York Aviation

THE STATES OF JERSEY
ECONOMIC AFFAIRS SCRUTINY PANEL

INCORPORATION OF THE PORTS OF JERSEY

April 2015

FINAL REPORT

in conjunction with MDS Transmodal

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1 INTRODUCTION

Terms of Reference

1.1 York Aviation LLP (YAL) and MDS Transmodal (MDST) were commissioned in March 2015 by the States of Jersey Economic Affairs Scrutiny Panel to undertake a desk-top review of proposals to incorporate the Ports of Jersey (comprising Jersey Airport and the Jersey Harbours).

1.2 The States of Jersey approved the incorporation in principle in 2012 and, whilst the Scrutiny Panel does not intend to revisit this decision, it is seeking expert assistance principally to review the proposals contained in the draft legislation, the proposed governance arrangements, and the Financial Model supporting the business case for incorporation. The main aim of the review is to ensure that any shortcomings or questions arising from the proposals are identified and given due consideration, and (if appropriate) any need for further work is highlighted, to ensure that States' Members are fully informed before coming to a final decision on the incorporation. However, our brief at this stage is not to undertake full 'due diligence' on the Financial Model and we also make this clear later in this report.

1.3 York Aviation LLP is a leading specialist air transport consultancy, founded in 2002, specialising in the airports business. YAL has extensive experience of preparing and analysing airport business plans and financial models, including capital programmes and airport traffic forecasting. YAL has also undertaken a similar assignment in Guernsey in relation to the commercialisation of Guernsey Airport, as well as advising the local authority shareholders on the governance and business plan for Gloucestershire Airport. YAL has extensive experience of advising clients in the public sector on airport-related matters.

1.4 MDS Transmodal is a leading consultancy providing analysis and advice on strategic, commercial and economic issues mainly related to freight transport and logistics. Its work is based on the development and maintenance of a unique and comprehensive set of databases and transport models as well as the expertise of its consultants. The consultancy was founded in 1983 and has completed hundreds of projects involving research for, and providing advice to, private and public sector clients worldwide. The company has been carrying out studies of the ports and ro-ro shipping sector for the past 30 years and has previous experience of working with the Jersey Harbours.

1.5 Our team has been provided with all relevant background papers and material in connection with the proposed incorporation, including reports prepared by independent consultants acting for the Ports to assess forecast traffic volumes, the capital expenditure programme, and a range of commercial projects which have been proposed by the Ports Management Team to underpin the business case for the incorporation.

1.6 We have been assisted by and held several discussions with the Ports Management Team, who have also provided us with full access to the Financial Model underpinning the case for incorporation and have comprehensively answered all the many questions we have put to them.

1.7 York Aviation also attended an initial meeting with the Scrutiny Panel on 18 March 2015, at which we discussed the Panel's primary objectives. The key concerns of the Scrutiny Panel are not to question the principles behind the political decisions that have already been taken, but rather to focus on an analysis of the detail of the proposed format of incorporation and the supporting business plan in order to ensure that there is a realistic prospect of the Ports achieving its aims of self-sufficiency whilst maintaining its public service obligations in the wider interests of the States of Jersey.

1.8 We also attended the Panel hearings on 22nd April 2015.

Structure of this Report

1.9 The remainder of this report is structured as follows:

- in **Section 2**, we examine the overall case for incorporation;
- in **Section 3**, we focus on the Financial Model;
- in **Section 4**, we consider issues around the proposed governance structure and the proposed Strategic Business Plan;
- in **Section 5**, we consider the regulatory environment under the proposed legislation;
- in **Section 6**, we address the protection of other interests including those of staff and the PSOs; we also consider the roles and responsibilities of the Harbour Authorities and the issue of lifeline services;
- in **Section 7**, we summarise our conclusions.

2 THE CASE FOR INCORPORATION

A Summary of the Case

2.1 The document 'The Ports of Jersey: The Case for Incorporation' of May 2014 sets out the key elements of the case for incorporation. The primary objective that underpins the recommendation to incorporate the Ports of Jersey, is to enable the Ports to continue to provide the essential public services to the Island of Jersey, but to do so in a commercial and financially self-sustainable manner that will both enhance services for customers and remove the significant future financial burden to the States.

2.2 Prior to the current process, there have been a number of other reviews, reports and statements evaluating the case for incorporation and all of these have recommended some form of corporate structure for the Ports that would give them the ability to act commercially, taking account of their strategic role, and reducing the burden on the taxpayer.

2.3 The Minister for Economic Development took the decision to establish a Shadow Board in 2010 and, following the Shadow Board's subsequent recommendation, the Minister approved the integration of the Harbours and the Airport into a single entity known as the Ports of Jersey (PoJ, or 'The Ports'), operating under a single Group Chief Executive. In 2012, the Shadow Board advised the Minister that incorporation represented the best option to deliver a sustainable commercial future for the Ports and, as a consequence, the Minister lodged P.70/2012 'Incorporation of the Ports of Jersey' seeking in-principle approval from the States for incorporation. The proposition was adopted by the States on 9th October 2012.

2.4 One of the key elements of the case for incorporation is financial. The Ports require a significant level of capital investment over the period to 2038 simply in order to maintain essential infrastructure. Without the commercial freedom to find new sources of revenue that incorporation would bring, there is a risk that price rises to customers would be required, or operating costs would have to be severely reduced, with implications for service standards. There could also be a call on the States Treasury to fund capital expenditure when cash flows fall short, with consequences for taxpayers. It is claimed that incorporation would obviate this need by making the Ports largely self-sustainable, with the ability to access alternative sources of funding for some commercial projects and with recourse to short term loans where cash flows require.

2.5 The Case for Incorporation also identifies further financial benefits to the States that could result from incorporation. These include dividend and taxation payments, and payments for centralised services provided by the States. This reverses the current position, in which the Ports represent a financial liability to the States, into one in which there could be a sustainable financial return from the incorporated entity to the States. There would also be financial benefits for parishes in terms of the payment of rates.

2.6 The Case for Incorporation also notes benefits for employees by protecting existing positions and existing terms and conditions, whilst offering the potential for new pay structures that incentivise performance. The increased commercial flexibility of an incorporated entity was also seen as bringing benefits for customers and users of the Ports, through faster responsiveness and decision making and by the ability to better respond to the needs of the market. Finally, but no less importantly, there will be wider benefits for the economy of Jersey deriving from an incorporated entity that is self–sustainable, makes no call on taxpayers funding, and is able to continue to meet its responsibility in terms of providing essential connectivity to the Island.

Initial Evaluation

2.7 As set out, incorporation, therefore, seems likely to bring substantial benefits. The prima facie case for incorporation is also supported by our experience elsewhere, not least in Guernsey, where York Aviation undertook a study of the options for commercialisation of the Airport in 2011 and which recommended incorporation as a first step, albeit that recommendation has not as yet been implemented[1]. As with Jersey, it was evident that the States' decision-making and administrative processes were not always conducive to the commercial responsiveness needed by the Airport in negotiating and dealing with fully commercial entities within the aviation business. The same is likely to be equally true in the case of the Harbours.

2.8 Perhaps the principal benefit of incorporation arises through the ability of the incorporated entity to act in a more commercial manner, with faster response times, and with greater flexibility in terms of pursuing new commercial opportunities and in responding to changing market conditions. There can be little doubt that incorporation would be beneficial in this respect, always assuming that the company and its Board have access to the appropriate skills to make this a reality. At the same time, however, there must be effective governance and regulation in place to ensure that commercial considerations are properly balanced with the wider responsibilities of a 100% States owned company with an effective monopoly on providing services to support the means of access to Jersey by air and sea. We address these issues further in later sections of this report.

2.9 The financial case for incorporation, as a means of managing the risk to public finances through the pursuit of new commercial opportunities, is 'prima facie' also clear from the Case for Incorporation document. But it does rest on the specific assumptions contained in the Financial Model and the ability of the Ports to deliver the Strategic Business Plan that will support it. For this reason, we examine the current Financial Model in more detail in the next section of this report and how this might relate to the Strategic Business Plan, which would guide the actions of the incorporated entity, in Section 4. Our discussion of the Financial Model does highlight the extent to which there may be a level of risk associated with the achievement of targets set out in the Model.

[1] Commercialisation of Guernsey Airport Operations, York Aviation, September 2011.

2.10 There are other potential risks relating to issues such as the governance and regulation of the newly incorporated entity, as well as the protection of other interests such as those of employees or clubs and societies. The provisions and safeguards relating to some of these issues also impinge on others; so, for example, the effectiveness of the structure of governance is to large degree dependent on the robustness of the Strategic Business Plan, and the degree to which there is proper oversight of this Plan. The Strategic Business Plan must also take account of the regulatory requirements of the licence issued to the Ports by the JCRA. We consider these key issues in turn in the following sections.

2.11 Overall, the case for incorporation rests on the achievement of two principal outcomes:

- ✈ enabling the incorporated entity to respond more quickly to commercial market developments through autonomous decision making within an independent board structure;
- ✈ enabling the incorporated entity to embark on new business ventures, including joint ventures, to deliver additional services to Jersey and to generate new income streams.

Assuming that these can be achieved without detriment to broader social and economic considerations relevant to Jersey, these are potentially powerful reasons in favour of incorporation.

2.12 However, the monopoly status of the Ports and their effective lifeline role in relation to ensuring connectivity for passengers and freight between Jersey and the rest of the world does place a special onus on the requirements for delivery. For this reason, incorporation needs to be accompanied by robust safeguards in terms of what the entity is empowered to do and the regulation of its activities.

3 THE FINANCIAL MODEL & STRATEGIC BUSINESS PLAN

Introduction

3.1 The Ports Management Team told us that the current Financial Model underpinning the case for incorporation has a long history and is an evolution of two initially separate models. Before integration, Jersey Airport's long term financial model was created and maintained by Deloitte and the initial Harbours model by Fisher Associates. These models were brought together to produce consolidated primary statements for the Ports as a whole. The fundamental objective of the Financial Model is to demonstrate the Ports' ability to cover its capital requirements over the period to 2038 whilst maintaining positive cash with limited commercial borrowing and without recourse to taxpayer's money.

3.2 Section 4.2 of the Case for Incorporation document of May 2014 notes the external expertise that has contributed to the Financial Model to date in the form of:

- the validation of the capital programme by Capita Symonds/Validus;
- a review and updating of the forecast growth assumptions by RDC in the case of the Airport and Fishers in the case of the Harbours;
- a validation exercise undertaken by the accounting firm BDO, which reported in June 2014. It is important to note, however, that BDO only reported on the mechanics of the Model rather than the business case itself or the validity of the assumptions in the Model;
- no validation appears to have been undertaken regarding the business case for the commercial projects, the delivery of which constitutes the principal financial benefit cited from incorporation.

3.3 It is important, from the outset, to be clear about what the Financial Model represents as it currently stands. It should not be taken to be equivalent to the incorporated entity's first Strategic Business Plan. It does, however, set out to illustrate the incorporated entity's potential to fulfil the ambition for the Ports to be financially self-sustainable and to maintain a positive cash position without recourse to States funding. It does this principally by making a number of fundamental assumptions, which include a range of proposed revenue generating commercial projects. It is the inclusion of revenues from these commercial projects that essentially form the difference between a Financial Model with, and without, incorporation as presented in the Case for Incorporation. This appears to be on the basis that such commercial projects have been difficult to progress under the current governance structure.

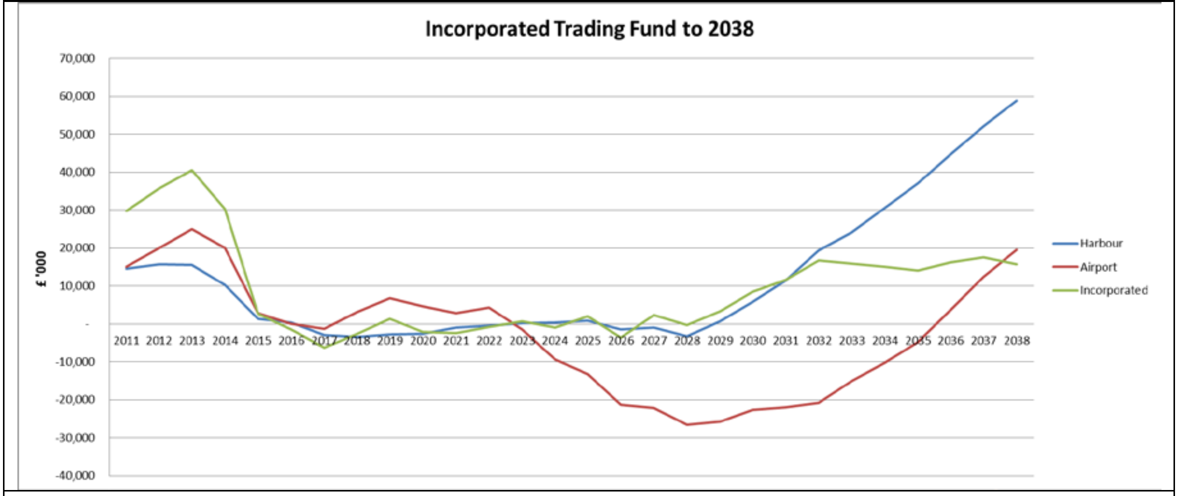
3.4 We, therefore, consider below the fundamental assumptions applied in the Financial Model from the perspective of the consolidated Ports Group, before evaluating aspects that relate specifically to the Airport and the Harbours.

Key Assumptions

3.5 There are a number of fundamental assumptions in the Financial Model that are common to the Airport and the Harbours and these are set out in detail in Appendix 6 of the Case for Incorporation document. This appendix also sets out what was contained in the original Model presented to the States in October 2012 and the development of each assumption up to May 2014.

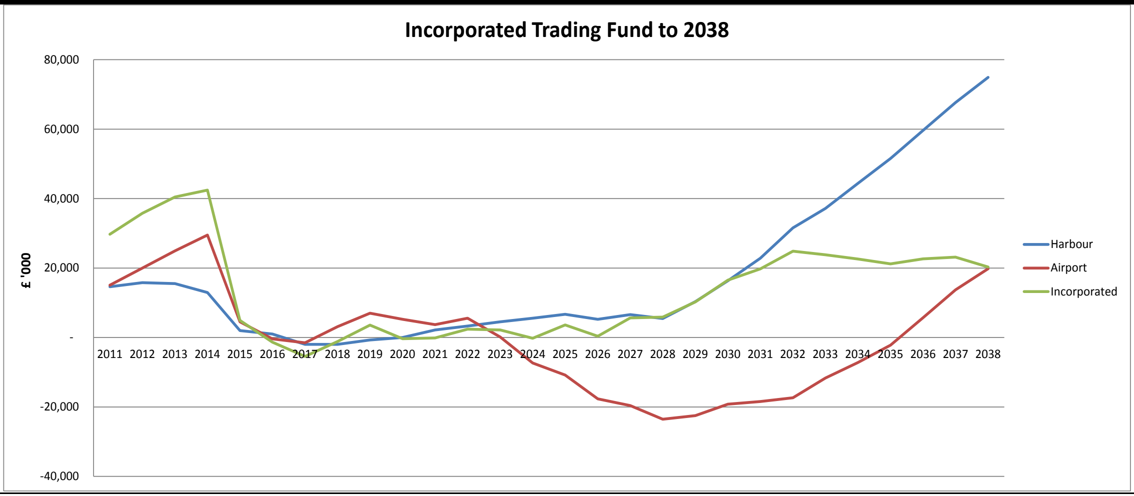
3.6 Following our discussion with the Ports Management Team, we asked for this model to be updated so that we could review the latest position, taking into account recent market developments and the initiation of work on the Airport Cargo Terminal in order to ensure that we had an up to date baseline against which to consider the case for incorporation. It is important to stress that, as presented to us by Ports Management, the overall long term financial position shown remains virtually identical to that set out in the Case for Incorporation. These are illustrated in **Figures 3.1** and **3.2**.

