impact of the reduction in oil-related income;
- describes the current Council budgetary position and the projected medium term budgetary position;
- outlines the current inter-island ferry service financial position;
- outlines the current inter-island air service financial position; and
- draws conclusions as to the implications of the above for the ongoing funding of air and ferry services.

# 2 Recent History

## 2.1 Overview

2.1.1 The Council's **Long Term Financial Plan (2015-50)** provides a short history of the Council's finances since 1975 which outlines how the Council came to its current financial position.

2.1.2 From the mid-1970s the Council generated a large surplus from oil related income which was invested and used to fund capital projects. Oil related income reduced from the late 1980s to a very low level by the late 1990s. With the reduction in oil related income, by the mid-1990s capital spending was in excess of oil related income meaning that the reserve was being depleted. By the mid-2000s revenue spending was in excess of the available funds and this shortfall was funded from the reserve. Had this situation continued, the reserve would have been exhausted within this decade. In 2015/16 the Council is operating a sustainable budget (where the capital value of the reserves is maintained) – the first time this has been the case since the 1990s. As capital spending has reduced from over £100m per annum to circa £15m the funds previously available to fund inter-island vessels and infrastructure has diminished rapidly.

2.1.3 The accelerated capital spending of the 1970s and 1980s has created a significant asset base. The challenge for the Council is the ongoing revenue costs associated with this and also the implied capital costs of replacing life expired assets.

### Income

2.1.4 During the 1980s the Council earned an average of more than £100m each year directly from the oil industry's presence in Shetland. Today the Council's only direct source of income from the oil industry is the Harbour Account, where the biggest challenge is currently to avoid making a loss on its operations.

2.1.5 Between 1974-75 and 2011-12 the Council received direct net income of approximately £1.6 billion (in 2012 prices) as a result of the oil industry presence in Shetland. The bulk of this was received during the 1980s. With the pooling nationally of National Non Domestic Rates income (over half of oil related income at that stage) and a reduction in throughput at Sullom Voe, this figure dropped to £300m over the past 20 years.

2.1.6 The figure below shows the timeline for direct oil-related income over the period 1975-2012.

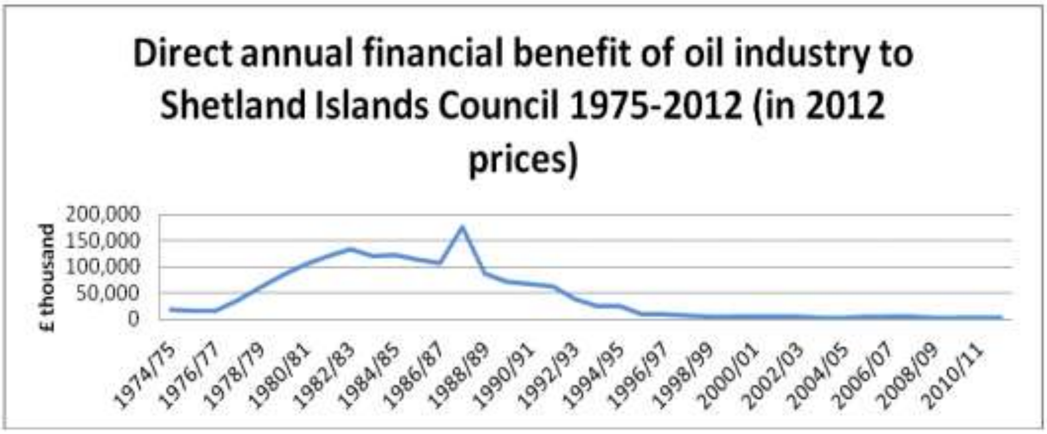



**Figure 2.1: Direct Oil-Related Income, 1974/75-2010/11**

2.1.7 During this time, a further £900m was generated (2012 prices) from investment returns on excess cash. This equates to a total of £2.5bn of oil-related income since 1975.

2.1.8 Part of the reason for the tail off in oil related income is that most of the original deals based on Sullom Voe throughput expired in 2000.

## Capital

2.1.9 In the light of this new oil-related income SIC invested heavily in capital projects to update the Islands' infrastructure (including the inter-island ferry service). This averaged £100m per annum in the second half of the 1970s, £40m per annum in the 1980s reducing to £28m in the 2000s. In 2014/15 the capital budget was nearer £10m.

