



Isle of Man
Government

Reiltys Ellan Vannin

GD 2016/0080



Background Information on Strategic Sea Services

November 2016

Department of Infrastructure

FOREWORD

To the Hon Stephen Rodan, MLC, President of Tynwald, and the Hon Council and Keys in Tynwald assembled.

Strategic sea services are one of the most significant influences on the current and future economic and social wellbeing of the people of the Isle of Man.

Tynwald recognised the importance of this in July 2016 when it debated strategic sea services and determined that a full economic appraisal be obtained to assess:

- a) the requirements for a ferry service;
- b) comparison with other similar ferry services;
- c) service level requirements;
- d) vehicle and operational requirements;
- e) commercial issues including length of contract and other potential models and;
- f) associated financial issues.

Tynwald also determined in that July 2016 debate that:

- all ownership models should be investigated and a report produced for debate and decision by Tynwald.

International economics consultants, Oxera Consulting LLP, were appointed to undertake the independent economic appraisal requested by Tynwald.

Park Partners Limited of London had already been appointed by the Department of Infrastructure to provide specialist support on the strategic options for future sea services by evaluating alternative ownership models.

I am pleased to present the reports produced by Oxera Consulting LLP and Park Partners Limited.



Hon R Harmer MHK
Minister for Infrastructure

Economic appraisal of sea links at the Isle of Man

Prepared for
Isle of Man Government
Department of Infrastructure

November 2016

Final report

www.oxera.com

Contents

Executive summary	3
1 Introduction	6
1.1 Background	6
1.2 Overview	6
2 Competitive assessment of the ferry service	8
2.1 Passenger traffic (incl. vehicles)	8
2.2 Freight	19
2.3 Vessel substitutability	22
2.4 Overall summary	24
3 Regulatory frameworks in ferry markets	25
3.1 Need for regulation	25
3.2 Current regulatory framework	26
3.3 Set-up of comparative ferry services	29
3.4 Overall assessment of regulatory frameworks	43
4 Optimal service level and ferry asset ownership	47
4.1 Nature of demand	47
4.2 Cross-subsidisation between freight and passenger traffic	47
4.3 Evidence for public demand in the Isle of Man	49
4.4 Implications for fleet composition	52
4.5 Ownership and contracting models	52
5 Scenarios for ferry service provision	62
5.1 Overview of the strategic decisions	62
5.2 Assessment methodology	66
5.3 Scenarios	66
6 Summary and further research	71
A1 Detailed comparator tables	74
A2 Details of economic impact assessment	86
A2.1 Methodology overview	86
A2.2 Direct benefits	86
A2.3 Wider impacts on the Isle of Man economy	87

Oxera Consulting LLP is a limited liability partnership registered in England No. OC392464, registered office: Park Central, 40/41 Park End Street, Oxford, OX1 1JD, UK. The Brussels office, trading as Oxera Brussels, is registered in Belgium, SETR Oxera Consulting LLP 0651 990 151, registered office: Avenue Louise 81, Box 11, 1050 Brussels, Belgium. Oxera Consulting GmbH is registered in Germany, no. HRB 148781 B (Local Court of Charlottenburg), registered office: Rahel-Hirsch-Straße 10, Berlin 10557, Germany.

Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Company accepts no liability for any actions taken on the basis of its contents.

No Oxera entity is either authorised or regulated by the Financial Conduct Authority or the Prudential Regulation Authority. Anyone considering a specific investment should consult their own broker or other investment adviser. We accept no liability for any specific investment decision, which must be at the investor's own risk.

© Oxera 2016. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.

