Advice to Department for Transport: Calculation of grants to be repaid in respect of City of Liverpool Cruise Terminal

Introduction

First Economics was asked by the Department for Transport ('the Department') to advise on the proper calculation of UK Government grants to be repaid by Liverpool City Council ('LCC'). These grants are to be repaid in return for the Department removing its objection to releasing the grant condition precluding the provision of turnaround services at the City of Liverpool Cruise Terminal ('the Terminal').

We have been asked for our views on the appropriate figure to be repaid to the Department. Specifically, we have been asked to consider the following three issues:

- What, if any, portion of the grant should not be repaid in respect of the elapsed period under which turnaround services were precluded?
- What, if any, portion of the grant should not be repaid in respect of the Terminal being utilised less than fully for turnaround services? And
- What supplemental calculations might be made in the event of a phased repayment of grant being agreed?

The objective of the repayment understood in this note is to alleviate concerns that the Terminal would otherwise benefit from public subsidy in its competition with other ports for providing turnaround services.

We understand that in addition to the UK Government-funded grants considered in this report, the Terminal has benefited from European Regional Development Fund (ERDF) support. We understand that the competition implications of this funding element will be considered, alongside the benefits that it will continue to support, in subsequent assessment by the European Commission of the compatibility of turnaround operations with State Aid requirements.

The remainder of this note does the following:

- It summarises our understanding of the proposed calculation put to the Department by LCC;
- It provides First Economics' views on the issues described above; and
- It proposes a revised calculation that the Department might put to LCC.

In providing the advice in this note we would ask readers to note that First Economics are not specialists in competition issues nor in the cruise industry. We were asked to provide our views as an economics consultancy and on the basis of the facts and arguments put to us, rather than our own market analysis.

Summary of LCC's proposed calculation

LCC proposed that it should make repayments of grant to DfT of £5,326,657, phased over fifteen years. The calculation of this figure is summarised in Annex A. Its main steps can be described as:

A. Taking the sum of the grants provided in 2007;
B. Reducing this for the five years elapsed to date, leaving the remaining balance;
C. Calculating a share of this relating to the expected utilisation of the facilities for turnaround;
D. Rolling up the grant from 2007 at an interest rate to preserve its present value; and
E. Calculating the phased payments over fifteen years using an interest rate assumption to reflect the relevant financing costs.

Our comments

Treatment of the elapsed period

LCC's proposal is to allocate the grant *pro rata* between the portion of the Terminal's asset lives that has elapsed and that which remains. This is consistent with a 'straight line' depreciation approach. On the basis of an asset life of 20 years, this implies that 25% of the grant received is assumed to have been defrayed in the period from 2007 to date.

We are not well placed to question the choice of asset life. We also recognise that the most precise calculation would consider the exact start dates of 'port of call' services from 2007 and turnaround services going forward to calculate the exact durations of each of the two periods. Such an approach might also adopt a profile other than 'straight line' for the depreciation of the assets (although we would recognise that the latter is a fairly conventional assumption). However, given the uncertainty on the inception date for turnaround services and on asset lives we consider the simple form of calculation used to be appropriate.

Utilisation

LCC's proposal appears to be that the grant is only repaid in proportion to the expected rate of utilisation of the Terminal for turnaround services. LCC has estimated that the Terminal would only be used for such services on 21% of the days of the year. LCC has doubled this figure and has therefore suggested that 42% of the value of the outstanding grant is repaid.

In respect of the objective, set out above, of seeking that the UK Government grants cannot be considered to subsidise turnaround services, we have serious concerns with such an approach. These concerns are based on the following:

- That other commercially funded terminals would also be expected to have less than 100% utilisation;
- That such facilities should be considered a fixed cost of providing cruise services. For a commercially funded terminal, such fixed costs would need to be recovered in full across whatever level of usage were achieved, without any such opportunity to 'reduce' the fixed cost for less than full usage;
- That future utilisation of the Terminal is uncertain and might differ significantly from any figure assumed in the calculation; and
- That, moreover, the high economic value of turnaround services, as described in the consultation responses, suggests that they might have allocated to them a disproportionately high share of fixed costs.