Figure 3.1: Trading Fund – Incorporation Financial Model



Source: PoJL Financial Model

Figure 3.2: Trading Fund – Updated Financial Model



Source: PoJL Financial Model

3.7 An important point to note is that these models assume that growth will be in line with the market assessments made by RDC and Fishers. These are, hence, equivalent to the 'growth' versions of scenarios set out in Section 4 of the Case for Incorporation, which show the expected performance of the Ports in the absence of incorporation. Equivalent modelling of the 'no growth' scenarios does not appear to have been carried out for the incorporated entity. This would be a downside risk, as with the 'without incorporation' scenarios, as the growth in passengers and freight using the airport and harbours is only within the control of the Ports to a limited extent and will be largely driven by exogenous factors, such as the performance of the economy.

3.8 We consider each of the key assumptions in turn:

Period/Timing

3.9 The period covered by the Model is to 2038, which matches the States' long-term capital and revenue reporting period. In the updated Model, the actual results from 2014 were incorporated as the baseline for the future projections. We comment on the effect of this later in considering the sensitivity of the Model's projected outturn to various key assumptions.

Capital Programme

3.10 A revised version of the capital programme was developed by the Ports Management Team in September 2013 and this was subsequently reviewed by Validus (via Capita Symonds) with some changes made to the timing of some projects. We understand that no further changes to the capital programme have been made since then and we comment on the specific capital programmes of the Airport and the Harbours later in this section.

Balance Sheet

3.11 All the relevant land, buildings and other assets owned by the States and under the operational control of the Ports of Jersey at the point of incorporation will be transferred to the newly-formed company. Any additions to the property portfolio, and their associated net revenues, over the life of the model have been treated separately as Commercial Projects (or ‘defined events’).

Staff

3.12 The core assumption is that there will be no redundancies as a result of the process of incorporation and that all employees will be transferred to the incorporated entity on existing terms and conditions. Existing employees will also continue to participate in the Public Employees Contributory Retirement Scheme (PECRS). We make some further comments on the protection of the interests of employees in section 6 of this report.

Pension

3.13 The Model assumes that the current liability of £17.6 million will be paid in full on incorporation from existing Trading Fund balances.

Inflation

3.14 The Model uses information on RPI that was sourced from the States’ Economic Advisor and the rates of inflation vary between 2.5% and 4% in the early years but settle at 3.5% from 2017. The majority of revenue and cost lines in the Model are inflated by these values year on year, with no explicit assumptions made regarding either potential efficiencies or economies of scale or areas where costs might rise ahead of inflation. This includes an assumption of a fixed value of services which would continue to be purchased from the States and which contribute to the financial benefit to the States from incorporation.

3.15 We queried the RPI values used in the Model in the light of current RPI, which is currently hovering around 0% in the UK. We would expect that future versions of the Model and the financial assumptions in the Strategic Business Plan, when it is prepared, would be updated to reflect the most recently available estimates of inflation and a more detailed assessment of the extent to which individual cost and revenue lines would necessarily vary strictly with inflation.

Borrowing

3.16 The Model assumes some limited borrowing to resolve liquidity issues during periods of intense capital expenditure, but it is fully repaid by the end of the period and there is no liability on the closing balance sheet. Borrowing may also be used to fund separate Commercial Projects which provide a return on investment within the life of the model. We understand that preliminary discussions with banks have taken place on the most appropriate form of borrowing and we would expect that the Strategic Business Plan would be specific about the exact form of borrowing that may be required and the conditions attaching to this. It should also be noted that the ultimate liability for any borrowing will remain with the States as 100% shareholder.

Growth Volumes

3.17 We consider traffic projections in more detail below under the relevant headings of ‘Airport’ or ‘Harbours’.

Channel Island Control Zone

3.18 The Model assumes that the provision of services to the UK and France will continue through the life of the model on substantially the same basis as currently exists, although a new contract is under negotiation.

Commercial Opportunities

3.19 We consider the commercial projects proposed in the Financial Model in more detail below under the relevant headings of ‘Airport’ or ‘Harbours’.

Taxation

3.20 Taxation is charged at 20% net profit before depreciation and after an estimate for capital allowances payable in the following year. The pension liability has been deemed a tax deductible expense and therefore 20% of the value added to the deferred tax asset.

Capitalisation

3.21 The States will own 100% of the ordinary shares.

Dividend

3.22 A dividend policy is to be agreed with the shareholder.

Cash

3.23 It is assumed that the cash from both businesses will be combined and available funds used for investment in either business. We understand that it is intended that the Trading Fund will remain as the 'Incorporated Trading Fund' and the cash flows from both businesses will contribute to this. It is important to note, however, that there are times during the period of the Financial Model (specifically between 2023 and 2035) when the cash flows from the Airport are negative, but the consolidated position is positive because of the flow of cash from the Harbours. The position by the end of the period is that the cash flows from both businesses are expected to be positive. There may be some regulatory issues which could impact on this assumption, which we return to in Section 5.

Airport

Traffic Forecasts (RDC)

3.24 We have reviewed the passenger forecasts produced by RDC Aviation (RDC) in January 2014, and subsequently updated in February 2015. The update was required because, by the end of the first year, actual performance in terms of passenger numbers was already more than 2% above the forecasts due in large part to rapid expansion of services by easyJet. In addition, RDC's original forecasts may not have adequately taken into account the 'bounce-back' effects of economic recovery on air travel, where demand grows rapidly coming out of an economic downturn to offset the rapid decline going into the downturn. This is simply a recovery of the market to more normal levels. It is likely that there is some scope for this recovery to continue as the Airport still handles fewer passengers than in the pre-recession recent peaks of close to 1.6 million passengers per annum (mppa). The scope for further recovery is recognised by RDC and their updated forecasts include a higher rate of growth in 2015 than their long term average. The improved performance in 2014 was in part driven by discounts on aeronautical charges to secure growth and we consider aeronautical revenues further below.

3.25 Air passenger numbers for Jersey will always be limited by a number of factors, as identified by RDC. In particular, the Island's population and capacity to handle inbound visitors will strongly influence demand, along with more conventional economic considerations. RDC's approach to forecasting recognises this, factoring in population, bed spaces, visitor forecasts and Gross Value Added (GVA) projections, with the source of most of these projections being the States of Jersey. The result is a low long term growth rate, the principle of which seems sound as there are unlikely to be any factors which would generate step changes in growth.

3.26 Overall, we believe that, in the short term, the forecasts may be understated and that, in the long term, there may be some risk to the overall achievability of the forecasts. In the most recent forecasts, RDC projects that it will take a further nine years to return to 2008 levels of demand, despite the recent growth of services to the Island by easyJet. Previously, this level of growth was achieved over only 4 years to 2008, and passenger demand exceeded this by some margin throughout the late 1990s. In part, the current shortfall may reflect the decrease in available bed spaces, but could be expected to be offset by population growth and non-staying visitor growth, although it is unclear why it is assumed that the latter will grow so quickly in the assumptions given to RDC.

3.27 In the longer term, however, the projections anticipate growth of 300,000 passengers per annum above current levels by 2038, to take the Airport to levels of usage not seen since the late 1980s when market conditions were very different. Given that demand has hovered around 1.4-1.6 million passengers a year for 25 years, it is not clear the degree to which there is scope for this level to be exceeded over the next 23 years. A major driver could be population growth, but this may be offset by reductions in bed spaces impacting on inbound visitor numbers. There are three key measures that lead us to believe that the long term passenger forecasts may have some degree of risk attached to their achievement:

- based on the Ports of Jersey estimates of journeys by residents in 2012, there would appear to be a propensity to fly of around 5.6 journeys per resident (i.e. excluding inbound visitors) at present. If residents continued to travel at a similar rate, projected growth in population could lead to only 75,000 additional passengers by 2038. If propensity to fly recovered to 2012 levels, then this could lead to a further 63,000 passengers by 2038;

- based on the ratio of staying visitors (arriving by air) to bed spaces, the projected decline in bed spaces may be expected to lead to a reduction of 51,000 passengers per annum. This decline in air passengers could be moderated for two reasons: first, if the length of stay in Jersey decreases further, a higher proportion of bed spaces may be used by those arriving by air than by sea and, second, the ratio between inbound visitors and bed spaces in 2012 may also be suppressed by economic conditions. A 10% adjustment to the visitor to bed space ratio to account for the economic conditions could result in only a 23,000 passenger reduction;

- based on the current ratio of non-staying visitors to population, there might only be an additional 48,000 passengers per annum by 2038, although this is significantly below the States' own projections. The basis for the assumption of a rapid growth in this market in the States' projections is unclear.

3.28 Combining these three factors (taking the upper scale of population impact and the lower scale of staying visitor impact) could result in only 163,000 net additional passengers. We recognise that our analysis above is somewhat simplistic and does not fully take into account economic growth or work from first principles, but it does serve to indicate the extent to which there may be risks attaching to the achievement of the full forecast growth over the longer term. These could translate to some degree into a revenue shortfall but this would, to a very large extent, be independent of incorporation. It is arguable that, with incorporation, the Airport may be better able to manage these risks.

3.29 In summary, we believe that the traffic forecasts for the Airport are relatively robust, albeit they do carry some risk which we have outlined above. We would not, however, see these risks as being significantly greater than might be expected in any airport forecast and there could be upside potential if tourism growth is re-energised.

Aeronautical Charges

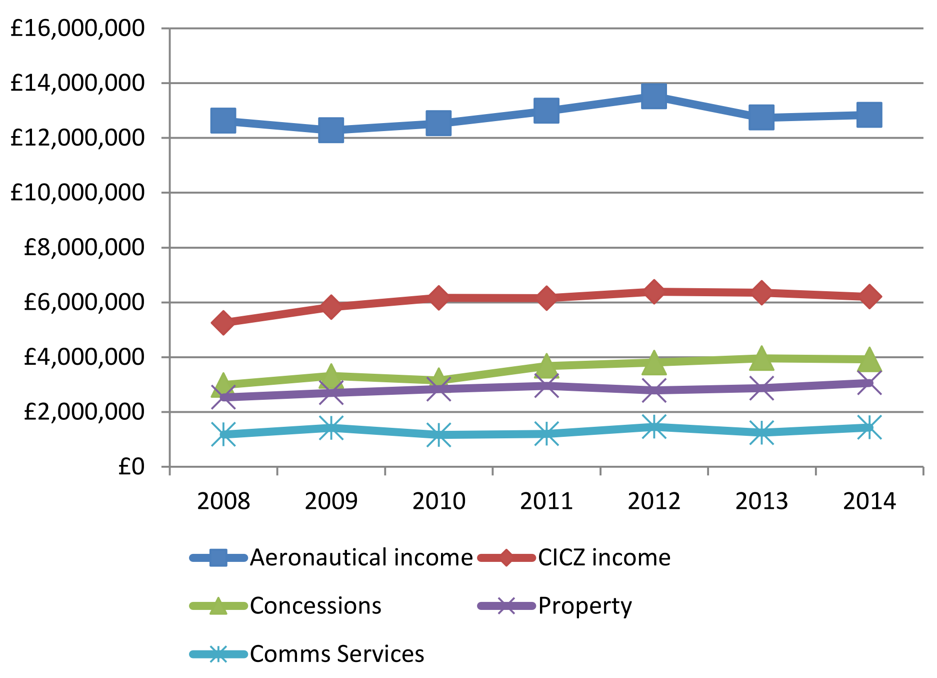
3.30 Aeronautical charges are projected to increase in the Model by a proportion of inflation annually. This proportion is currently set at 85% to reflect the fact that some carriers may be on non-inflationary deals or will at least be unwilling to accept full inflationary increases. However, we note that between 2012 and 2014, the actual change in average income per passenger was negative in both years, falling from £9 per passenger shown in the Model for 2012 to £7.96 (£7.81 in 2012 prices) shown based on 2014 actuals, which is equivalent to CPI-6.8% p.a. over the two years. Hence, actual aeronautical revenue growth fell some way short of the assumed 85% of inflation or even CPI-1% (understood to be the previous control), albeit that total revenue was higher due to passenger growth. When this 2014 shortfall was taken into account in the updated version of the Model, leaving the future years' assumption of growth at 85% of inflation unchanged, the effect was dramatic, with a £27 million shortfall in revenue over the period to 2038, albeit this was more than compensated for in the overall Model by the effect of other adjustments made to the 2014 baseline as we discuss later in the section.

3.31 It seems likely that this reduction in average aeronautical revenue per passenger arises from the impact of commercial deals done to secure growth in passenger volume. It is outside the scope of our work to consider the detail of any commercial agreements[2], but the performance in 2014 gives rise to a doubt as to whether consistent growth in aeronautical revenue per passenger at 85% of inflation will be achieved, particularly in the early years of the Model, although this may be a reasonable assumption over the medium to long term. For example, RDC's projection of 1.9% growth in passengers for 2015 may well require the continuation of discounts from 2014, with carriers paying less than the standard charge and this may be expected to dilute the existing yield still further. This could lead to a further real terms decrease in average aeronautical yield per passenger, with the Airport not attaining its assumed 85% of inflation increase in revenue per passenger for the third year running. In the longer term, as deals with carriers unwind over time, yields may increase closer to the rate of inflation but this may still leave a financial gap which would need to be filled by other sources of revenue to maintain the overall financial position shown in the Model.

3.32 Overall, this represents a key risk area in terms of the attainment of the projected financial outturn for the Airport, especially in view of the importance of aeronautical revenues as a proportion of total (see **Figure 3.3** and **Figure 3.4** below). Again, this is largely unrelated to incorporation and it is arguable that, post-incorporation, the Airport may be better able to adapt its pricing structure to achieve higher revenues, for example in peak periods, and to develop new commercial approaches with its airline customers. However, this will to a large extent be controlled by the regulatory regime put in place by the JCRA.