2.1.10 The figure below shows the level of capital expenditure over this period.

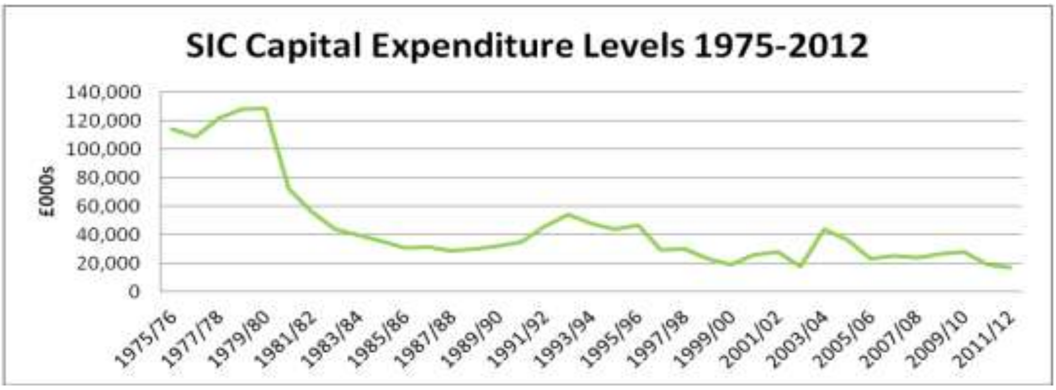
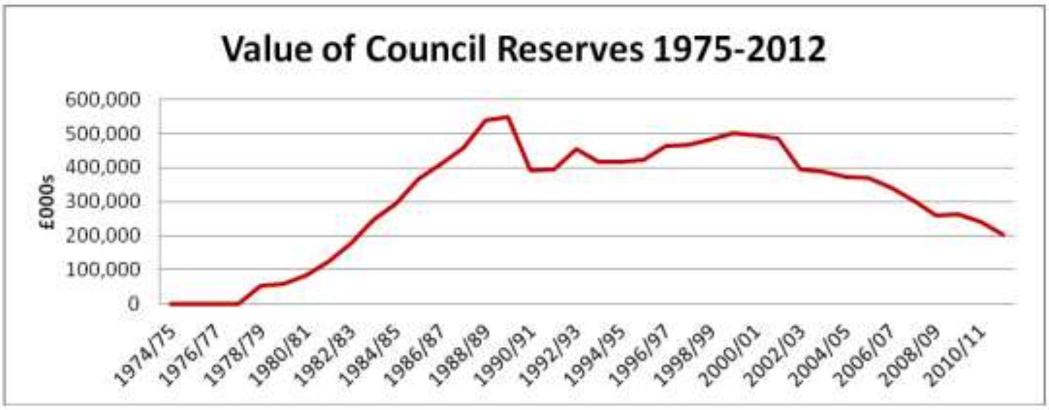



Figure 2.2: Capital Expenditure, 1975/76-2011/12

## Reserves

2.1.11 The Council began to grow reserves from the late 1970s as income from the oil industry exceeded spending levels meaning there was excess cash. As income from the oil industry declined towards the end of the Millennium, spending levels did not decrease in proportion, meaning the reserves declined by 60% between 2000 and 2012.

2.1.12 The figure below shows the value of the Council's reserves over this period.




Note: Steep decline in 1990-91 represents Shetland Charitable Trust reserves being separated from the Council's reserves for reporting purposes.

Figure 2.3: Council Reserves, 1975-2012

2.1.13 The Long Term Financial Plan describes the evolution of the reserves fund as follows:

2.1.14 During the 1980s:

- High level of income from oil industry (over £100m per year).
- High capital expenditure (£40m per year).
- Overall significantly more income generated than expenditure incurred.

2.1.15 During the 1990s:

- Decreasing income from the oil industry but still significant (£25m per year).
- High reserves level generating significant investment returns (£20-25m) per year.
- High capital expenditure (£37.5m per year).
- More income generated than expenditure incurred, but a narrowing gap as the decade progresses.

2.1.16 During the 2000s:

- Significant tailing off in income from oil industry (£4 million per year).
- Falling investment income as the capital value of the reserves erodes averaging £25m per year in 2000 but declining to £10m per year by 2012.
- Capital expenditure reduces but remains high (£28 million per year)
- From 2007 onwards, revenue expenditure increases significantly above available resources, requiring deficit funding from the reserves
- More expenditure than income over the period results in the reserves decreasing by 60% over a 12 year period.

2.1.17 The Long Term Financial Plan short financial history concludes with the following:

- The high level of capital expenditure during the 1980s was only affordable because of the income generated from the oil industry.
- Attempts to maintain capital expenditure at high levels during the 2000s when oil income fell has contributed to the decline in the reserves value.
- Oil income is set to remain low into the future but 1980s and 1990s capital expenditure levels will be required in the future to sustain the Council's existing asset base as old assets are decommissioned and require replacement.

2.1.18 The Council's 'Review of Council Spending 2003-13' was undertaken to address the issue of the 'structural' deficit. In this nine year period, there was a large increase in General Fund Revenue spending (30%) when the increase in income to the Council was only 3%. This led to a net draw on reserves on General Fund expenditure varying between £22m and £40m, and a diminution of reserves by nearly 60%.

2.1.19 In the decade between 2003 and 2013 the Council was therefore running an unsustainable deficit which was funded from reserves and surpluses on eg Harbour activities. Had this position continued, the oil-based reserves built up by the Council would have been depleted within a decade (it was estimated in 2013 that these reserves would be depleted by 2017). In recognition of this and also in the light of reductions in grant income from Scottish Government, the Council took a different direction from 2013 and approved a sustainable budget in 2015-16. The policy now is to maintain the capital value of the reserves by only drawing on the return on these reserves investment.

# 3 Current Council Financial Position

## 3.1 Revenue

3.1.1 The principal sources of income are the (i) General Revenue Grant (GRG) from the Scottish Government, (ii) a share of the pooled Non-Domestic Rates and (iii) Council Tax.

