Portsmouth CITY COUNCIL

Title of meeting:	Leader's Portfolio Full Council
Subject:	Crane Purchase
Date of meeting:	Leader's Portfolio 11 October 2019 Full Council 15 October 2019
Report by:	Director of Finance & Revenues (Section 151 Officer)
Wards affected:	All
Key decision:	Yes
Full Council decision:	Yes

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1. Purpose of report

1.1 To seek approval for a new crane to be purchased, and to be leased to Portico.

2. Recommendations

2.1 The Council purchase a crane at a cost of £3.0m and this be added to the Capital Programme. To be funded by Prudential Borrowing.

2.2 The crane is leased to Portico on terms and at a rate consistent with state aid rules.

3. Background

3.1 On 26 February 2019 Cabinet considered a report on the available options for the use of the Portico site. The report evaluated all viable alternative uses of the Portico site (including disposal), and concluded that continued operations and investment of c£50m in Portico over the next 20 years provided the Council with greatest return for similar levels of risk.

3.2 On 12 February 2019 City Council agreed in principle that a loan facility of £15m to be provided to Portico. On 26 February 2019 Cabinet agreed that this loan facility of £15m could be provided to Portico subject to strict criteria for its release. Specifically, the decision approved by Cabinet was:

1. The Cabinet adopted Option 2 [retain Portico] as their preferred option.

2. The Cabinet agreed that a loan facility of £15m be provided to MMD [Portico] (subject to decisions 3, 4 and 5 below) for the necessary Capital Investment required to deliver a return of £19.3m over the 5 year period 2019/20 to 2023/24, which was approved in principle by City Council on 12 February 2019.

3. The Council loan is provided at a rate consistent with state aid rules.

4. Any draw down on the loan facility by MMD [Portico] is subject to the following:

   a) The 20 Year Business Plan demonstrates the continuing viability of MMD [Portico] and that the continued operation of MMD [Portico] continues to deliver the best financial return compared with all other viable alternatives.

   b) The Capital Investment is necessary either for the sustainability of existing income streams or for the generation of additional income.

   c) The proposed Capital Investment itself represents the most favourable return when assessed against the balance of:

      i) The financial return on a Net Present Value (NPV) basis and over the whole life of the asset created versus other potential options for the same outcome.

      ii) The relative risk of each alternative option.

5. Continued parent company support and the availability of the loan facility is subject to the annual review and approval of a satisfactory 3 Year Business Plan and 20 Year Future Forecast which must demonstrate to the shareholders satisfaction that:

   i) The assumptions that underpin the 3 Year Business Plan are robust with a more than reasonable chance of being achievable.

   ii) That the 3 Year Business Plan is prepared to illustrate the financial effect of reasonable optimistic and reasonable pessimistic scenarios in order that the Shareholder is aware of the reasonable range of risk associated with the "Base Case" Business Plan.

   iii) Recognising the exposure of the company to cyclical trade factors and adverse weather, that the overall 3 to 5 Year financial results of the Company provide an overall net return to the Shareholder over the period taking into account all returns received by the Shareholder through rents, dues and all other profit elements of services provided by the Shareholder (including the Portsmouth International Port).

6. The Council keeps under review the returns that would reasonably be expected to be achieved from alternative uses of the site, undertaking a formal review at the earlier of every 3 years or failure to achieve the financial performance set out in recommendation 5 above.

7. That there be an annual information report to Council setting out the financial position of MMD [Portico].

3.3 The £15m loan facility approved by the Council for MMD [Portico] was not intended to be used for crane purchases. Historically and moving forward, the Council's policy has been to acquire the cranes themselves and lease those cranes to Portico. Since cranes have strong re-sale value, it is considered that having ownership of the asset affords the Council the most secure method of underwriting the loan which has been taken out for the purchase.

4. Crane Investment

4.1 Portico is currently in a transition period. Traditionally the facility at Portico has focused on fresh produce. This has meant that the company has been exposed to the vagaries of the harvest of fruits around the world which are volatile and subject to influence from external factors such as climate and natural disasters. Inevitably this has an impact on the quantity of product being trans-shipped and therefore volume of business transacted by Portico.

4.2 Being a single commodity facility does not provide long term sustainability for Portico unless it is underpinned by stable medium to long term contracts which provide for minimum guarantees of income. Ultimately the terminal operated by Portico is a resource which in its broadest terms has the capability to take goods off and put goods onto ships. Restricting what goods are handled through the terminal is, in the view of the management team, a strategy which carries significant risk unless it is backed by stable contracts with minimum guarantees or alternatively high margin contracts.

4.3 A new diversification strategy at Portico of attracting a broader base of commodities through the facility, has the advantages that the reliance on produce is reduced and longer term deals can be established with shippers whose demand is not subject to natural variation.