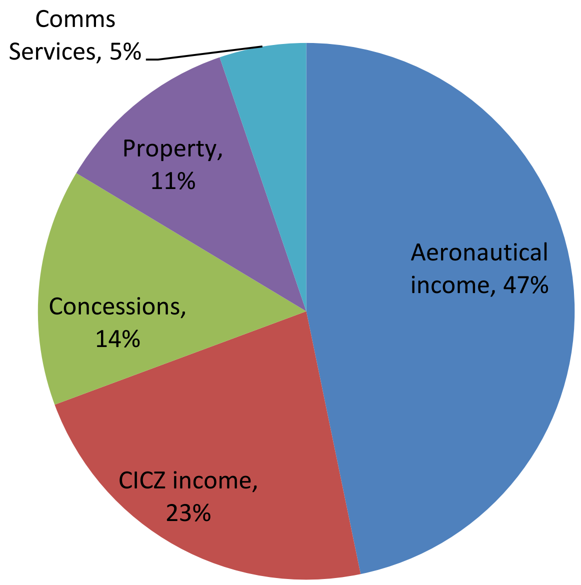
[2] It should be noted that such commercial arrangements are normal practice in the commercial airport sector.

Figure 3.3: Jersey Airport Sources of Revenue



Source: PoJL Financial Model

Figure 3.4: Jersey Airport Sources of Revenue (2014)



Source: PoJL Financial Model

Capital Programme

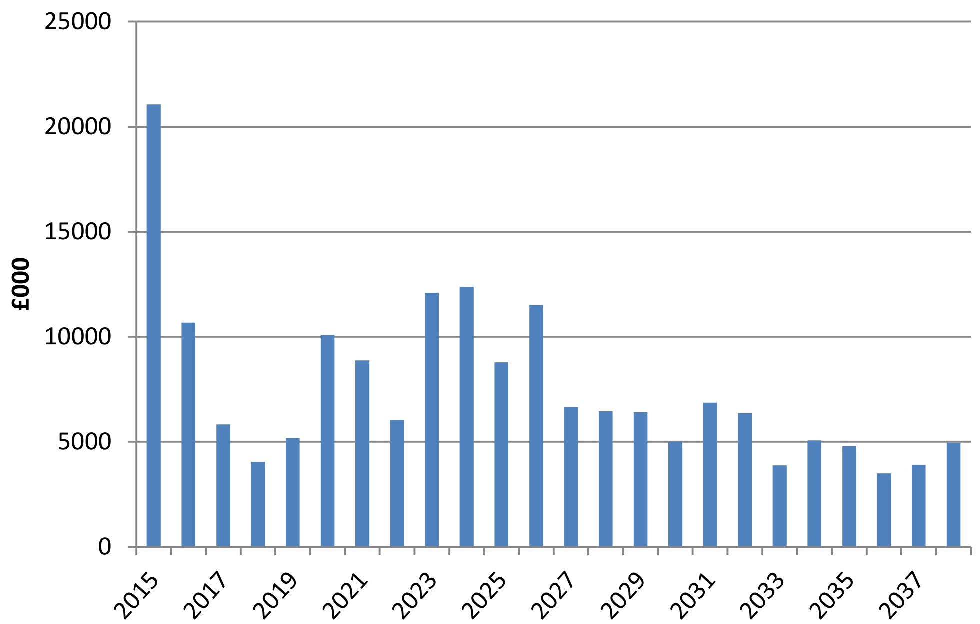
3.33 The Financial Model contains a capital programme which is considered to be the minimum necessary to main the safe operation of the Airport going forward and to allow for necessary new infrastructure to meet capacity requirements or for essential infrastructure renewals. It does not, therefore, contain any capital expenditure for new commercial projects, to which we refer further below.

3.34 The capital programme was reviewed by Capita Symonds in 2011 but has been significantly altered since that time and we understand that a revised version approved by the Ports Management Team in September 2013 was also reviewed by Capita Symonds and recommended changes were made to the timing of some projects. This review did include the capital costs for some projects later defined to be commercial projects or 'defined events' but did not extent to assessing the commercial viability of these projects.

3.35 It was not part of our remit to undertake a further detailed review of the capital programme, although we have examined the projects it contains in relation to the likely requirement and we have no major issues to raise on the operational projects and their costs. The planned capital expenditure is shown in **Figure 3.5**.

3.36 We also asked the Ports Management Team to take us through their latest Master Plan for the Airport, which shows the proposed physical development of the Airport to 2030. The methodology used to prepare the Master Plan follows conventional approaches and is consistent with the current traffic forecasts and capital programme, except where commercial projects requiring capital expenditure are envisaged, which would be funded separately through a 'stand alone' business case.

Figure 3.5: Jersey Airport Required Capital Expenditure to 2038 (current prices)



Source: PoJL Financial Model

Commercial Projects

3.37 There are five new 'commercial projects' relating specifically to the Airport that are included in the Financial Model, alongside a number of Harbours projects discussed below. In addition, it is assumed that in the longer term, a second tranche of commercial projects will be implemented with the same capital and revenue implications and, overall, these commercial projects (across both the Airport and the Harbours) are estimated to have a positive effect on cash balances of £90 million over the life of the Model, which is attributed as the principal financial benefit of incorporation. We were provided with a summary of the projects, highlighting the cash flow analysis and providing an overview of the feasibility and practical implications of each. We also discussed these projects with the Management Team.

3.38 The Airport specific projects are:

- ✈ **Cargo Centre Phase 1** - this project has already been the subject of approval by Ministerial Decision and construction is underway; initial capital expenditure was £4.7m and net annual revenues were initially set out to be around £303,000 in 2015 rising to £775,000 by the end of the period, after allowing for inflation. However, in discussion as highlighted below, the revenues were stated in the original Financial Model on a gross basis before allowing for the existing cargo centre revenues. This was corrected in the updated Financial Model supplied to us and the implications of this are described further below. Although these revenues are attributed to incorporation in the Model, they would now accrue in any event, albeit we understand that capital expenditure approval was granted in anticipation of incorporation taking place;

- ✈ **Corporate Aviation Facility** – the development of a new business aviation facility for use by the Fixed Base Operator 'Hangar 8 plc' (with whom Heads of Terms have been agreed) on the existing Cargo Centre site; initial capital expenditure is estimated to be £600,000 with net annual revenues of £380,000 comprising rental and additional landing fees, which seems broadly reasonable, although we have not undertaken a detailed market assessment;

- ✈ **Executive Lounge (Atrium) Project** - this project aims to create a new executive lounge in the Atrium area of the Airport in partnership with a specialist provider; the capital expenditure is estimated at £20,000 and the ongoing net annual revenue is £57,000. In practice, this is a relatively minor project and it is not entirely clear why implementation is dependent on incorporation, if the market exists. There may also be greater revenue earning opportunities from the use of the area for catering, freeing up additional space in the terminal for retail activities;

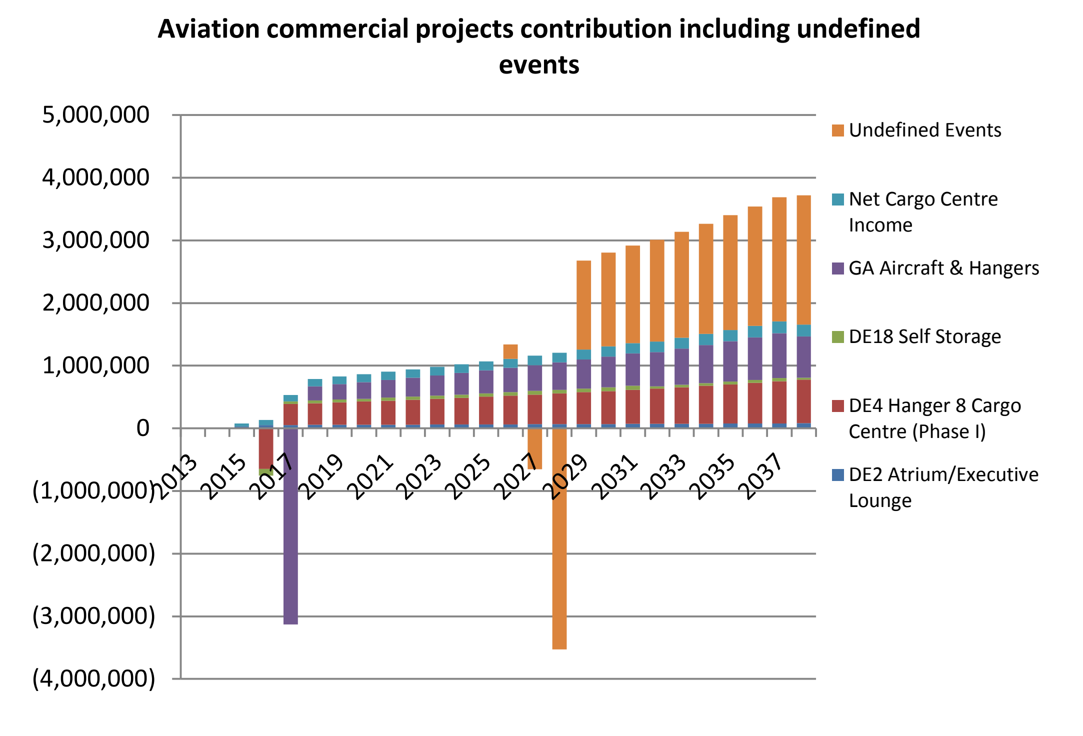
- **Secure Self-storage Project** - the establishment of a secure self-storage facility for use by businesses and individuals initially as a pilot project utilising space in the Cargo Centre and, if this is successful, a longer term plan could be devised using further cargo centre space or land adjacent; initial capital expenditure is £100,000 with ongoing net annual revenue of £50,000. Prima facie, this is not an airport-related activity but may be a suitable use if there is unlet space within the new Cargo Centre. It is not entirely clear the extent to which the revenue would be in addition to the Cargo Centre income stated above;

- **General Aviation (GA) Parking Area and Associated Hangars**; the construction of a concrete apron and base on which general aviation parking and hangars can be provided: the capital expenditure is estimated at £2.9 million and the ongoing net annual revenue is £458,000. These costs and revenues seem broadly consistent with what could be achieved from the scale of development contemplated.

3.39 As identified, there are some risks associated with these commercial projects, which are to a large extent identified in the 'Business Case Summary Document' relating to each project. Whilst some risks are relatively small, others could be significant. For example, the risk associated with the self-storage project is principally whether there is sufficient level of demand for this service, given the existing level of provision by competitors, although the levels of revenue at risk in this case are relatively low. On the other hand, the risk associated with the general aviation parking project is that if the only parcel of land available for this is in 'Green Zone' to the south of the Airport, there could be major planning challenges which would place the projected revenues from this project at risk. These risks mean that it cannot be assumed, even with incorporation, that the projected incremental revenues from these commercial projects as currently shown in the Financial Model are guaranteed. Certainly, more detailed business case appraisals would be required before such projects could be accepted into the Strategic Business Plan.

3.40 A further risk attaches to the way in which the cash flows from these initial projects is assumed to repeat halfway through the Model, from 2026 onwards, from similar but as yet unidentified commercial projects. The impact of these illustrated in **Figure 3.6**.

Figure 3.6: Jersey Airport Commercial Projects Contribution incl. Undefined Events



Source: PoJL Financial Model

3.41 We raised this issue at our meeting with the Ports Management Team and were told that the five commercial projects identified in the Financial Model were illustrative of the type of project that could generate incremental income for the Airport under an incorporated scenario and that, without incorporation, the successful implementation of commercial projects such as these would be much more difficult. We were also told that there were other potential commercial projects which had been identified but, as yet, no detailed evaluation of these had taken place. We were provided with a list of these other potential projects, which comprised both Airport and Harbour related projects.

3.42 As a consequence, whether it is these particular five projects as currently identified in the Financial Model that generate the additional revenues, or whether other similar commercial projects might eventually be implemented, seems to be an open issue. These additional commercial projects include (inter alia) proposals such as an expansion of the terminal retail offering, expansion of ATC services, and optimisation of car parking facilities. However, these additional projects have not been worked up into specific business cases as yet.

3.43 In short, therefore, there are a range of risks attached to achieving the projected cash flows from these identified projects and the other assumed commercial projects, and these risks need to be understood in the context of the projected cash flows in the Financial Model. It is reasonable to assume, nevertheless, that incorporation will lend a significant impetus to driving through commercial projects of this nature, but the Strategic Business Plan should be very clear about the risks and achievability of each project and what contingency plans should be in place to overcome potential barriers to their realisation.

Other Opportunities

3.44 At present, the Financial Model makes no specific assumptions about the growth of non-aeronautical revenues (such as from terminal retail and catering) other than that these will grow in line with inflation. Equally, the Model makes no productivity assumptions in relation to operational expenditure (opex) and assumes that opex will simply grow in line with inflation. To this extent, the Financial Model may actually understate the income generating potential of the incorporated entity and its ability to improve its financial performance generally.

3.45 It could be argued that this is a prudent approach to take in a Financial Model and results in a conservative view. However, we would expect that the Strategic Business Plan would consider the upside potential in these areas and set more specific targets in this regard.

Harbours

Traffic Forecasts (Fishers)

3.46 The traffic forecasts for the Harbours have been provided by Fisher Associates. Their report describes ‘Best’, ‘Worst’ and ‘Likely’ case scenarios for throughput of port traffic. This includes bulk freight imports and exports, fuel imports, cars, goods vehicles and passenger traffic arriving by ferry and the associated number of ship arrivals in each of the three sectors of ferry, dry bulk freight and fuel (liquid bulk). The forecasts were re-worked in March 2015 to reflect updated data for 2013 and 2014. The resultant forecasts for the ‘Likely case’ have been used to update the Jersey Harbours Financial Model.

3.47 The Fisher report states clearly that the methodology has involved neither a detailed economic review nor any econometric modelling. The report also points out that the correlation between economic growth and the volume of imports has been shown to be relatively weak. Instead, the work has been based on consultation and the forecasts based on broad assumptions of economic growth measured by Gross Value Added (GVA), which is a measure of the *value* of goods and services and sometimes used as a proxy measure of GDP. The greatest contributors to GVA in Jersey's case are financial services and 'other' activities which include items such as public administration. Taken together, these two sectors account for around 80% of GVA but neither sector contributes to the physical movement of goods. Moreover, the financial services sector will have little or no impact on changes in the volume of tourists visiting Jersey. In the supplementary note produced in tandem with the original report in February 2014, Fisher notes that the use of economic modelling using forecast GVA as a variable was avoided, citing the wide deviation in Jersey's own Fiscal Policy Panel forecasts at that time. Yet the forecast scenarios do link the relative movement of imports, exports and passenger movements to changes in GVA.

3.48 The forecasts are noted to be 'long term' based on fundamental drivers. There are no 'what if' scenarios that test changes in key variables such as fuel prices, passenger fare prices or growth in the economies of the UK and France, for example, which are the principal sources of tourism and, hence, ferry traffic and peaks and troughs in freight volumes. The 'Best' and 'Worst' case scenarios assume either 'slight' growth or decline in the economy and the direct impact on traffic of plus or minus 0.25%-1.25%.