3.1.2 Grant Aided Expenditure (GAE) is the means of allocating the pre-determined Spending Review funding totals equitably amongst local authorities. The Scottish Government Green Book notes that in 2015-16 the Council's allocation is a total of £68.047m in '*GAE – Estimated Service Expenditure*'. This includes a '*Special Islands Needs Allowance*' of £5.949m (this factor is unrelated to ferries or air services). A component of the GAE settlement is a recognition that the Council has to support inter-island ferry and air services. In 2015/16 this amounts to **£6.755m** for '*Support of Ferries*' and **£0.705m** for '*Support of Airports and Harbours etc*'. The Scottish Government set an overall local authority budget for each of these items (£13.027m for ferries and £3.035m for airports and harbours) and the percentage allocation of the overall budget in a given year is based on average spending in the previous two years by each local authority. GAE is used to calculate the General Revenue Grant, one of the three sources of Scottish Government funding to local authorities.

3.1.3 The Scottish Government provides Local Government Finance Circulars which detail the General Revenue Grant funding using the base GAE calculations, adjusted for other factors such as support for servicing outstanding debt and protection against large year-on-year changes through the use of a funding floor. The latest Local Government Finance Circular, No 7/2015 informs that for 2015/16 the revenue settlement to the Council is as follows:

- Non Domestic Rates: £17.454m
- GRG: £69.582m
- **Total: £87.036m**

3.1.4 The equivalent total revenue settlement figures for 2014/15 and 2013/14 were **£86.674m** and in **£86.957m** respectively.

3.1.5 Council Tax income for 2015/16 is budgeted at £8.421m bringing total core funding to **£95.457m**. Income from Council Tax is currently stable.

3.1.6 The graphic below shows how Council funding from the Scottish Government (NNDR & GRG) rose rapidly prior to the crash before dropping sharply. The red bars are recent projections produced by the Council to 2020/21.

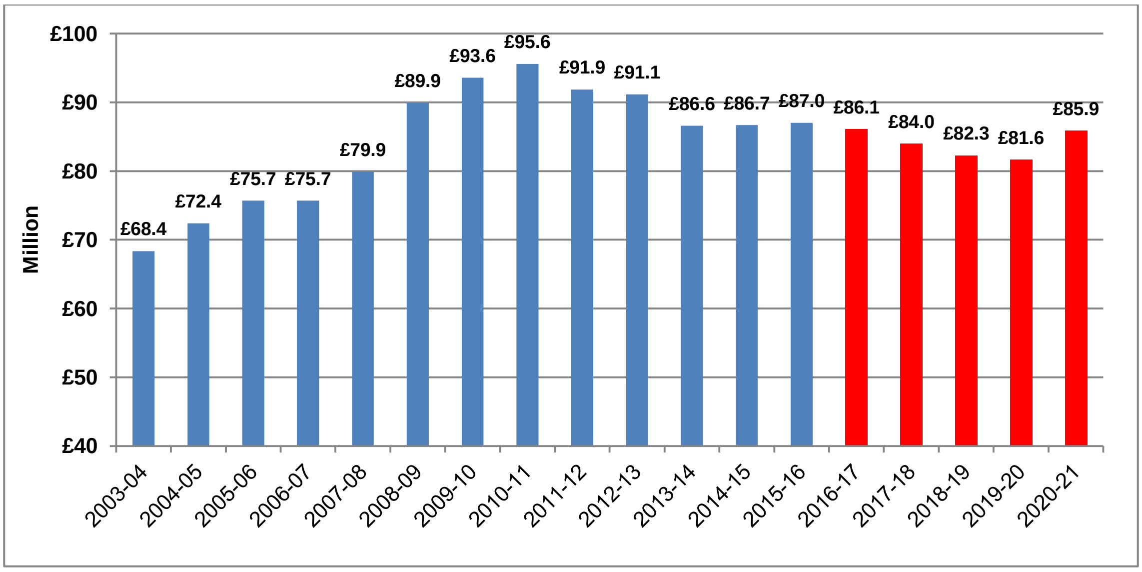



**Figure 3.1: Shetland Islands Council Income from Scottish Government, 2003/04 to 2020/21**

3.1.7 It is therefore clear that the Council's core revenue funding will continue to reduce until the end of the decade at the earliest.

3.1.8 In 2015/16 the Council's General Fund Net Expenditure Budget is **£109.7m**. With core funding of only **£95.5m**, the deficit of **£14.2m** is bridged from a sustainable draw on reserves, harbour account surplus, income from the Shetland Gas Plant and expected investment returns. As such this budget represents a sustainable position where the value of reserves is protected.

## 3.2 Capital

3.2.1 As noted above, capital spending in recent years was funded from reserves which is no longer a sustainable position. Indeed the Medium Term Financial Plan (MTFP) effectively now **rules out the use of reserves to fund capital expenditure**.

3.2.2 The 2015-16 Scottish Government General Capital Grant totals £7.7m. The grant figures for 2014/15 and 2013/14 were £7.0m and £4.9m respectively.

3.2.3 With a total budgeted capital spend of £28.5m in 2015/16, there is a funding requirement of £17.5m to be met through borrowing for specific capital projects (mainly the Anderson High School Replacement).