4.4 Portico's increased focus on attracting a range of cargos has resulted in the company securing a 10 year deal with a major customer. To continue to service the customer, Portico has identified an urgent need for a new larger crane. Retaining this major customer is an important part of Portico's diversification strategy.

4.5 Within the current financial year Portico are positively ahead of the budget that was part of the new business plan. Portico are handling increased lift on lift off container services to the Channel Islands, project cargos, regular yacht ships and has secured an additional weekly fresh produce service. Fresh produce will remain Portico's core business, but it is positive that the diversification business plan is currently achieving its goals. Additionally, Portico have now secured the return of Geest Line under a five year agreement. Fruit will remain the core activity for the Portico business and part of their objectives was to secure long term sustainable contracts such as the new Geest agreement. The increased activity commencing from January 2020 will also be beneficial to Portsmouth International Port for port dues and pilotage activity.

4.6 As part of the Council's assessment of whether to invest in a new crane and lease to Portico, it needs to satisfy itself that this expenditure is commercially justified by asking the same commercially-based questions that a private shareholder in business would ask; namely:

- Is the larger crane needed at this point in time or can the business continue to use existing equipment?
- Is there a reasoned business case for the crane based on the requirements of customers?
- Is the cost commercially justified in view of the projected returns on the investment?
- Are the risks associated with the investment acceptable?

4.7 Portico has identified the urgent need for a larger crane to allow the company to continue to service trade with a major customer. This is because the customer is moving to larger vessels, and a larger crane with a greater reach is needed to service the new vessels. This is consistent with the trend of other customers moving to larger vessels as these are more economically viable for shipping lines to operate. Portico is dependent upon its ability to service these vessels, and this can only be achieved by continued investment in suitable equipment and infrastructure.

4.8 The addition of a new larger crane to the existing offering will provide Portico with greater flexibility and will allow the company to more quickly service other customers, who are looking to increase capacity through the deployment of larger vessels. The new crane purchase will, therefore, support Portico's marketing strategy of communicating the port is open for business and can service a wide range of cargos including fresh produce.

4.9 If a new crane isn't purchased, in addition to losing the new contract and hindering improving service levels to customers, there would be significant reputational damage to the business. It would send the message to industry that Portico is not taking the running of its business seriously and investing in infrastructure to enable customers to be efficiently and effectively serviced. This will reduce the industry's confidence in Portico, which could lead to a significant loss of future revenue opportunities.

4.10 The key risk to PCC of investing in a new crane and leasing to Portico are identified below:

- **The crane is purchased but the major customer decides to no longer use Portico's facilities.** If this were to happen the crane would still be of use to Portico because the crane will also be used to service other customers. In addition, irrespective of the trade with the major customer, in the short to medium term there is a need for a new crane at Portico because of an existing crane that will soon reach the end of its economic life. This was recognised in the strategic assessment of the available options for the use of the Portico site.

- **Portico not realising its business plan and the return to the Council being less than identified.** However, the profitability of Portico would need to reduce by a considerable margin before retaining the company was not financially the best option. In addition, some of the investment in Portico, such as cranes, could be sold by the Council.

4.11 A number of crane options have been considered, including buying a second hand crane. Research has identified that there are very few cranes on the second hand market which would meet the requirements of Portico. Second hand cranes have usually exceeded their hours or life expectancy from the original investor, and would therefore, not be a viable option.

4.12 Another option considered was buying an electric crane. An electric crane produces less pollution than a diesel crane, which is an important consideration given the need to improve air quality in Portsmouth. However, buying an electric crane was found not to be viable because of the insufficiently robust electrical loss emergency back-up plans presently in place at Portico. A new crane will be more efficient and have the ability to add electric power in the future.

4.13 The investment option appraised in the financial appraisal is the purchase of an electric ready crane, which provides the option to power by diesel if needed.

5 Reasons for recommendations

5.1 The investment supports Portico's diversification strategy, which will reduce the company's dependence on fresh fruit produce.

5.2 There is an urgent need for Portico to use a larger crane with a longer reach to allow the company to continue to service trade with a major customer. This is because the customer is moving to larger vessels, and a larger crane with a greater reach is needed to service the new vessels.

5.3 The new crane will allow Portico to more speedily service other customers and provides the business with greater flexibility.

5.4 If a new crane isn't purchased, in addition to losing the trade with the major customer and hindering improving service levels to customers, there would be significant reputational damage to the business.

5.5 Crane purchases were identified as a necessary investment in the report to Cabinet on 26 February 2019 that evaluated all viable alternative uses of the Portico site, which concluded that continued operations and investment in Portico over the next 20 years provided the Council with greatest return for similar levels of risk.

5.6 Taking all factors into account, the investment in a larger crane in 2019, to be leased to Portico, is commercially justified.