3.49 The original Fisher report was updated in March 2015. In this, there are several comments that the previous 'best case' projections had been exceeded, for example in the case of passenger travel by sea in the French and inter-island market. The 'benchmark' or base line for the updated forecasts, therefore, had also been raised, though mentioning that the actuals have exceeded the previous best case projections because of short term fluctuations. This, therefore, raises the question why the original forecasts should have been changed?

3.50 In the long-run, there may be greater value in examining trends in the total tourism market and the drivers determining the relative market shares of passenger arrivals by sea and air, and/or the relationship between these trends and the frequency of air and ferry services. The forecast of ship arrivals takes account of the recent change in Condor Ferry's schedules in the updated report, but makes no assumptions regarding any change in future ship sizes or sailing patterns. This may be an oversight as in the next 25 years – the time horizon of the study – replacement of ferries would be expected and the question arises as to the availability of suitable vessels on the market that have the parameters that fit the physical constraints (draught and length) of St. Helier Port.

3.51 Our overall conclusion is, notwithstanding the possible shortcomings in the approach used, that the traffic forecasts for the Harbours indicated in the 'likely case' and used in the Financial Model are probably within acceptable standards of confidence in the context of incorporation. They largely reflect stability in the Jersey economy, stasis in all sectors of port traffic, and no change in the number of ship arrivals (after adjustment to reflect recent changes in ferry services). It means that Ports of Jersey can have a certain degree of confidence that there will be no major shocks to port revenue because of market fluctuations over the next 20-25 years.

Ports Revenues and Costs

3.52 As a general observation, ports can obtain revenue from a variety of sources depending on their business model:

- charges (effectively tolls) on ships entering the port and on cargo crossing the quay;
- charges for stevedoring (loading and unloading cargo);
- rent from third party terminal stevedores, manufacturing facilities and storage facilities located on the port estate;
- fees and charges for providing services such as inland road haulage services and warehousing services.

3.53 Post incorporation, the possibility will be available for the Ports of Jersey to determine especially how to take advantage of or optimise income streams particularly from the third and fourth items above. For example, the Ports of Jersey would have the commercial freedom to acquire companies, form subsidiaries or enter into joint-ventures with third parties in order to generate new sources of income and spread the risk of investment.

Port Tariffs

3.54 It is normal practice in most ports to charge port tariffs in two forms:

- harbour dues charged by the Harbour Authority including charges to the ship for port entry and safe navigation (conservancy) and passenger and goods dues; and
- charges for ancillary services including stevedoring, craneage, storage and other services, which may be charged by the Harbour Authority or by private companies and terminal operators providing such services within the port.

Power of Harbour Authorities to set charges

3.55 Harbour Authorities in the UK have the power to raise dues to pay for the discharge of their legal obligations. Harbour Authority boards must ensure that adequate resources are available to discharge marine safety obligations and should set dues accordingly. Harbour 'Dues' are defined in the UK Transport Act 1964 as:

- charges levied in respect of ships entering, using or leaving the harbour and charges made on the ship for marking or lighting the harbour (ship dues);
- charges made for passengers embarking or disembarking, but not charges made in respect of any services rendered or facilities provided for them (passenger dues);
- charges made in respect of goods brought in, taken out of or carried through the harbour by ship, but not charges made in respect of work performed, services rendered or facilities provided in respect of those goods (goods dues).

3.56 The practice of levying combined charges (which formerly raised some difficult legal questions) was expressly authorised by the Transport Act 1981. Such charges have to be reasonable and there is a right of appeal to the Secretary of State under Section 31 of the Act.

3.57 There are related obligations to publish dues and to keep accounts. It is this requirement which probably leads to the disaggregating of consolidated charges in port and harbour authority accounts and the apportionment of these combined charges between services rendered, for instance stevedoring, craneage etc., and those elements of the charges which relate to conservancy, ships dues, passenger dues and goods dues.

3.58 Port charges are addressed in the Draft Air and Sea Ports (Incorporation) (Jersey) Law 201- at Article 54 (4C). It is our understanding that Jersey Harbours' introduction of separate ship dues and passenger dues is relatively recent example of introducing greater transparency into port accounts and bringing port tariffs more into line with conventional international practice.

Overall Costs and Revenues

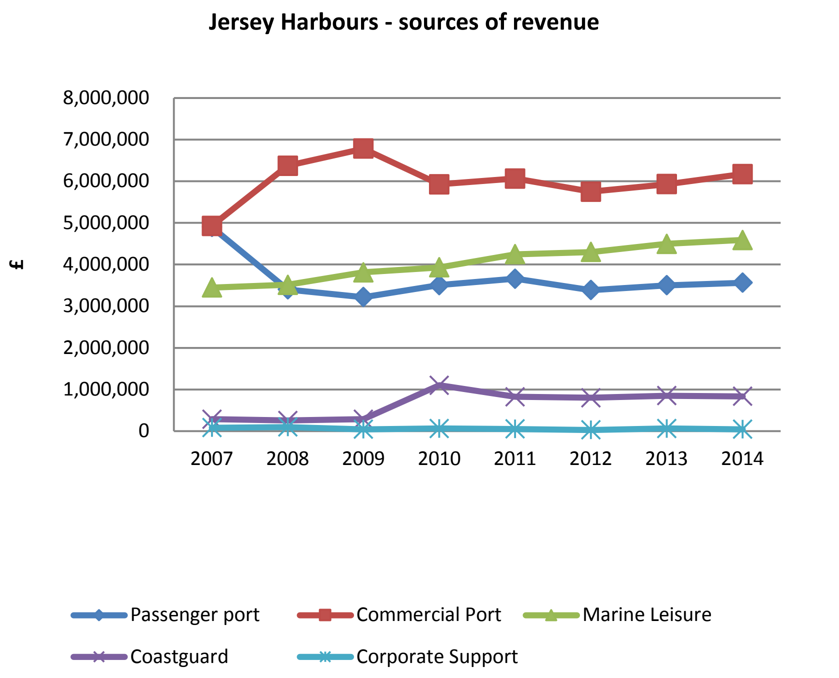
3.59 The main components of port revenues and costs as reported by Jersey Harbours are provided in the following figures and tables.

Table 3.1: Port Costs and Revenues 2014			
	Revenue	**Costs**	**Contribution**
Passenger port	3,561,986	1,292,756	2,269,230
Commercial Port	6,169,543	3,592,937	2,576,606
Marine Leisure	4,590,451	2,477,358	2,113,093
Coastguard	835,319	982,848	(147,529)
Corporate support (1)	44,420	2,858,733	(2,814,313)
Total	**15,201,719**	**11,204,632**	**3,997,087**
(1) Includes Staff costs (incl. PECRS liab) and non- staff cost (including the TTS contract)			
Source: PoJL Financial Model			

3.60 Revenue generated by the passenger port relates to the levies charged per passenger and passenger vehicle disembarking from ferries at St. Helier Port. Commercial port revenue includes the revenue raised per goods vehicle loaded/unloaded onto to commercial vessels carrying freight (recorded as a 'linkspan' charge) and per tonne of cargo unloaded plus charges levied on the ships themselves. The latter 'ship charge' is a relatively recent revision to the published port tariff and is charged per ship call based on the gross tonnage of the vessel. This is capped at a 5,000gt. The total income derived from the ship charge accounts for 5% of the commercial port income. Taken together, the passenger and freight port operations account for two-thirds of total port revenue with income from marine leisure (mainly marina moorings) accounting for 30%.

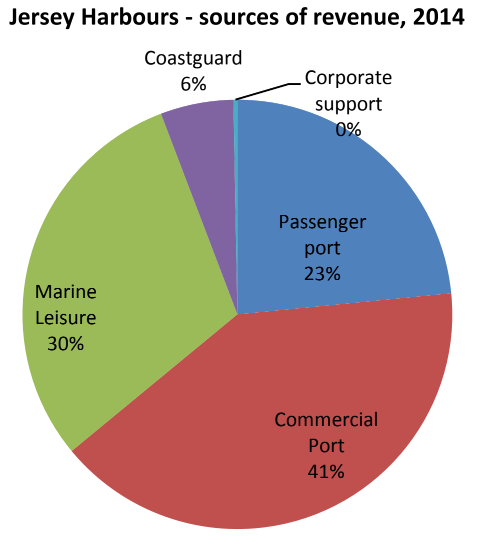
3.61 Attention is drawn to provision for the Coastguard where the Financial Model indicates that this service is likely to run at an increasing loss in the next years (**Figure 3.11**). It raises the question whether this service should be paid from the purse of the incorporated entity if Ports of Jersey Ltd is to meet the objective of becoming a self-financing commercial enterprise. Support of the Coastguard service by Jersey Harbours is shown as a negative component of freight revenue in the Model.

Figure 3.7: Jersey Harbours Sources of Revenue



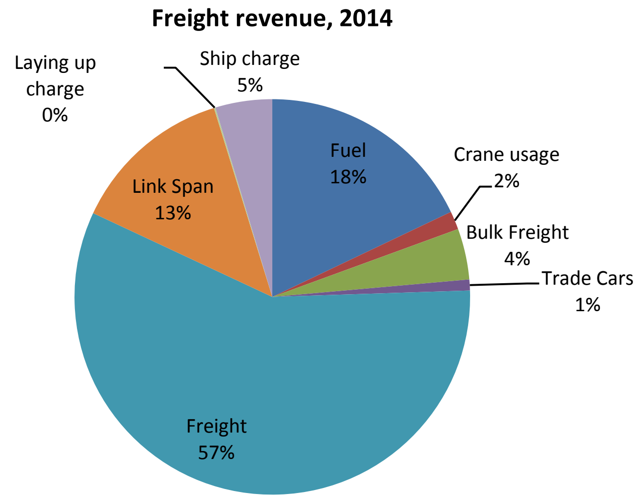
Source: PoJL Financial Model

Figure 3.8: Jersey Harbours Sources of Revenue (2014)



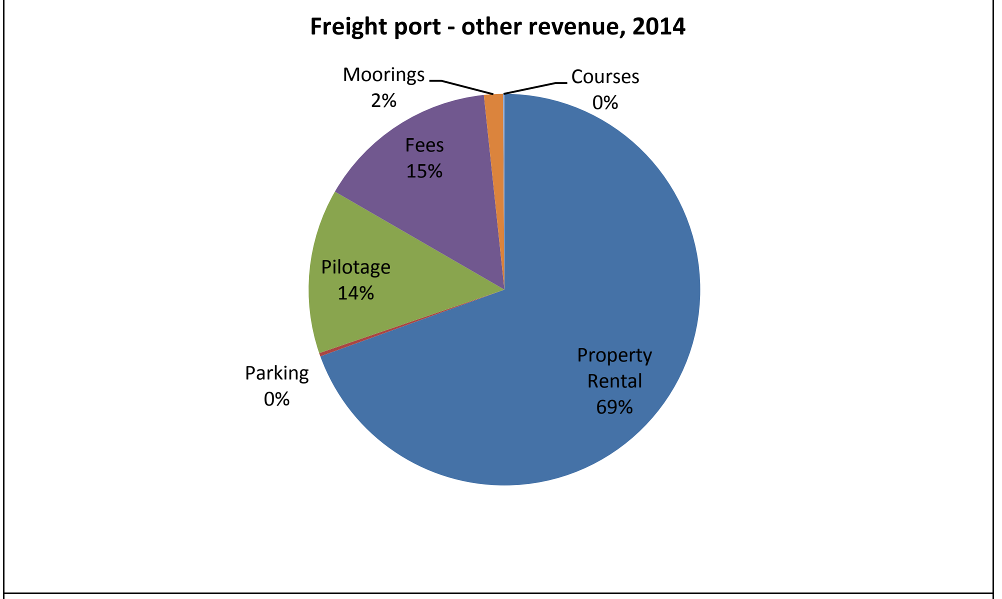
Source: PoJL Financial Model

Figure 3.9: Jersey Harbours Freight Revenue (2014)



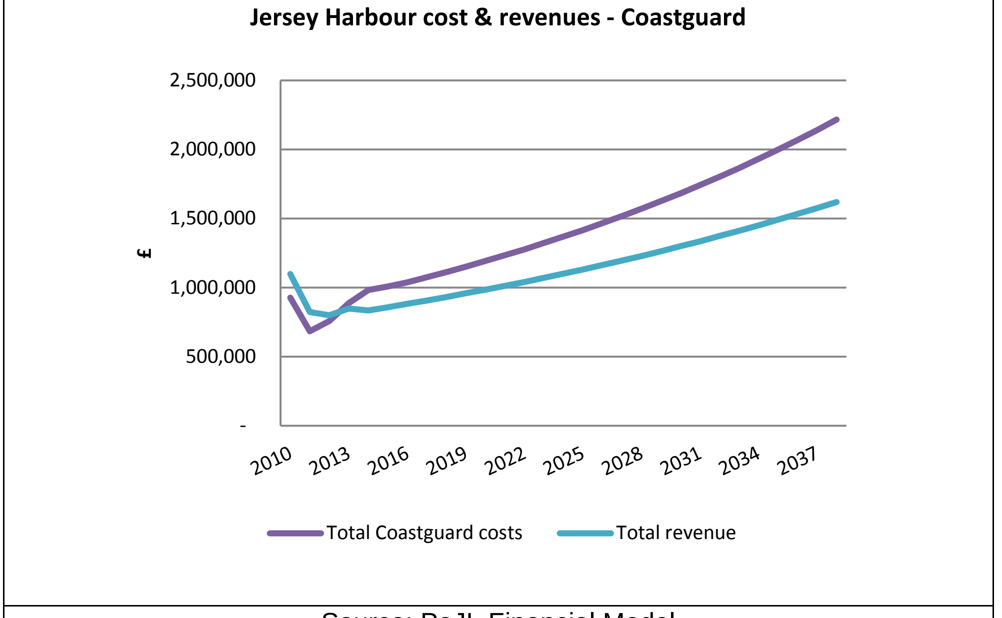
Source: PoJL Financial Model

Figure 3.10: Freight Port – Other Revenue (2014)



Source: PoJL Financial Model

Figure 3.11: Jersey Harbours Coastguard Costs & Revenues



Source: PoJL Financial Model

Capital Programme

3.62 We have considered the Harbours capital programme though only through an inspection of the spreadsheet and not a detailed discussion of the elements within it. The programme excludes the commercial projects that are the subject of separate business cases. We have noted that the model reports a comprehensive programme of civil works involving refurbishment, removal or replacement of many of the marine infrastructures (breakwaters, harbour sill, berths, quay walls, pontoons, ramps and slipways, moorings and beacons). In some cases, there is a rolling programme of replacement and some items incur annual maintenance costs (e.g. offshore beacons and buoys).

3.63 The biggest ticket items are the replacement of the West Berth ro-ro ramp and walkway and East berth ramp with costs over the period to 2038 estimated at £6.6 million and £5.5 million respectively. We note that there is no provision for maintenance dredging though provision is made for dredging equipment. None of the costs in the programme stand out as being unreasonable in our view. The model may be subject to another iteration following the development of the St. Helier Master Plan later this year.