3.2.4 The Council's proposed Asset Investment Plan covers the period 2016/17 to 2020/21 within which capital expenditure is budgeted to be approximately £14.8m per year until the end of the plan period.

## 3.3 Ferry Services Finances

3.3.1 As noted above, the Council's 2015/16 General Fund Net Budget totals £109.7m. Of this, £14.1m is attributed to the operation of Ferries and Terminals - this is a net figure – total expenditure is £16.3m with income of £2.2m.

3.3.2 The £14.084m Ferries and Terminals budget is split between routes as follows:

**Table 3.1: Expenditure & Income Budget 2015/16**

| | Gross Expenditure (£) | Income (£) | Net Budget (£) |
|---|---|---|---|
| Bressay | 1,870,569 | 397,920 | 1,472,649 |
| Fair Isle | 362,073 | 13,800 | 348,273 |
| Fetlar | 843,421 | 82,850 | 760,571 |
| Unst | 2,247,901 | 181,428 | 2,066,473 |
| Papa Stour | 434,787 | 9,900 | 424,887 |
| Skerries | 938,374 | 30,300 | 908,074 |
| Whalsay | 3,390,030 | 510,572 | 2,879,458 |
| Yell | 5,807,093 | 981,270 | 4,825,823 |
| Foula Contract | 397,462 | 0 | 397,462 |
| **Total** | **16,291,711** | **2,208,040** | **14,083,671** |

3.3.3 The capital budget for ferry services in 2015/16 is £1.215m.

3.3.4 The 2014/15 total figures were £15,122,102, £2,243,431and £12,878,671, respectively. Capital spending was £1.250m.

3.3.5 Included in the total expenditure there is a berthing charge for inter-island vessels of £0.07 per gross tonne per berthing in line with the Council's Table of Dues for terminal berthing which totals £3.1m in the 2015/16 budget.

3.3.6 The MTFP outlines that the Infrastructure Services budget (of which Ferries is part) will fall steadily to 2020/21 when the annual budget will have reduced from £20.6m to £17.5m, a reduction of 15%.

3.3.7 The Council has provided a profile of recent and projected capital spend requirement for ferries and ferry terminals until 2033-34 (the projection from 2016/17 is based on a draft Long Term Asset Investment Plan).

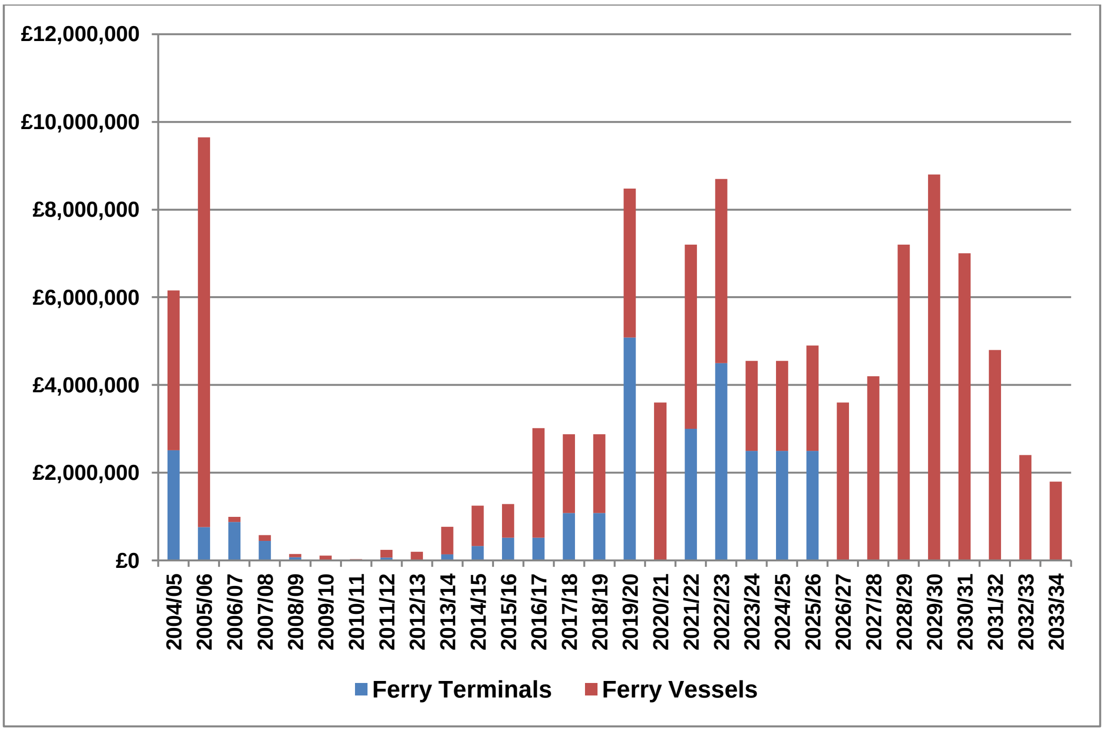



**Figure 3.2: Ferry Service Capital Expenditure, 2004/05 to 2033/34**

3.3.8 It can be seen that capital spend on ferry vessels and terminals dropped sharply from 2005/06 (when new vessels for Whalsay and Yell Services were purchased). It can be seen that there is a requirement for major capital spend in the coming years, in part associated with the very low levels of spend since 2006/07.