6 Equality impact assessment

6.1 An equality impact assessment is not required as the recommendation does not have a negative impact on any of the protected characteristics as described in the Equality Act 2010. The capital investment is in Portico's business, and it is not for any service that could impact on customers from an equality perspective.

7 Legal implications

7.1 Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), provides a general ban on state aid unless it has previously been approved by the EU Commission, it falls below the *de minimis* threshold or it falls under pre-approved types of state aid that do not require prior approval from the EU Commission. State aid is assistance (in any form whatsoever) given by public bodies to selected undertakings (who are engaged in economic activity) which could distort competition and affect trade between EU member states.

7.2 If a measure constitutes state aid, there may be a requirement to notify it to the European Commission for approval prior to its implementation, in accordance with Article 108(3) of the TFEU.

7.3 However, economic transactions in the form of investment in a private undertaking carried out by a public body which do not confer an advantage on the undertaking, do not constitute aid if they are carried out in line with normal market conditions and in accordance with the so-called 'Market Economy Operator (MEO) Principle'. In order to satisfy the MEO Principle, the Council must assess whether, by making the proposed investment based on the Portico Business Plan, it will act as a private investor would, in similar circumstances. The decisive factor is whether the Council would act as a market economy operator would have done in a similar situation. Only the benefits and obligations linked to the situation of the Council as a market economy operator (and not as a local authority) should be taken into account.

7.4 If the proposed investment in Portico is based on genuinely commercial terms, and the Council is investing in a way that a rational private investor would, then it is not providing state aid prohibited under Article 107(1) of the TFEU and therefore it can be exempted from prior EU Commission approval. In order to satisfy the MEO Principle, the Council's decision to lease the crane to Portico must be on terms that would be acceptable to a genuine private investor. This means that Portico would not be receiving an advantage from the Council that it would not have otherwise obtained on the market.

7.5 The Council should also maintain evidence of the reasoning behind the decision to buy the crane and subsequently lease it to Portico and, upon request, be able to provide such evidence to show that the decision to lease the crane to Portico, at the time it was taken, was a genuine investment that a rational market investor would have made in similar circumstances taking into account profitability, economic advantage and associated risks.

7.6 The Council must ensure that:

- Conditions are attached to the lease to ensure that there is sufficient protection for the Council if Portico fails to meet its obligations under the lease;
- From a wider perspective, it continually reviews the progress of the implementation of Portico's Business Plan to check that it continues to present an attractive investment that a rational private investor in the Council's position would be prepared to make.

8 Director of Finance's comments

8.1 The defining financial consideration for the Council from Portico operations, is the total return to the Shareholder (often referred to as the "net benefit"). This takes into account all income streams to the Council derived as a direct consequence of operating Portico, net of all costs in deriving that income and is described below:

Portico Profit / Loss

+	Net Income to Port (from port dues etc.)
+	Net Income to PCC (from rent and interest on loans and leases etc.)
+/-	Dividend / Financial Support
-	PCC Capital Financing Costs
+/-	Increase / reduction in the investment value of Portico (i.e. capital gain / loss)

= Total Return to Shareholder (Portsmouth City Council)

8.2 Accordingly, Portico's profit / loss is not the same as return to PCC, rather it is one component of the overall return to which other income streams and costs are added.

8.3 Without a new crane with a longer reach, Portico will no longer be able to service trade with a major customer which will result in a loss of income to Portico. This will impact on the profitability of the business, which reduces the return to PCC. The Port would also receive less Pilotage and Tonnage Due income as a result of the loss of trade. Another financial consideration is the cost of buying the crane. A financial appraisal has been undertaken which quantifies all material financial consequences of each shortlisted option.

8.4 A summary of the financial appraisal is set out in Exempt Appendix A. Each option has been modelled on a Net Present Value (NPV) basis over a 9 year period. NPV is a recognised method of comparing options which have differing cost profiles and differing income streams for future years. The method provides a comparison of total costs and income (both capital and revenue) on a like for like basis by bringing the total financial effect of each option back to a single comparative value.

8.5 The options appraisal has shown that in financial terms, the best option by a considerable margin is for PCC to purchase a new crane and to lease it to Portico at a rate consistent with state aid rules. This recognises that without a new crane with a longer reach, Portico would no longer be able to service trade with a major customer. This would result in a loss of income to Portico and the Port, which would adversely impact on Portsmouth City Council.

8.6 Importantly, the crane investment option has a lower risk profile than the non-investment option.

8.7 The recommended crane purchase formed part of the assessment of the available options for the use of the Portico site report, which went to Cabinet on 26 February 2019. The options appraisal identified that in both financial and risk terms, the best option by a considerable margin, is to retain Portico. The overall return to the Shareholder over the next 20 years is expected to be £70m at today's value, being 5 times greater than the next best alternative for a similar level of risk.

Exempt Appendix

Exempt Appendix A: Summary Financial Appraisal

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Signed by (Director)

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location