Commercial Projects

3.64 Of the nine core commercial project included in the Financial Model, four relate to the commercial harbour and port operations. Anticipated additional income from these four projects has been estimated at around £830,000 per annum by 2018 rising to £1.4 million per annum by 2038 as shown in **Figures 3.12** and **3.13** below. The accumulated income of the four key projects over the period from 2015 to 2038 is indicated to be £24.2 million of which 43% (£10.4 million) derives from the re-development of the La Folie site. A key assumption in the Financial Model is that a similar quantum of income will be derived from similar types of projects ('undefined events') generating revenue from 2027 onwards and carrying similar levels of capex.

3.65 A description of each of the four primary projects is set out below.

- ✈ **Guernsey Waste Project** - this involves the importation of waste material from Guernsey for processing at La Collette. The project could generate income to Jersey Harbours of over £300,000 per annum (£6.6 million over the period to 2038. The revenues generated relate to dues paid for the tonnage of waste in and ash (the product of incinerated waste) out of the harbour. The political challenges associated with the project means that there are no guarantees that this project will go ahead. We understand that there is also uncertainty regarding Guernsey's position in relation to the possibility.

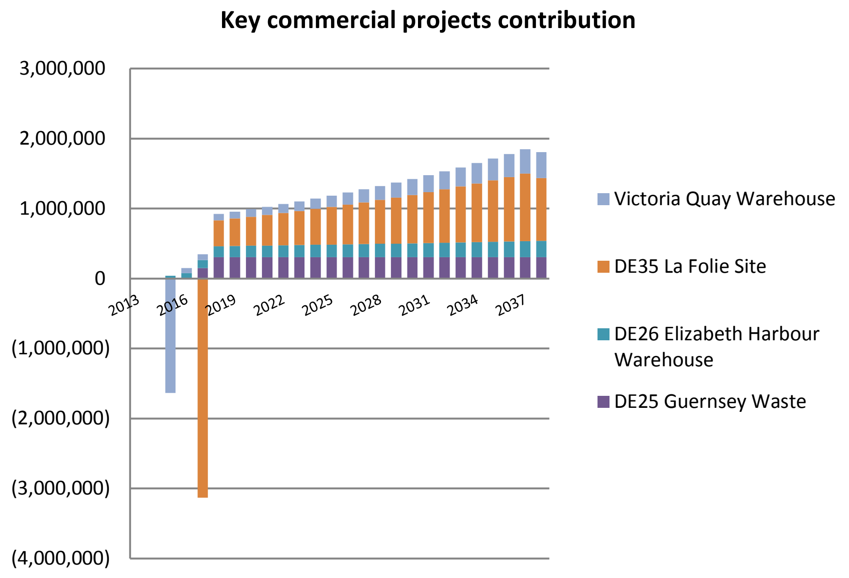
- **Elizabeth Harbour Warehousing Phase 3** - the project involves development of a new freight warehouse facility at Elizabeth Harbour, with subsequent re-allocation of existing sites at Elizabeth Harbour and New North Quay. We understand that planning permission has been granted for the warehouse and agreement has been reached with the logistics provider Ferryspeed, which will be able to consolidate its operations from other locations within and outside the harbour. The door is then opened for other tenants to move into Ferryspeed's vacated premises in the port from which additional revenue is anticipated. The total projected revenue from the new Ferryspeed warehouse will amount to £155,000 per annum. Negotiations are already ongoing with another logistics company to occupy one vacated site and there are plans to look at the allocation of vacated space at New North Quay. The anticipated additional income is not specifically included in the Model, but would be part of the anticipated further income generated from the basket of 'undefined events'/longer term commercial projects in the Financial Model.

- **Victoria Quay Warehouse Project** - this involves the acquisition of the warehouse from J.W. Huelin at a negotiated cost included within the Financial Model. It will provide for a 'common-user' facility that provides storage space for a number of tenants rather than a single user. The net revenue projection is circa £200,000 per annum. This is already being provided by existing tenants. This is the least risk project in the programme of Harbour projects though there will need to be some renegotiation of existing tenant agreements.

- **La Folie Quay and Buildings** - this is the most ambitious of the current projects being proposed involving the mixed-use redevelopment of La Folie Quay to include the renovation of La Folie Public House together with commercial and retail units. As mentioned above, the project generates the greatest revenue potential and carries the greatest capital investment requirement of the Harbour projects, estimated at £2.9 million in the Model.

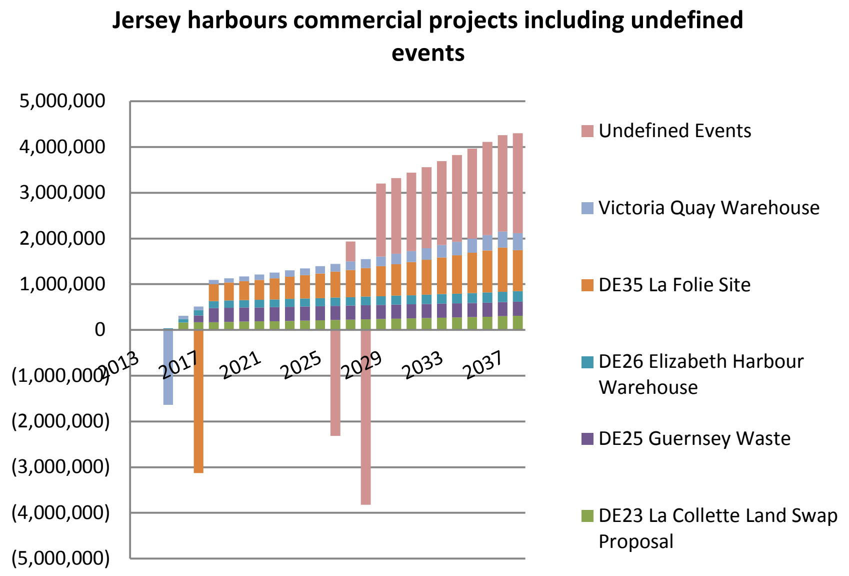
3.66 Other Harbour related projects not included in the Financial Model at this stage include the development of a new marina berths and extension of the existing St Helier and La Collette Marinas and new restaurant facilities and the possible redevelopment/reconfiguration of the layout of facilities on New North Quay. However, it is not clear whether these other projects, as allowed for in the Financial Model in the longer term, would have the same revenue generation potential as the four above mentioned.

Figure 3.12: Jersey Harbours Commercial Projects Contribution



Source: PoJL Financial Model

Figure 3.13: Jersey Harbours Commercial Projects Contribution incl. Undefined Events



Source: PoJL Financial Model

Summary of Key Risks and Sensitivities

3.67 We were given full access to the Financial Model by the Ports Management Team and we asked for a number of modifications to be made in order to assess the likely achievability of the financial projections informed by the recent performance of the business. Specifically:

- ✈ we requested that the aviation passenger yield be updated to 2014 values, which was done, along with a full update of 2014 actual results;
- ✈ an error in the inflation calculation on the repeat of the commercial projects from 2026 onwards was identified and corrected; adjustment was also made to the delay in completion of the cargo centre and the subsequent development for ‘Hangar 8’; cargo centre revenues were delayed by six months and ‘Hangar 8’ revenues by one year;
- ✈ a review of 2014 actuals was undertaken by the Ports Management Team to identify any ‘one-off’ items that are not expected to recur; and
- ✈ a review of the gross and net revenues for the cargo centre identified that the lost rental from the old cargo centre had not been removed from the extrapolation of the ongoing property rentals; this was corrected.

3.68 In summary, the changes identified by the Ports Management Team in relation to the actual 2014 out-turn are set out in **Table 3.2** and the effect of correcting the identified errors in the treatment of income from the commercial projects is set out in **Table 3.3**. These are stated in terms of the cumulative cash flow effect over the life of the Financial Model.

Table 3.2: Breakdown of Effect of Changes due to 2014 Actual Performance

	£'000
Aviation Yields	- 27,270
Increases in base line 2014 (Fishers Report)	7,560
Increased scope of BAU income	3,233
Adjustment to staff extrapolation	9,618
Reduction in non-staff costs (one off bad debt write off due to primary freight carrier going bankrupt)	9,850
Net Adjustment	**2,991**

Source: Ports of Jersey

Table 3.3: Combined Effect of 2014 Adjustments and Other Adjustments	
	£'000
Update for 2014 actuals*	2,991
Correct inflation on commercial projects & move cargo centre 6 mths and hangar 8 1 year	- 9,628
Update anticipated cargo centre revenues	- 2,975
Remove non-recurring PFOS from 2015	18,728
Remove double count on cargo centre income	- 4,479
Net Adjustment	**4,637**
Source: Ports of Jersey	

3.69 We recognise that this Financial Model now differs in some respects from that included within the Case for Incorporation but it delivers a very similar outcome in terms of the Profile of the Trading Fund, as shown in Figure 3.2. However, the extent of these changes does show how sensitive the Model is to changes in key assumptions, some of which are of particular concern.

3.70 The aviation passenger yield adjustments to the 2014 starting point were extrapolated to the end of the Model period (i.e. to 2038) and because the aviation yield in 2014 was significantly reduced as a result of increased discounts, this resulted in a net overall cash reduction of some £27m at the end of the period as previously noted. However, this was compensated for by other adjustments to the Model, such as increased freight revenues and operational efficiencies achieved from the 2013 starting point, which resulted in an overall net positive effect on the cash position by the end of the period of £20.3m.

3.71 It is not within our present scope of work to conduct extensive sensitivity analysis on the Financial Model, but the adjustments above are illustrative of the sensitivities to which the Model is subject when changes to key assumptions are made. In particular, this highlights the vulnerability to shortfalls in revenue. In the light of this, there remains some risk in terms of the achievability of the traffic forecasts and, more significantly, the ability to maintain yields from aeronautical charges at 85% of RPI, which currently makes up a high proportion of Airport income.

3.72 In addition, we have noted above the risks attaching to the commercial projects as currently included in the Model. Of all the projects included in the current Financial Model, the importation of Guernsey waste carries the greatest uncertainty and is largely outside the control of Jersey Harbours. Should this not be achievable for reasons beyond the Ports control, then it is unlikely that a similar project bringing more goods into the port could be replicated. The other projects seem more reasonable, though may have timing issues depending on the speed of gaining planning permissions and securing contracts with different developers. This could pose some risk to the timing and scale of income uplift deliverable.

3.73 This is particularly so in relation to the second tranche of undefined commercial projects. The long list of projects currently on the table appears less likely to deliver the same level of income uplift as the first tranche. The major constraint on Jersey Harbours, as with any port, is the lack of space and it is prudent that a Master Plan of the port has been commissioned that will enable the optimal layout of berths, marinas and land areas and landside access to be identified. The Airport Master Plan also identifies areas for development, although some of these may be challenging in planning terms. However, as with the Harbours, land is constrained on the Airport site.

3.74 By pointing out these risks and sensitivities, we do not mean to cast doubt on the robustness of the Financial Model as an analytical tool, nor do we believe that these risks and sensitivities undermine the case for incorporation. However, we do believe that it is important for the Scrutiny Panel to be aware of these risks and sensitivities and what steps might be taken to fully understand and mitigate them <u>after</u> incorporation. It is important to stress that these risks exist independent of incorporation and the financial position would almost certainly be worse if incorporation did not take place. The risks to traffic and aeronautical revenues would exist in any event and the incorporated entity may well be better placed to mitigate these risks.

Appraisal

3.75 The risks associated with the commercial projects are principally related to the quantum of deliverability. However, the corrections made to the expected net revenue from the cargo centre do give rise to a concern about the rigour of appraisal to which this and other projects were subject to prior to inclusion in the Model, particularly in terms of the reliance on examining the net cash position overall (i.e. the effect on the Trading Fund), not in terms of whether it was a sound investment delivering a profitable return to shareholders in terms of its net present value or internal rate of return. In terms of the cargo centre, whilst it appears unlikely to deliver a commercial rate of return as an individual project, we understand that there were broader strategic considerations. Nonetheless, following incorporation, it will be essential that projects are subject to more rigorous commercial appraisal. There will need to be enhanced scrutiny of the business cases for these commercial projects under the new governance structure due to the risks to which the business could be exposed if borrowing is incurred to fund such projects. Such an analysis would need to be a fundamental part of a robust Strategic Business Plan and at the heart of the scrutiny by the Board and Shareholders of the Plan. Otherwise, there could be some risk of destabilising the business if investment decisions are not robust.

3.76 The key control document will be the Strategic Business Plan (SBP), which in part will derive from this Financial Model. This needs to be underpinned by sound business cases for the projects contained therein in a greater degree of detail than lay behind the Incorporation Financial Model if it is to be an effective control and monitoring tool. The SBP forms an integral part of the new governance regime. We discuss this further in the next section.

Conclusion

3.77 The Financial Model, as it currently stands, represents an illustration of how an incorporated Ports of Jersey could fulfil the ambition to be financially self-sustainable and maintain positive cash without recourse to States funding. In this sense, it serves a valuable purpose as a support to the case for incorporation. We also acknowledge that the Model has been informed by expert external consultants in relation to the traffic forecasts and capital programme requirements and we have no fundamental issues with either of these aspects of the Model. We also recognise that the Model has been reviewed by accounting experts BDO from the perspective of its mechanics.

3.78 However, the Model has not been subjected to a full ‘due diligence’ process, in which each and every assumption is reviewed and tested for sensitivity. In particular, the achievability and viability of each of the commercial projects in the Model has not been independently reviewed and we were told that the commercial projects in the Model were essentially illustrative of what an incorporated entity with the freedom to act commercially could achieve.

3.79 We do not believe that the case for incorporation hangs on the detail of the current Financial Model as it currently stands, but we do believe that the Scrutiny Panel needs to be aware that the Model should not be taken to be equivalent to the Strategic Business Plan, which has yet to be prepared. The fully worked up SBP may or may not replicate the financial forecasts currently indicated post-incorporation, not least due to the risks we have identified in this section. We would expect the Strategic Business Plan to be much more specific (rather than illustrative) in terms of setting targets for the management team in the short to medium term, post incorporation and subject to rigorous scrutiny by the Board and Shareholder.

4 GOVERNANCE

Introduction

4.1 In this section of our report, we deal with governance issues. We have divided our comments into 'external governance', which deals with the relationship between the incorporated entity and the States as shareholder, and 'internal governance', which deals with the Board and management of the company

External Governance

4.2 Article 3 of the proposed legislation sets out that:

"(1) There shall be a company known as Ports of Jersey Ltd. ("POJL").

(2) POJL shall be a company limited by shares and capable of being a transferee company in the sense given to that term by Part 5.

(3) The Minister for Treasury and Resources shall, following consultation with the Minister –

(a) appoint the first Chairman of the Board of directors of POJL; and

(b) determine the terms and conditions of service which are applicable to the first Chairman of the Board on appointment.