3.3.9 The total vessel related costs associated with the operation by route by year are provided below [source: SIC].

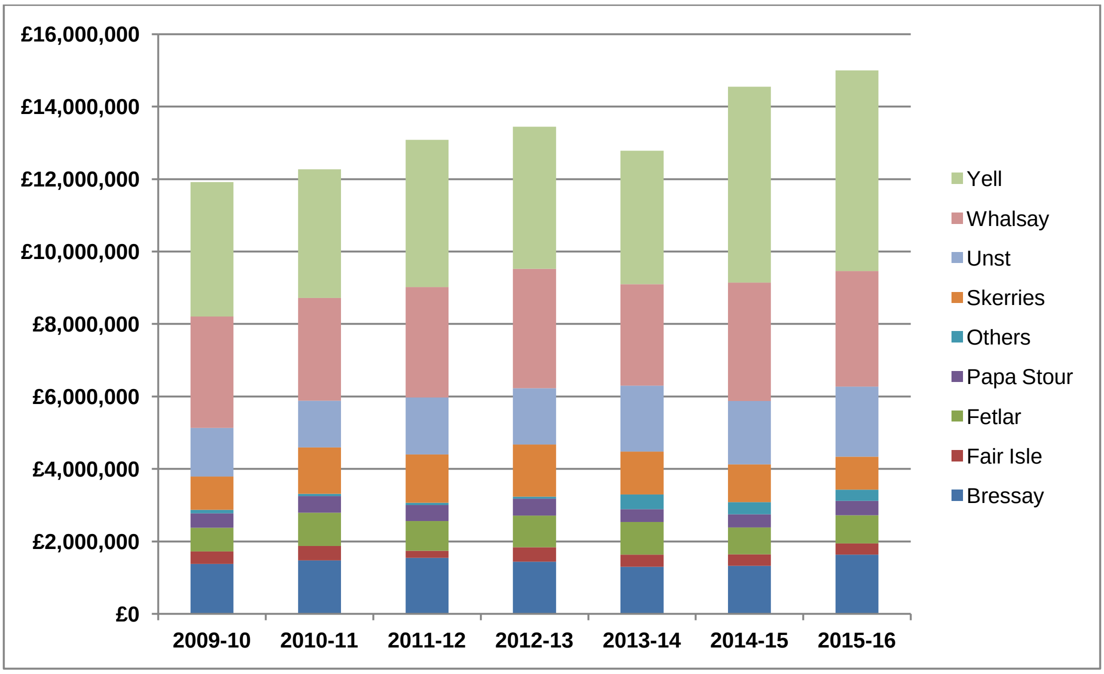



**Figure 3.3: Ferry Service – Vessel Related Costs by Route, 2009/10 to 2015/16**

3.3.10 It can be seen that recent cuts to the services did feed through to reduced costs in 2013-14 compared to 2012-13. Costs were reduced by 9% in this time. In absolute terms, the Yell Sound and Whalsay services are the most expensive.

3.3.11 The total terminal related costs by route are shown below. These costs are very low compared to the vessel-related costs.