Because of the above we consider that any reduction of the grant payment on the basis of utilisation risks the prospect of public subsidy of turnaround services by means of the non-repayment of UK Government grants. The only practical approach to avoiding this risk would be to make no deduction to the grant repayment for less than full utilisation.

Phasing

LCC's calculation allows for the grant to be repaid over fifteen years. In doing so it applies an interest rate assumption to take account of the financing costs on the balance to be repaid over the period. The interest rate is based on the simple average of HM Revenues & Customs' official rates over the last ten years.

A more detailed approach could make reference to an index of interest rates and thereby use future effective interest rates to calculate the payments due in each year. It could also base the interest rate on the observed financing costs of an equivalent operator.

However, the approach taken is clear and simple and has the benefit of giving certainty of payments to both parties. The interest rates used are based on a recognised and relevant index and seem reasonable as a long term projection of financing costs for agreed fixed payments between two public sector parties.

Other issues

Whilst the above issues are those we were specifically directed to comment on, we would also raise two further matters.

First, there appears to be a minor error in step D (see above), that is the rolling up of the grants to preserve their present value. An interest rate of 6.2% has been assumed for 2008/09 whereas the figure quoted by HMRC is 6.1%. We have corrected this in the calculation of our proposed repayment (below).

Second, we agree with the Department that the ongoing payments on the basis of a phased approach to repayment should <u>not</u> be conditional on the continuing provision of turnaround services, as we understand LCC proposed. In our view, the capital cost of the Terminal should be viewed as a 'sunk cost' of providing such services and its cost should not be made recoverable, in effect, by allowing repayments of UK Government grants to cease should services be discontinued. Freedom to recover such sunk costs would, in our view, constitute a potential competitive advantage over other commercial providers of such services.

Our proposed calculation

On the basis of the above we have revised LCC's calculation. The changes made are:

- The removal of the deduction for limited usage (in step C); and
- A minor correction to the rates used in rolling up the grant (in step D).

The revised calculation is set out in Annex B.

It results in a lump sum repayment in 2012 of £8,803,160 or a series of phased repayments as set out in the table below.

Table of phased repayments

Year	Payment
1	£900,000
2	£900,000
3	£900,000
4	£900,000
5	£900,000
6	£900,000
7	£900,000
8	£900,000
9	£900,000
10	£900,000
11	£900,000
12	£900,000
13	£900,000
14	£900,000
15	£15,437

The sum of the repayments on the phased approach is £12,615,437. This is significantly higher than the nominal sum of the grants themselves, as paid in 2007. However, this is to be expected because of the extended period of the repayment and the effect of financing costs over this period. A lump sum repayment would clearly avoid much of this effect.

March 2012

ANNEX A: LCC CALCULATION

North West Development Agency		£7,156,294
Single Regeneration Budget		£1,875,780
Mersey Waterfront Regional Park		£157,858
TOTAL UK GRANT	**A**	**£9,189,932**
DEFRAYMENT Based on 20 year asset life starting in 2007 and Turn around starting in 2012 so 15/20ths to be considered for repayment	**B**	**£6,892,449** (Ax75%)
PROPORTIONALITY Based upon expected 21% usage of site doubled to 42%	**C**	**£2,894,829** (Bx42%)
TOTAL COST TO REPAY	**D**	**£3,700,812** (C x 106.25% x 106.2% x 104.75% x 104% x 104%)
TOTAL COST TO REPAY INCLUDING INTEREST Assumes 5.2% Interest Rate	**E**	**£5,326,657** (D modified by repayments)

ANNEX B: ALTERNATIVE CALCULATION

North West Development Agency		£7,156,294	
Single Regeneration Budget		£1,875,780	
Mersey Waterfront Regional Park		£157,858	
TOTAL UK GRANT	**A**	**£9,189,932**	
DEFRAYMENT Based on 20 year asset life starting in 2007 and Turn around starting in 2012 so 15/20ths to be considered for repayment	**B**	**£6,892,449**	(Ax75%)
PROPORTIONALITY No adjustment made	**C**	**£6,892,449**	(B x 100%)
TOTAL COST TO REPAY	**D**	**£8,803,160**	(C x 106.25% x 106.1% x 104.75% x 104% x 104%)
TOTAL COST TO REPAY INCLUDING INTEREST Assumes 5.2% Interest Rate	**E**	**£12,615,437**	(D modified by repayments)