(4) In relation to any appointment subsequent to the appointment of the first Chairman under paragraph (3), POJL shall not appoint a person as Chairman of the Board without the approval of the Minister.

(5) Subject to paragraph (6), the Minister for Treasury and Resources shall exercise, in relation to POJL, the powers of the States in their capacity of holder of securities in a company, but in doing so the Minister for Treasury and Resources shall act –

(a) in the interests of the States in that capacity; and

(b) in such a way as to encourage sustainable growth in the economy of Jersey in the medium to long term.

(6) The following powers may not be exercised by the Minister for Treasury and Resources unless directed to do so by the States and in accordance with any such direction, namely –

(a) powers to dispose of shares or share rights in POJL and to create or dispose of security interests over, or otherwise charge, such shares or share rights;

(b) power to authorize the issue of shares or share rights in POJL to any person other than the States;

(c) power to vote on a resolution to wind up POJL; and

(d) such other powers as the States may prescribe by Regulations."

4.3 Article 5 sets out the primary object of the Ports of Jersey Ltd, as:

(1) The primary object of POJL shall be to provide, or ensure the provision of, safe, secure and efficient port operations for Jersey, whether by itself or by any other person acting as its subsidiary, agent, employee or subcontractor.

(2) Without derogation from the primary object stated in paragraph (1), in carrying out commercial port operations POJL shall act in the manner best calculated to secure sustainable growth in the economy of Jersey in the medium to long term.

(3) In paragraph (2), "commercial port operations" means any port operations licensed under Part 3, but does not include harbour operations which form part of POJL's public service obligations as expressed in Article 6.

4.4 The Introduction to the draft legislation refers to the intention to set out the exact relationship between the shareholder and the company, as well as the general responsibilities of the directors, in the Memorandum and Articles of Association. This would be normal practice when setting up a new company and we understand that the draft Articles are based on a generic template for Jersey and as such are currently very general, leaving the main control document to be the Memorandum of Understanding. It appears to us essential that a more formal linkage is made between the Articles of Association and the Memorandum to ensure that both are legally binding.

Memorandum of Understanding

4.5 As noted above, a Memorandum of Understanding (MOU) has been drawn up between the company and the shareholder and we were provided with a draft of this document. The MOU deals with the following issues:

- more specific objectives of the company (in addition to principal objects as defined under the law and set out above);
- definitions and interpretations;
- the treatment of sensitive information;
- the date of applicability and duration of the MOU;
- the manner in which the incorporated entity is expected to conduct its business;

- the appointment of Directors;
- the process of preparing and approving the Strategic Business Plan;
- the preparation and delivery to the Minister of an Annual Report;
- the preparation and delivery to the Minister of half yearly reports;
- the principles for setting Key Performance Indicators;
- conformity with the principles of corporate governance;
- the circumstances under which the consent of the Minister will be sought in relation to important management decisions;
- the provision of information to and consultation with the Minister;
- ongoing communications with and accountability to the Minister;
- directors' remuneration;
- the responsibilities of the company in relation to Insurance;
- a 'without prejudice' clause;
- further assurances that the States will agree to consider reasonable requests from the company;
- the relationship with the Ports Policy Group and specifically that the Minister will be guided by policy decisions reached by the Ports Policy Group.

The Role of the Ports Policy Group

4.6 As noted above, the MOU refers to a 'Ports Policy Group', which is a group comprising the Chief Minister, the Minister for Economic Development, and the Minister for Treasury and Resources and whose objective is to agree policy positions in respect of the Ports of Jersey and to consider where the proper balance should lie should the objectives of a commercial company conflict the wider strategic objectives of States ownership. It is envisaged that this Group would meet annually and ensure that the Strategic Business Plan properly reflects policy objectives. It is evident that the role of this group is key and it will have the authority to approve the Strategic Business Plan. The monitoring of performance against the Plan will be the responsibility of the Minister for Treasury and Resources in his/her role as shareholder representative.

4.7 The proposed terms of reference of the Ports Policy Group are:

Membership

- Chief Minister (or designate);
- Minister for Economic Development (or designate);
- Minister for Treasury and Resources (or designate);

Regular Meetings

- The Group will meet annually to agree:
  - The overall policy objectives for the incorporated Ports of Jersey Limited (PoJL). This may include interpretation of Article 5 (2) to ‘secure sustainable growth in the economy of Jersey in the medium to long term’. (This will inform the Minister for Treasury and Resources in exercising his powers of direction in this regard.)
  - A statement of government’s policy objectives in relation to the PoJL for the guidance of the JCRA.
  - The PoJL SBP for the forthcoming year.
  - The dividend policy for the forthcoming year.
  - The planned expenditure on the Public Service Obligations (PSOs) during the forthcoming year.
- Decisions in these areas will be taken by the Group as a whole;

Irregular Meetings

- Additional meeting may be held if-
  - The Treasury Minister wishes to change the dividend policy mid-year.
  - A Minister wishes to change the expenditure on the PSOs mid-year.
  - PoJL proposes a change to its SBP.
- Should such events arise, the relevant Minister will inform the PPG in advance prior to taking the relevant action or approving changes to the SBP. If the other members confirm that the matter is not of interest, no meeting need be held.

Additional Meetings

- In addition to the scheduled meetings, a Minister may offer any decision for which they are responsible under the ASP, or in relation to the PoJL under the Companies Law, or in relation to the Harbours or Airport Authorities, to the PPG for consideration. If the other members confirm that the matter is not of interest, no meeting need be held.
- Any Minister may call a meeting to coordinate policy in an area where there is freedom in implementing policy, (i.e. that is not an area reserved for the Authority in its independent capacity) where issues arise in year between the Ports of Jersey and the JCRA.
- This will be entirely subject to the discretion of the party taking the decision. Ministers will have no right of review over decisions of other Ministers outside of those which are specified above.

Outcomes

- The PPG will have no powers in Law, but will guide the membership as to the exercise of those powers held individually in respect of the PoJL.
- In addition, if the PPG reach a policy position, the Group may write to the Board of PoJL, privately or publicly as it sees fit, stating its opinion on actions or the general course of action of the Board.

Administration

- The PPG will be advised as appropriate by the Treasurer of the States, the relevant government maritime and civil aviation professionals and the JCRA.
- Secretarial support and responsibility for ensuring meetings are called will be provided by EDD.

Timeframe

- Ministers will prioritise PPG meetings as necessary to meet the turnaround times laid down in the Memorandum of Understanding (MoU) between the PoJL and the shareholder.

4.8 This group clearly plays a key role in ensuring that the Ports continue to act in the best interests of Jersey following incorporation. It may also be desirable for this Group to have a role in monitoring the performance of the incorporated entity in terms of delivering the Strategic Business Plan as well as simply setting the objectives for the Plan and approving it on an annual (or periodic[3]) basis. We also note that there is some lack of clarity as to whether the SBP has to be approved by Ports Policy Group or simply the Minister for Treasury and Resources as shareholder representative, as indicated in the draft MOU.

4.9 We note that the MOU sets out, in paragraph 13, detail about 'important management decisions' and the conditions under which it would be expected that the company would seek the consent of the Minister before taking action, such as making 'material' changes to the Strategic Business Plan, or entering into 'material' commercial contracts or joint ventures. It would be for the Board to determine what changes might be considered to be material. This is potential weakness, albeit the Board would be bound by the overarching duty of the company to promote sustainable growth in the Jersey economy over the medium to long term.

4.10 We understand that the MOU was developed in consultation with the Treasury, Economic Development, and the law officers and that reference was made to the MOUs for Jersey Post and Andium Homes. A report by Deloitte on the implementation of a best practice shareholder model that would enable Treasury & Resources to exercise proper oversight of the States investment in the four utilities[4] was also referenced, as was a recent report of the Comptroller and Auditor General to the States on the governance arrangements relating to Jersey Telecom[5], which raised a number of pertinent points such as:

- the clarity of the objectives of the States in maintaining ownership of the Ports of Jersey and the level of risk the States is prepared to accept as shareholder;

- the way in which Key Performance Indicators (referred to in the MOU, but presumably intended to be specified in the SBP) relate to the objectives of the incorporated entity and how they are monitored; and,

- the lack of clarity in the MOU, particularly over *"important management decisions"* and the possibility that the incorporate company's Board may fail to seek consent for matters that the States might consider to be "material".

[3] The frequency at which the Strategic Business Plan is to be updated is not set out. We would normally expect a Business Plan to cover at least 5 years, albeit there would be greater detail for the early years. The Plan should be subject to annual rolling updates with a more fundamental strategic review every 5 years.
[4] States of Jersey Owned Utilities Governance Review, Deloitte, June 2010.
[5] 'The States as Shareholder – Jersey Telecom', Comptroller & Auditor General, Jersey Audit Office, July 2014.

4.11 The clarity of objectives of the States in maintaining ownership of the Ports and the level of risk appetite is expected to be something that the Ports Policy Group would set and review through the Strategic Business Plan, which would also contain Key Performance Indicators that are aligned with strategic objectives. However, it may still be necessary to clarify or give more specific guidance in the MOU as to what is meant by *"important management decisions"*. This relates to the decision currently left to the discretion of the Board as to the materiality of proposals in terms of changes to the SBP or decisions falling outside of the scope of the SBP.

4.12 The MOU, as drafted, is not dissimilar in content to what we would expect to see with a local authority owned airport company in the UK and so the proper exercise of governance may not be dependent on the precise wording of the MOU, but rather on the effectiveness of the processes of scrutiny and accountability that lie outside of the MOU between the Ports Policy Group, the Minister (as shareholder), and the incorporated entity.

4.13 As the report on Jersey Telecom makes clear, the fundamental concern is to ensure clarity of objectives in terms of what the incorporated entity will be required to deliver/achieve. Overall, this places a substantial onus on the Ports Policy Group and the Minister as to how it will transparently go about setting and communicating objectives for the Ports Company and striking the correct balance between commercial considerations and the wider strategic objectives of the shareholder. Clarity of objectives, accepting that they may need to be adjusted over time, is the first pre-requisite for ensuring that the incorporation delivers what is required for the benefit of the Island as a whole. We also note that the JCRA has already flagged up the importance of there being clarity of objectives for the regulated company in terms of having an effective economic regulation framework[6].

4.14 This concern does give rise to the question as to what if any, level of scrutiny is required of the work of the Ports Policy Group and how this group will be held to account. We understand that this issue has not arisen in relation to the previous incorporations of States owned assets in Jersey but, to some degree at least, these incorporations related to entities which are open to an element of competition for at least part of the business. The extent of the monopoly held by the Ports over access to and from the Island does legitimise a greater degree of concern. However, this needs to be balanced against the fact that the Ports Policy Group will, in approving the Strategic Business Plan, be examining material which is commercially confidential, such as commercial policies and dealings which the Ports of Jersey Ltd will be having with its customers in the private sector. These dealings could be prejudiced if the contents of the Strategic Business Plan were subject to full public scrutiny.

[6] Letter from Michael Byrne of the JCRA to the Minister for Economic Development, 29 April 2014.

4.15 We do recommend, however, that, in the interests of transparency and accountability, it would be desirable for the Ports Policy Group to report key decisions which it takes to vary the objectives for the Ports, approve new business opportunities (such as permission for joint ventures etc.), and the performance of the company more generally to the States. This would not, however, extend to commercially confidential details of the Strategic Business Plan. It will be important, nonetheless, that the decisions taken by the Ports Policy Group are binding and not subject to extended periods of scrutiny and debate, otherwise the benefits of incorporation, in terms of permitting a more commercially responsive approach by the Ports, would be lost.

Strategic Business Plan

4.16 It is evident that the Strategic Business Plan is the key control document for the incorporated entity. The effectiveness of the MOU is bound up in the process by which the Strategic Business Plan (SBP) is developed, approved and monitored. The MOU specifies in paragraph 8 that the SBP is the document which approves, controls and limits what the incorporated entity can and cannot do. There is nothing inherently wrong in this in terms of the positioning of the SBP at the heart of the MOU, but it does place great emphasis on the rigour of the process by which the SBP is developed, approved and monitored. For example, the MOU does not set out any process by which the SBP is reviewed, in terms of an independent 'due diligence' exercise, before it is approved by the Minister. This is particularly important in the light of the concerns we have expressed about the rigour of appraisal underpinning the critical commercial projects in the Model currently.

4.17 As we have made clear in the previous section, the Financial Model as it currently stands is not yet equivalent to what we would expect to see in terms of a cogent SBP and does not, in its current form, provide an appropriate framework for directing and monitoring the performance of the incorporated entity post-incorporation. In other words, the Financial Model is not yet in a form which could form the initial SBP, which would in any event need to be informed by more rigorous assessment of business opportunities and risks. We would expect the initial plan to be subject to a greater degree of scrutiny than might be the case in the medium to long term when a track record of sound business planning has been established through the monitoring process.

4.18 According to paragraph 13 of the MOU, the SBP also becomes the vehicle for controlling borrowing and the extent to which the incorporated entity may engage in partnerships and activities outside of Jersey, which we note was also one of the concerns expressed in the report of the Comptroller and Auditor General regarding Jersey Telecom, as referred to above.

4.19 There are, therefore, two key safeguards which we believe should be addressed:

- the role of the Ports Policy Group in setting and communicating clear strategic objectives for the incorporated entity, including a clearer definition of the circumstances in which important management decisions would require consent; and
- the need for a robust Strategic Business Plan to be drawn up by the Ports and the rigour of the processes in place for its approval and monitoring, including appropriate independent due diligence of the assumptions underpinning it.

4.20 As we have pointed out in the introduction to this section, the Financial Model is not the same thing as the incorporated entity's first Strategic Business Plan (SBP), which we understand is under preparation but is not yet available for review. We believe that this is an important distinction to make because it is through the SBP that the risks and sensitivities of the Financial Model can be managed. The SBP will also serve other important purposes including acting as the means by which the controls envisaged in the Memorandum of Understanding (MOU) can be exercised and monitored.

4.21 There is no standard template for what should be contained in a Strategic Business Plan, but we would expect it to include, as a minimum:

- the Vision for the incorporated entity, its primary raison d'être, and its key strategic objectives;
- an assessment of the market conditions in which the business is operating, including short and medium term traffic forecasts;
- regulatory requirements and how these will be met;
- cross reference to other key documents such as Master Plans;
- a series of specific management targets for the period covered by the SBP, clearly linked to the overall strategic objectives, and how performance against these targets will be monitored and reported;
- capital and revenue budgets for the period covered by the SBP including forecasts of profit and loss, balance sheet and cash flows;
- sources of finance, as required;
- risks and how they will be managed.

We would expect the detailed business cases for specific major projects which are due to be implemented in the near term to be appended to the SBP.