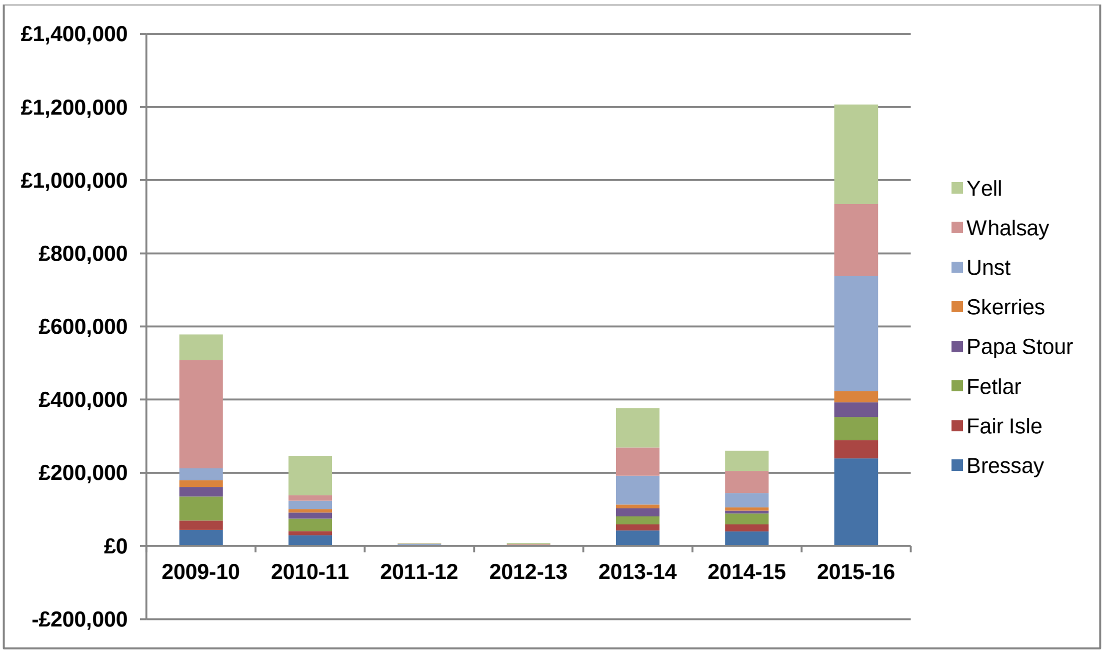



**Figure 3.4: Ferry Service – Terminal Related Costs by Route, 2009/10 to 2015/16**

3.3.12 The total vessel costs are now split by type in the chart below.

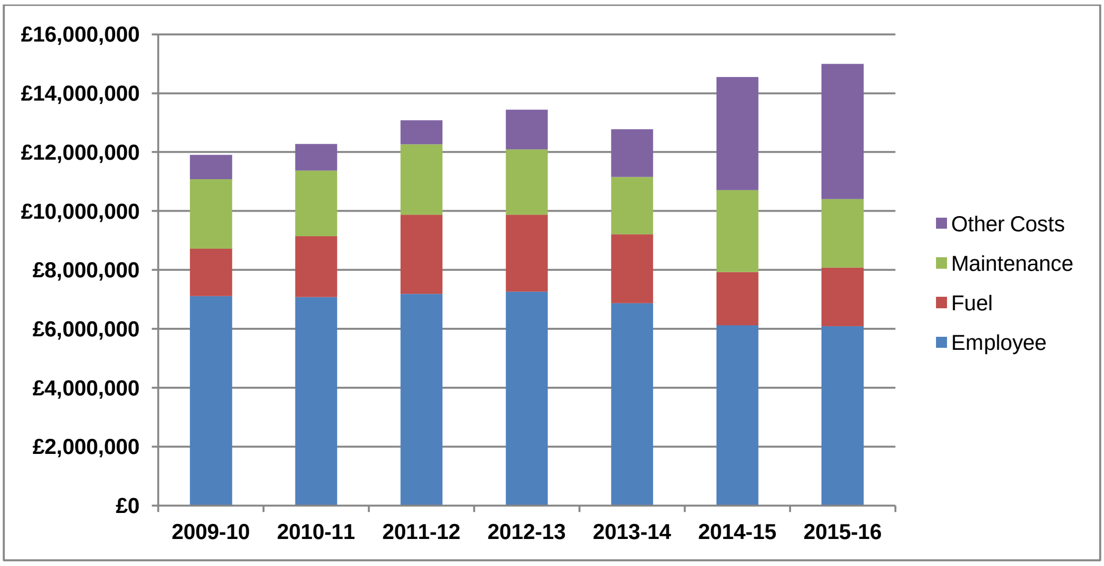



**Figure 3.5: Ferry Service – Ferry Related Costs by Type, 2009/10 to 2015/16**

3.3.13 Crew costs have reduced by £900k since the 2012-13 peak and fuel costs have also reduced markedly (£600k) as a consequence of reduced sailing hours and the drop in the price of oil.