4.22 The SBP is therefore a critical document in terms of translating the Financial Model into an effective business plan, which can be used as a means of controlling how the business performs and is monitored. We do not see the lack of a SBP at this stage as a reason to delay the process of incorporation, although it would be desirable for the process of Shareholder scrutiny to commence as soon as possible. It is strongly recommended that the initial SBP should be subject to its own due diligence exercise prior to approval by the Ports Policy Group in the light of the risks and sensitivities which we have identified in considering the Financial Model. This will be an essential first task <u>after</u> incorporation.

Internal Governance

4.23 Turning now to internal governance and the role of the incorporated entity's Board and management team, it is important to remember that one of the key considerations in moving the Ports to incorporated status is the ability of the Company to act in a much more 'commercial' manner than was previously possible, albeit within any limitations set out in the MOU and agreed in the SBP. The success of this new commercial approach may require a particular set of managerial skills in relation to developing and driving forward commercial projects of the type being proposed by the Ports. Such skills are likely to also require prior experience of commercial projects implemented at other airports and harbours.

4.24 Similarly, the Board of the newly incorporated entity, whose role it is to oversee the management of the business and the preparation and monitoring of the Strategic Business Plan, should also have members with appropriate experience of the commercial management of airports and harbours. This would be in addition to the existing competencies in operational and safety matters and those representing the specific interests of Jersey.

Conclusion

4.25 In terms of external governance, the Memorandum of Understanding should clarify the status of the Ports Policy Group and its relationship to the Minister of Treasury and Resources' role as shareholder representative as well as how the decisions of the Policy Group will be effected through the Board of the incorporated entity. Given the monopoly status of the Ports, it is recommended that a mechanism is established for the Ports Policy Group to report back decisions taken but it is important that such decisions remain binding if the greater commercial freedom underpinning the Case for Incorporation is not to be undermined. Some decisions may be of a magnitude which require formal notification to the States, such as any major disposal of land or assets.

4.26 The rigour of the process for drawing up, approving and monitoring the Strategic Business Plan will also be a critical factor in ensuring that the objectives set out in the Memorandum of Understanding are met. We recommend that the SBP is subject to due diligence, at least in the first instance. However, it would be detrimental for the contents of the SBP to be exposed to full public scrutiny due to the commercially confidential nature of contracts between the Ports and its private sector customers.

4.27 In terms of internal governance, given that one of the key objectives of incorporation is to ensure that the incorporated entity is able to act with greater commercial freedom, it will be important to ensure that right commercial skills are available to the Board and the Ports Management Team post incorporation.

4.28 We do not believe that these concerns relating to external governance should inhibit incorporation but resolving some of these issues within the current timetable will be challenging. Others can be dealt with post incorporation, such as the establishment of a robust process for approving the Strategic Business Plan. The observations relating to internal governance can be addressed post incorporation as necessary.

5 REGULATION

Introduction

5.1 In this section, we consider the role of regulation with regard to the incorporated entity, both in terms of economic regulation and safety regulation. Under the proposed legislation, the Jersey Competition Regulatory Authority (JCRA), as part of the Channel Islands Competition Regulatory Authority (CICRA) will be responsible for the economic regulation of the incorporated entity, while the responsibility for the regulation of safety and security will rest with the Director of Civil Aviation (DCA) in the case of the Airport and the Minister for Economic Development in the case of the Harbours. We make further comment on these arrangements below. .

5.2 We held a discussion with relevant staff members of the JCRA on 1 April 2015 in order better to understand the proposed role of the regulator with regard to the incorporated entity. That discussion was very helpful and has informed the analysis set out below.

Economic Regulation

5.3 The role of the JCRA, as the economic regulator, is set out in the proposed legislation. The duties of the Minister and the JCRA are addressed specifically in Part 4, Article 26, of the Law. It is worth re-iterating these at the outset before we make further comment:

"(1) In relation to port operations, the Minister and the JCRA shall each have a primary duty to perform their respective functions under the Law

- *a) so as best to protect and further the interests of users of port operations, in the short and long term, and to do so where appropriate by promoting competition in the provision of port operations; and*
- *b) so as best to ensure*
  - (i) *that provision is made to satisfy all reasonable demands, both current and prospective, for port operations,*
  - (ii) *that port operations are provided efficiently and effectively, and*
  - (iii) *that a company (in particular including POJL), to the extent that it is or is to be licensed under this Law, has sufficient financial resources to discharge its liabilities under securities issued by the company to the State.*

(2) In relation to lifeline services, the Minister and the JCRA shall each have a primary duty to perform their respective functions under this Law so as best to ensure that such services are provided –

- *a) efficiently, effectively and without interruption; and* *b) so far as consistent with sub-paragraph (a), with due regard to –*

(i) any relevant policies of the States of Jersey,

(ii) the interests of persons using or likely to use such services, and

(iii) the special needs of persons who are disabled.

(3) So far as consistent with paragraphs (1) and (2), the Minister and the JCRA shall each have duties to perform their respective functions under this Law –

(a) so as best to encourage sustainable growth in the economy of Jersey in the medium to long term;

(b) so as to impose a minimum of restriction on persons engaging in commercial activities;

(c) with due regard to any relevant policies of the States of Jersey;

(d) with due regard to preserving and maximizing the benefits of Jersey's resources; and

(e) with due regard to the special needs of persons who are disabled."

5.4 The legislation also requires that the incorporated entity must hold a licence issued by the regulator, which is granted subject to certain conditions. Such conditions may include the setting of a price control mechanism. The letter from Michael Byrne of the JCRA to the Minister for Economic Development of 29 April 2014 suggests that this is likely to be the means by which the regulator would fulfil its duty to protect users and to ensure that services are provided efficiently. Our discussion with staff of the JCRA confirmed that some form of price control is likely to be included in the licence conditions. However, the scope and form of price control (for example whether this takes the form of a price cap on average revenue yield) is something which the JCRA has yet to determine. We understand that the JCRA's intention is to commence consultation on this post-incorporation as they do not have the powers currently.

5.5 Given the emphasis that the regulator places on achieving efficient operations and the indication given to us that a 'single till' approach was unlikely to be favoured, this does give rise to the concern as to whether the implicit cross subsidy between the Harbours and the Airport, inherent in the case for incorporation and the need to fund capital renewal works at the Airport, would in practice be allowed by the regulator. If regulation of the Harbours and the Airport were considered in their own terms on the basis of cost recovery, this could result in price increases at the Airport and price reductions at the Harbours. This no doubt underpins the regulator's request for clarity of objectives, which we understand would be achieved by way of a Ministerial Direction. Again, early clarity on this seems essential as it potentially goes to the heart of the case for incorporation.

5.6 A more minor point is that the legislation refers to *"users of port operations"* and we asked the regulator whether it had any particular views on how this should be interpreted. We were told that the regulator intended to consult widely with all stakeholder groups on incorporation and that its current view was that the term 'users' would be interpreted in the broadest sense. It, therefore, has no intention of according primacy to any particular type or group of users of the Ports when carrying out its duties.

5.7 The incorporated entity will have a right of appeal against the exercise of the regulator's powers and the legislation refers, in Article 24, to the right of appeal by individuals or parties to the Royal Court. The Court has the power to confirm the determination, refer it back to the regulator, or to assume the role of the regulator itself, which we take to mean that it could quash the regulator's determination and make a different one. We understand that the Court quashed a determination by the regulator in relation to Jersey Telecom in 2013.

5.8 The regulator has no specific obligations in relation to maintaining the Ports' Public Service Obligations (PSOs) other than to take the cost of these into account in the same way it would any other service provided by the Ports.

5.9 The legislation also provides for the granting of a licence by the regulator for the operation of a 'lifeline service' and such a licence could be exclusive if the JCRA deems this to be appropriate. However, we understand there are no 'lifeline services', as defined in the legislation, currently in operation and that the legislation is simply providing for a potential future situation in which a lifeline service could be regulated.

5.10 The JCRA told us that they would be cognisant of the approach taken by other regulators in the aviation and maritime industries and that it intended to take a pragmatic and light handed approach to regulation wherever it felt possible rather than pursue an excessively bureaucratic approach.

5.11 It should be noted that the legislation gives the Economic Development Minister the same duties as the JCRA although, in practice, the Minister is unlikely to be involved on a day-to-day basis in regulatory matters. The Minister will also have the power to issue written directions or guidance to the JCRA about how it should carry out its duties, should he or she see fit. As indicated above, these could be critical but such directions could potentially compromise the independence of the regulator. This might open up the process to a legal challenge from one of the Ports customers, particularly if it perceived that charges are rising for part of the customer base more than would otherwise be the case. Hence, the importance of an early indication of the scope of any initial Directions which might be issued.

Regulation of Safety & Security

5.12 The primary purpose of the Ports of Jersey Limited, as required by the Law, will be to ensure the provision of safe, secure and efficient port operations for Jersey.

5.13 It is intended that the Ports of Jersey Limited will also serve as the 'Harbour Authority' and the 'Airport Authority' for Jersey and that the relevant legislation[7] would be amended accordingly. This is designed to make it clear that the obligations of the Harbour Authority and Airport Authority in terms of safety and security remain compliant with existing regulations, albeit administered by the incorporated entity. To the extent that there is any conflict with the commercial aims of the incorporated entity, safety and security would take precedence.

5.14 We note the following statements in the document 'The Regulatory Framework' of May 2014, which deals with safety and security:

"The ultimate oversight of the safety and security of the harbours and airport will remain with government. For the avoidance of doubt, where there is any conflict between the pressure to make a return to the States and considerations of safety and security, safety and security will come first. This is the current situation and will remain so after incorporation. The law and wider regulatory framework has been specifically developed to ensure that this is the case.

There will be no change to the arrangement for the safety and security of the airport after incorporation. Safety and security in respect of aviation is overseen by the Director of Civil Aviation (the DCA), who performs in Jersey a similar role to that of the Civil Aviation Authority in the UK. The DCA is part of the Chief Minister's Department, not the Ports of Jersey, and has overall responsibility to ensure the safety of civil aviation in Jersey and its airspace. The DCA is responsible for issuing a licence to Jersey Airport to operate as an aerodrome, which certifies that the airport is safe and secure for that use. The staff at the airport will continue to carry out their roles with due consideration of safety and security, and their responsibilities in this area will not change.

The Economic Development Minister will retain his current legal responsibility for oversight of the safety and security of the harbours. The day to day maintenance of safety and security will still be the responsibility of the staff at the harbours, in particular the Harbour Master, albeit as a company employee rather than as a civil servant. The Harbour Master will retain some legal rights and powers, albeit he will be a company employee, and in the exercise of the powers he will be subject to the oversight of the government via the Harbour Authority. Although the details differ this is not an unusual situation in the UK, where Harbour Masters of trust ports and private ports have legal powers."

[7] The Harbours (Administration) (Jersey) Law 1961, and the Aerodromes (Administration) (Jersey) Law 1952.

5.15 Clearly, therefore, the role of the DCA in providing independent regulatory oversight of safety for aviation is not mirrored by an equivalent organisation for the maritime sector in Jersey, where the responsibility appears to rest to some degree with the Economic Development Minister and to some degree with the Harbour Master. We understand that the legislation is here intended simply to replicate the existing situation, although we feel that there is some potential for confusion. In essence, the proposed structure is broadly the same as that which other commercialised port entities would operate in complying with security and safety directions issued by relevant regulators. However, whilst this will be the situation is clear in relation to the Airport Director complying with a direction from the DCA, the situation is perhaps less clear with the role of the Harbour Master, who will fulfil a regulatory role but remain an employee of the Ports, albeit distinct from the current role as Chief Executive of the Ports. The potential implications of this are discussed further below.

The Role of the Harbour Master and Harbour Authority

5.16 The role and responsibilities of the proposed Ports of Jersey Limited (PoJL) are covered in the Draft Regulatory Framework of May 2014.

"The primary purpose of the PoJL, as set by the Law, will be to ensure the provision of safe, secure and efficient port operations for Jersey. 'Port operations' includes the operation of the commercial port, the harbours and the airport. PoJL will be expected to provide facilities and services for commercial passenger travel and freight transport, as well as facilities and services for non-commercial travel and leisure pursuits around the Island.

In some instances these duties will carried out by PoJL and its employees and in others by agents or sub-contractors. In carrying out these operations PoJL will be required to act in the manner best calculated to secure sustainable growth in the economy in the medium to long term."

5.17 A comprehensive code of operational powers is required to ensure the effective management of harbours. Such powers are normally established in primary legislation. In Jersey, the requisite legislation is contained in Harbours (Administration) (Jersey) Law 1961, the Pilotage (Jersey) Law 1965 and the Harbours (Jersey) Regulations 1962. The latter sets out in detail the powers and responsibilities of the Harbour Master who essentially has the last word in matters relating to safety and security in Jersey's harbours and territorial waters. The Harbour Master is a statutory position sworn by oath before the Royal Court. All of the obligations set out under these laws are retained in law post-incorporation. For purposes of comparison and illustration in this section some reference is made to the UK Harbours Act 1964.

5.18 First and foremost, the primary obligation of a harbour authority (HA) is to ensure safety of navigation of the harbour for all who may choose to navigate it. This includes an obligation to conserve, and facilitate the safe use of the harbour; and a duty of care exists against loss caused by the authority's negligence. There is an obligation to have regard to efficiency, economy and safety of operations as respects the services and facilities provided. There is typically an express duty to take such action as the harbour authority considers necessary or desirable for or incidental to the maintenance, improvement or conservancy of their harbour.

<u>'Open Port' Duty</u>

5.19 The other fundamental obligation of a HA is what is known as the 'open port' duty. In the UK, this is contained in the 1847 Act section 33 as follows: "*Upon Payment of the Rates made payable by this and the special Act, and subject to the other Provisions thereof, the Harbour, Dock and Pier shall be open to all Persons for the shipping and unshipping of Goods and the embarking and landing of Passengers' i.e. the harbour dock and pier shall be free to the public on payment of the rates made payable by the local legislation."*

<u>Conservancy</u>

5.20 A harbour authority has a duty to conserve the harbour so that it is reasonably fit for use as a port and also has a duty of care to see that the harbour is in a fit condition for a vessel to resort to it. This covers several specific responsibilities including the duty to:

- conduct surveys and maintain the best navigable channel;
- to keep watch and change the channel and markers when necessary;
- to place and maintain navigation marks and lights;
- to keep proper hydrographic and navigational records;
- to publish such further information as will supplement the guidance given by navigational marks.

<u>Pilotage</u>

5.21 The Pilotage (Jersey) Law 2009 gives specific powers to pilots to discharge the pilotage duties imposed on them under the Act. Under the Law, pilots are formally appointed by the Harbour Master. It is for the Harbour Master to determine whether pilotage services are necessary, whether it should be compulsory, apply to which vessels, and make reasonable charges for the services provided by the Harbour Authority, publishing the charges.

Marine Safety

5.22 The Port Marine Safety Code, published in March 2000, introduced a national standard for port safety and was written to apply to all ports regardless of size. It was clearly stated that it was not intended to be optional and was expected to be implemented by the end of 2001. The Code made it clear that each harbour authority was accountable for managing operations within the port safely and efficiently and that its board members should hold themselves responsible for ensuring that it does so. The Code also makes it clear that each harbour authority is obliged to seek and adopt appropriate powers for the effective enforcement of their regulations and for setting dues at a level which adequately funds the discharge of all their duties.

5.23 It appears to us that the roles of the Harbour Master and the Harbour Authority were not made as clearly distinct in Jersey law as they are in UK law. Under the UK pilotage Act 1987, it was determined that each harbour should have a designated Competent Harbour Authority (CHA) which was solely responsible for aspects of marine safety. The roles and responsibilities of the CHA are separate from a company that operates a port as a business. In the UK, there may be many different companies that own or operate and manage port facilities within the same harbour. All will be required to adhere to the rules and regulations set down by the CHA with regard to marine operations.

5.24 It appears that this issue is, at least in part, being addressed within the Draft Incorporation Law, specifically at Schedule (Article 54). It is stated that POJL will be appointed as the Harbour Authority and will take responsibility for all of the public service obligations that relate to marine operations with the ability to charge for them. This will be effected by revisions to the Harbours (Administration) (Jersey) Law 1961. Organisations carrying out commercial port operations (including POJL) will be subject to a licensing regime. Such licences will be granted by the Regulator (JCRA).

5.25 In Jersey, the same obligations as set out above fall to the Harbour Authority. Post incorporation, the Ports of Jersey Limited (PoJL) will effectively replace the Harbour Authority. The office of Harbour Master will then become a legal entity in its own right. This role is quite separate and different to the current ‘Harbour Master’ of Jersey Harbours who also fulfils the role of the Group Chief Executive Officer of Jersey Harbours and Jersey Airport and whose role is more broadly akin to an executive management position in a private company (though the major stakeholder here is the State). In the current position, as well as all of his or her other duties, the Harbour Master is responsible for signing commercial contracts with private companies, for example with companies providing shipping services and tenancy agreements.

5.26 The office of Harbour Master currently has the double title of ‘Harbour Master’ and ‘Chief Operating Officer – Marine, Ports of Jersey’. This conveys that the role is focussed on marine operations and marine services and not the land-side operations. The office of Harbour Master is an extremely important position and rightly will be kept as a distinct statutory function post-incorporation. It is our observation that post-incorporation there should be a more clear distinction of the statutory and commercial roles within the Harbour Authority. At present, it appears that there are five functions at risk of being highly confused:

- commercial management of the port;
- maritime safety at the port (port harbor master);
- coastguard functions;
- dealing with strategically important shipping services that could be considered 'lifeline';
- regulation.

5.27 It might be sensible to actually identify five separate job titles, such as:

- Port Director
- Port Harbour Master
- Head of Coastguard
- an economic administrator
- the Regulator

5.28 This does leave one potential loose end; if the economic administrator should strike a deal with a shipping line that conferred some degree of monopoly or privileged position (berthing times) for strategic (lifeline) reasons, then he will need to be able to instruct the Port Director to act accordingly. In such conditions, the charges levied by the port are clearly relevant and these would need to be shown (to the regulator) as reflecting the long run mean cost of providing those services including the cost of capital to regularly upgrade port capability to deal with existing a foreseeable shipping demand.

5.29 In any event, it is recommended that to remove any doubt and avoid confusion the title of Harbour Master should be allocated only to the statutory office and should not be part of PoJL’s executive.

Lifeline Services

5.30 Although we understand that there are currently no lifeline services operating in the defined legal sense, there may be some confusion in respect of the status of certain shipping services currently operated under contract.

5.31 In common-sense terms, a lifeline service should be seen as one whose absence would significantly affect the quality of life on Jersey. This would probably not apply to any individual aviation services as passengers would be able to find alternative gateways (Southampton instead of Gatwick for example), although failure to be able to access a major international hub would certainly have economic impacts. However, in the case of maritime services, the sudden absence of a ro-ro freight service would have an immediate impact of the quality of life.

5.32 The expression 'lifeline' need not imply that subsidy is required. Indeed, the dependence of the island on such a service means the opposite is likely to be the case. This is of particular sensitivity because the limited population of Jersey is such that for a regular high quality service to be available probably means that it will be a natural monopoly and, therefore, (like other natural monopolies) a candidate for regulation to avoid it being over-priced or run inefficiently in the absence of competition.

5.33 There is potential confusion as a consequence of the reference in the operating agreement between Condor and the States of Jersey (represented by the Harbour Master) of August 2014 to the ro-pax service (specifically) from Portsmouth being a 'lifeline' service. This appears to be within the context of the States of Jersey seeking to secure Condor’s commitment to ensure this service being given priority and being as close to being guaranteed as possible. There is specific reference to the need to be able to accommodate up to 40 refrigerated trucks on any one sailing, emphasising the dependence of the Island on this service.

5.34 In the context of commenting on the incorporation process and creation of POJL, there might be some value in clarification in terms of this contract to avoid confusion with the legally defined lifeline service and the potential for subsidy. One option would be for the Government to be responsible for the procuring of such a critical service (its definition to be updated from time to time), which would leave it free to negotiate with shipping lines as it saw fit, but subject to regulatory supervision (and perhaps transparency with respect to rates of return and efficiency levels). This approach would avoid the expression 'lifeline' being used to imply a case for subsidy.

Conclusion

5.35 The regulatory powers envisaged in the legislation appear reasonable and to provide satisfactory safeguards. To large extent, the duties and powers of the JCRA will be similar to those exercised by other regulators, including the UK Civil Aviation Authority. However, there is a concern regarding the potential confusion inherent in the Harbour Master's role as a regulator and position within the incorporated entity and potentially in relation to the cross over between commercial negotiation of terms to use the harbours and the designation by a regulator of a 'lifeline' service.

5.36 The precise form of price control regulation will not be determined until after incorporation has taken place and, depending on what form this takes, could constrain the incorporated entity's commercial freedom to adjust its prices upward. As we have indicated, there is potentially some tension between the regulator's overarching duty to seek economic efficiency and the proposed financial integration of the Harbours and the Airport. Hence, the importance of the objectives being set up front particularly in relation to any directions which the Minister may issue. Whatever the eventual price cap, there would remain some risk that the POJL may not be able to price up to the cap, at least in terms of commercial contracts at the Airport.

5.37 The regulation of safety and security will be largely the same as at present and although it might have been preferable for an equivalent to the DCA to have been set up in relation to the regulation of the ports, in terms of an independent Harbour Master, we do not see this as an impediment to incorporation.

6 PROTECTION OF OTHER INTERESTS

6.1 In this section, we consider whether there are any other concerns in relation to the proposed incorporation which we believe the Scrutiny Panel needs to be aware of and whether the protection of other interests have been adequately catered for.

Employees

6.2 The Case for Incorporation makes clear that the Ports have made a commitment that all members of staff will be transferred to the new body on identical terms and conditions to those which they currently enjoy as States employees. Furthermore, there will be no job losses or reduction in levels of pay as a result of incorporation. A consultation programme has also been conducted with employees and trade unions. An employee engagement programme has also been in operation and it is the intention of the Board, post incorporation, to initiate a review of reward structures so that individuals and teams can be rewarded for contributions to the success of the business going forward.

6.3 We note from the Response of the Economic Development Minister to the public consultation on incorporation that the trade unions (Prospect and Unite) were concerned about the treatment of staff during and after incorporation and took the general position that incorporation was detrimental to the interests of the staff of the Ports[8]. On the other hand, comment had also been received to the effect that the staff transfer terms were too generous and that that incorporation would be an opportunity to change terms and conditions[9]. The Minister's response to this latter comment was that there is no wish to unfairly penalise staff or to use the incorporation as an excuse for wage cuts or redundancies.

6.4 The commitments given to employees in relation to incorporation seem to us to be entirely reasonable and we see no basis for the concerns of the trade unions that incorporation will be detrimental to employees' interests. Having acknowledged these commitments, however, we would still expect the management of the business to continue, where possible, to pursue productivity and efficiency initiatives post incorporation, in consultation with its employees, in the same way as any other airport or harbour business would do.

6.5 The business must also ensure, post incorporation, that its employees have the necessary skills to be successful in its commercial approach to new projects and initiatives. The Ports Management Team also stressed to us that the greater commercial freedom post-incorporation was likely to open up new opportunities for employees.

[8] Ports Incorporation – Response of the Economic Development Minister to the Public Consultation, paragraph 4.2
[9] Ibid, paragraph 4.1

Public Service Obligations

6.6 The incorporation proposals are underpinned by a central assumption that the Ports of Jersey Limited will continue to assume the responsibility for Public Service Obligations (PSOs) that its predecessor currently fulfils today. The legislation sets out what the specific obligations are in Article 6:

- co-ordinating, or providing resources for co-ordinating, maritime search and rescue within the Jersey Search and Rescue Region;
- maintenance of aids to navigation in territorial waters;
- acting as custodian of Jersey harbours;
- enforcement of shipping legislation in territorial waters;
- responsibility for port State control;
- management of the Channel Islands Control Zone/Area.

6.7 The covering report to the legislation notes:

"As the name suggests, these Public Service Obligations (PSOs), are legal requirements on the company, and their effective provision is a duty owed by the company to the Public. These include the co-ordination of search and rescue services and the maintenance of historic Harbours, as well as other requirements. These particular functions are defined in the Law, and will be subject to agreement with government. Should there be any failure of provision by the new company, or should an agreement be impossible to reach, the relevant Minister will have the power to instruct the Ports of Jersey Limited as to the manner in which the services should be provided. This provides an essential safeguard to the Public by ensuring that the PSOs must be conducted."

6.8 The Financial Model assumes that the PSOs, including the cost of the Coastguard service and the protection of the historic harbours, are fully accounted for. Although there has previously been some concern about the status of the historic harbours under an incorporated Ports of Jersey, we believe that the financial provisions made in the Model and the protection afforded by the legislation provide reasonable assurances.

Clubs and Societies

6.9 There has similarly been some concern over the future of the various clubs, associations and societies. However, continuing support has been allowed for in the Financial Model and the PoJL has made commitments through its Corporate Social Responsibility Statement[10] to continue to support these organisations. It is also true that a growing and financially self-sustainable Ports would be better placed to invest in and support these organisations. The economic regulatory role of the JCRA is also designed to protect their interests, taking into account any directions which the Minister may issue in this regard.

[10] Appendix 15 of the Case for Incorporation, May 2014.

7 CONCLUSIONS

7.1 There is a clear benefit from incorporation, which arises principally through the ability of the incorporated entity to act in a more commercial manner, with faster response times, and with greater flexibility in terms of pursuing new commercial opportunities and in responding to changing market conditions. This is a view that was supported by previous reports into the potential for incorporating the Ports and is also supported from our own experience elsewhere.

7.2 Without the commercial freedom to find new sources of revenue, there is a risk that price rises to customers would be required, or operating costs would have to be severely reduced, with implications for service standards. There could also be a call on the States Treasury to fund capital expenditure, with consequences for taxpayers. Incorporation is more likely to allow the Ports to be largely self-sustainable, with the ability to access alternative sources of funding for some commercial projects.

7.3 However, there is also some risk to the achievement of the cash flows projected in the current Financial Model and it is important that this is understood. The Financial Model, as it currently stands, represents an illustration of how an incorporated Ports could fulfil the ambition to be financially self-sustainable and maintain positive cash without recourse to States funding. This is heavily dependent on the delivery of a number of commercial projects. However, the achievability of each of the commercial projects in the Model has not been independently reviewed and we were told that the commercial projects in the Model were essentially illustrative of what an incorporated entity with the freedom to act commercially could achieve. Incorporation will provide greater freedom to allow these projects to be pursued in a timely manner and, undoubtedly, the ability to bring forward beneficial commercial projects will be significantly enhanced post-incorporation. However, incorporation itself does not guarantee that the full financial returns from these projects will be attained and it is important that appraisal processes are strengthened both at the level of the Board and the Shareholder to ensure that inherent risks are minimised.

7.4 Nonetheless, we do not believe that the risks relating to the delivery of the quantum of these commercial projects (and the other revenue risks we have identified) fundamentally undermine the case for incorporation, but the key to managing and controlling these risks lies with the Strategic Business Plan. We would expect the Strategic Business Plan to be much more specific (rather than illustrative) in terms of setting targets for the management team in the short to medium term, post incorporation. The rigour of the process for drawing up, approving and monitoring the Strategic Business Plan will also be a critical factor in ensuring that the objectives set out in the Memorandum of Understanding are met. We recommend that the SBP is subject to due diligence, at least in the first instance. However, it would be detrimental for the contents of the SBP to be exposed to full public scrutiny due to the commercially confidential nature of contracts between the Ports and its private sector customers.

7.5 In terms of external governance, the Memorandum of Understanding should clarify the status of the Ports Policy Group, and how the decisions of the Policy Group will be effected through the Board of the incorporated entity. Given the monopoly status of the Ports, it is recommended that a mechanism is established for the Ports Policy Group to report back decisions taken but it is important that such decisions remain binding if the greater commercial freedom underpinning the Case for Incorporation is not to be undermined.

7.6 In terms of internal governance, given that one of the key objectives of incorporation is to ensure that the incorporated entity is able to act with greater commercial freedom, it will be important to ensure that right commercial skills are available to the Board and the Ports Management Team post incorporation.

7.7 We do not believe, however, that these concerns should inhibit the incorporation but it may be challenging to ensure that those relating particularly to the MoU are addressed within the existing timescales. It is also vital to ensure that there is a robust process for approving the Strategic Business Plan in place post incorporation. The observations relating to internal governance can be addressed post incorporation as necessary.

7.8 The regulatory powers envisaged in the legislation appear reasonable and to provide satisfactory safeguards. The precise form of price control regulation will not be determined until after incorporation has taken place and some greater clarity is needed as to the balance between the regulator's general duty to seek economic efficiency with the broader States objectives in incorporating the Ports and how these will be embodied in any Ministerial Directions. In practice, it may be unlikely that a regulatory price cap would significantly constrain the company to a greater degree than is assumed in the current Financial Model over and above the constraints facing the Airport, in particular, in its commercial negotiations with the airlines.

7.9 The office of Harbour Master currently has the double title of 'Harbour Master' and 'Chief Operating Officer – Marine, Ports of Jersey'. This conveys that the role is focussed on marine operations and marine services and not the land-side operations. The office of Harbour Master is an extremely important position and rightly will be kept as a distinct statutory function post-incorporation. It is our observation that post-incorporation there should be a more clear distinction of the statutory and commercial roles within the Harbour Authority and in terms of the position of the Harbour Master. It may be desirable for consideration to be given to a separation of the functions on a similar basis to those of the DCA and the Airport Director.

7.10 Overall, we believe that incorporation has the potential to bring significant benefits for the Ports, for the States as shareholder, and for wider interests as well. Given the identified risks to the achievement of financial self sustainability, it is essential that there is proper oversight of the incorporated entity. We believe that the risks can largely be managed if a rigorous process of preparing, approving, implementing, and monitoring the Strategic Business Plan is put in place.