3.3.14 The Terminal related costs are also split out by type:

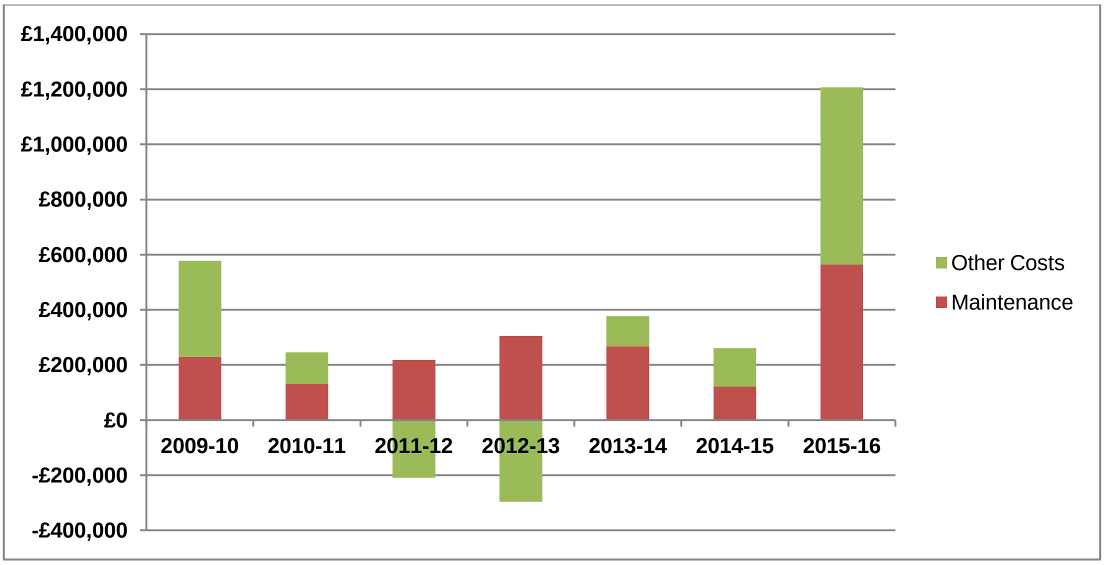



Figure 3.6: Ferry Service – Terminal Related Costs by Type, 2009/10 to 2015/16

3.3.15 The high cost maintenance item in 2009-10 is associated with Whalsay.

3.3.16 Finally, the costs to the Council associated with the Foula contract are shown below:

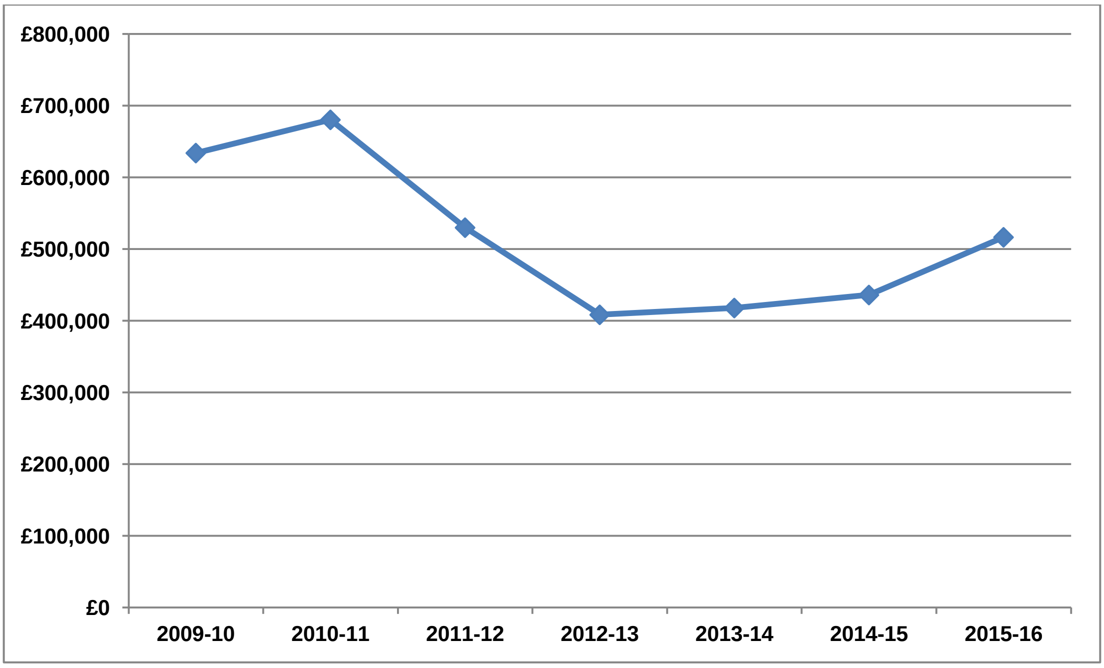



Figure 3.7: Ferry Service – Foula Contract Costs, 2009/10 to 2014/15

3.3.17 The costs associated with Foula have dropped sharply from a peak in 2010-11, although these costs are relatively low in absolute terms.

## 3.4 Funding of Air Services

3.4.1 The chart below shows the costs to the Council of providing inter-island air services over the last six years [source: SIC].

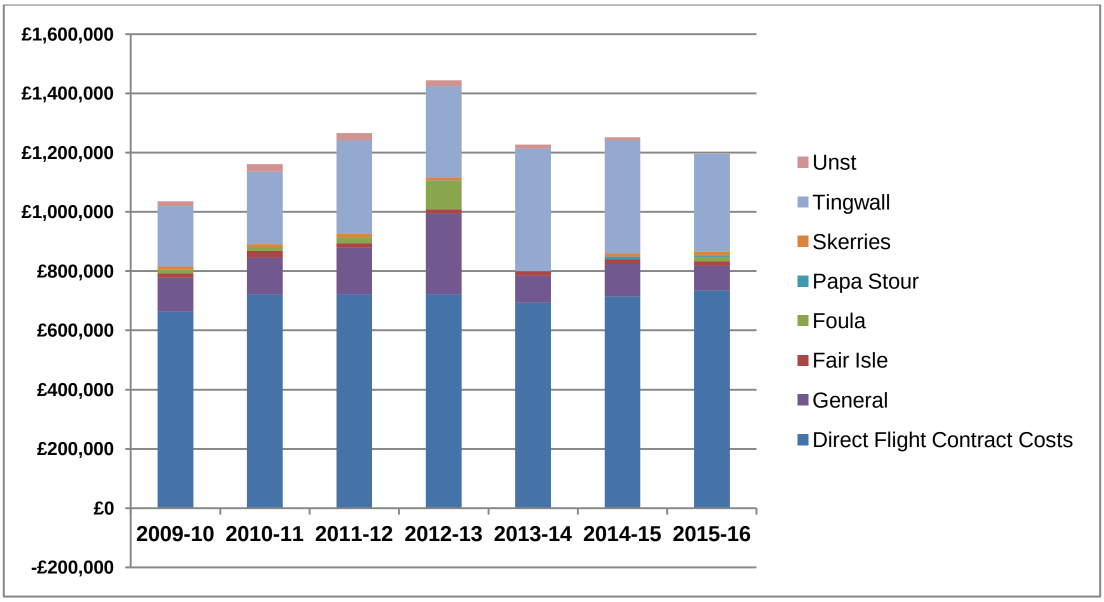



Figure 3.8: Air Service – Costs by Type, 2009/10 to 2015/16

3.4.2 As with the ferry services, the overall costs of air services have reduced since 2012-13. In 2015-16 the highest cost items are the Direct Flight contract (61%) and Tingwall Airport (28%). The costs associated with airstrips at Fair Isle, Foula, Skerries, Papa Stour, Unst and Whalsay sum to only 4% of this total cost.

3.4.3 Recent capital spend (all associated with Tingwall) is shown below.

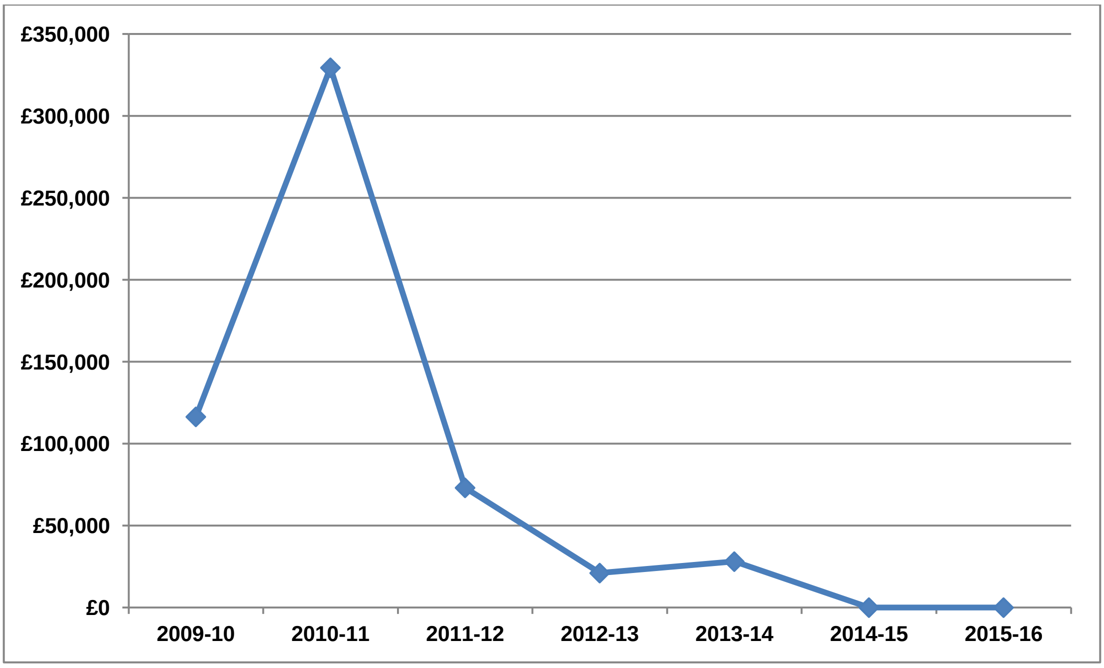



Figure 3.9: Air Service – Capital Spend, 2009/10 to 2015/16

3.4.4 There is currently no projection of capital spend in relation to air services.

# 4 Implications for Future Funding of Air and Ferry Services

## 4.1 Revenue

4.1.1 There is a deficit between the funds the Council receives as part of the GAE settlement associated with internal air and ferry services and the actual cost of providing these services. This is laid out in the table below.

**Table 4.1: Shetland Islands Council Air and Ferry Budget Summary**

| Sector | 2015/16 GAE Settlement | 2015/16 Budgeted Net Cost to SIC | 2015/16 Deficit |
|---|---|---|---|
| Ferry Services | £6.755m | £14.084m | £7.329m |
| Air Services | £0.705m | £1.199m | £0.494m |
| **Total** | **£7.460m** | **£15.283m** | **£7.823m** |

4.1.2 The Council therefore has a ‘deficit’ of nearly £8m in annual revenue spending associated with air and ferry service provision which has to be met out of the General Fund Budget. The previous practice of drawing on reserves to fund current spending is now considered unsustainable and SIC is running a sustainable budget which is designed to protect the value of the Council’s reserves.

4.1.3 The Council has already implemented a set of cost saving measures which have resulted in reductions to air and ferry services. Income is expected to fall and, with the underlying costs associated with providing air and ferry services likely to rise, this means services including ferries and air transport cannot be delivered at current service levels.

4.1.4 Medium term projections show that the Council faces a gap between income and expenditure over the next five years amounting to £48m.

## 4.2 Capital

4.2.1 The Council’s fleet of 12 ferries was acquired between 1982 and 2005. In the early part of this period the Council was receiving significant oil-related income which funded this capital expenditure. Towards the end of this period, although oil-related income had diminished, capital spending was still considerable but was being funded by drawing on reserves.

4.2.2 Council policy now effectively precludes the use of reserves for capital projects. The projected levels of capital spend in the medium term is low. New capital projects are being funded through prudential borrowing, which will also increase pressure on revenue resources.

4.2.3 The capital funding stream available to the Council will therefore be insufficient to fund the replacement of life expired assets across the internal air and ferries network.