A2.4 Modelled results**87****Tables and figures**

Figure 2.1	Isle of Man total annual passenger arrivals ('000, 2006–15)	8
Figure 2.2	Isle of Man total annual passenger arrivals (% , 2006–15)	9
Figure 2.3	Isle of Man average quarterly departing passengers on scheduled routes ('000, 2015)	9
Figure 2.4	Isle of Man passengers and vehicles arrivals by sea per week ('000, 2015)	10
Figure 2.5	Total passengers carried by destination by month ('000, 2015)	11
Figure 2.6	Isle of Man scheduled passenger departures by type (%)	11
Figure 2.7	Isle of Man visitors by area of residence ('000, 2015)	12
Figure 2.8	Distribution of Isle of Man visitors by mode of travel and area of residence (% , 2015)	13
Figure 2.9	Current passenger connections from the Isle of Man	14
Figure 2.10	Number of monthly sailings by destination (2015)	15
Figure 2.11	Map of air connections between the Isle of Man and other major airports	16
Figure 2.12	Annual average ferry and airline ticket price evolution on selected routes (£, 2011 – 16)	19
Figure 2.13	Freight routes map by operating company	21
Figure 2.14	Frequency of freight services by month and provider (2015)	22
Figure 2.15	Number of European vessels of a specification similar to Ben-my-Chree, Manannan and Arrow	23
Figure 3.1	Changes in fares compared to price indices (2013-15)	34
Figure 3.2	Actual weighted average fares and fares based on various price indices (2012-15)	35
Figure 3.3	Cost per mile for 'car+2 return' fare (£, 2016)	36
Figure 3.4	Current ownership structure and debt	40
Figure 3.5	IOMSPC Group ROCE and EBIT margin (% , 2000–14)	42
Figure 4.1	Approximate passenger capacity utilisation across various routes, by month (% , 2015)	51
Figure 4.2	Diagram of Douglas harbour	53
Table 2.1	Details of IOMSPC vessels	14
Table 2.2	Indicative ferry times to each destination	15
Table 2.3	Approximate journey times between the Isle of Man and a range of selected cities in the summer	17
Table 2.4	Total indicative price comparison of selected journeys	18
Table 3.1	Key stakeholder objectives	26
Table 3.2	Comparison of User Agreement provisions with current service levels	27
Table 3.3	Comparison of minimum service requirements	27
Table 3.4	Overview of comparators	30
Table 3.5	Differences across price indices	34

Table 3.6	Comparison of minimum service requirements	43
Table 4.1	Various ownership and operating models for the port facilities in GB	55
Table 4.2	Various port facility operating models assessed against different stakeholder objectives	56
Table 4.3	Various ownership and operating models for ferries	57
Table 4.4	Various ferry operating models assessed against different stakeholder objectives	60
Table 5.1	Key strategic issues concerning ferries and ports	62
Table 5.2	Overview of the feasible scenarios	68
Table A2.1	Modelled economic impacts (£m, per year)	88
Box 3.1	Impact of different inflation measures	34
Box 3.2	Condor Ferries' recent service delivery performance	39
Box 5.1	Range of Douglas expansion options	64

Executive summary

Oxera has been commissioned by the Isle of Man Government Department of Infrastructure to review the ferry market, and to provide advice on future options for the oversight of this essential service.

In short, we recommend that to ensure long-term resilience and remove barriers to economic growth,

a) future services would either be provided under the proposed extension to the User Agreement, which we recommend would be subject to separate economic regulation or other enhanced control mechanisms; or tendered on the open market after a period of transition (the existing User Agreement could run its course, or be terminated early); and to support that

b) the Isle of Man secures passenger *and* freight port facilities on the GB mainland, and enhances the capacity of the port at Douglas to maximise the flexibility of ferry services. This resilience and flexibility then forms the bedrock of future ferry services, which would be operated by the private sector according to redefined passenger and political specifications.

Our market assessment of the current ferry service has shown that:

- there is a considerable degree of market power in the provision of ferry services to the Isle of Man, in particular with regard to roll-on roll-off (Ro-Ro) freight and passengers travelling with vehicles. The passenger vehicle market is a natural monopoly and the Ro-Ro freight segment is contestable (i.e. prices are suppressed due to the threat of entry);
- the current ferry service to the Isle of Man can be characterised by significant excess capacity for freight and for passenger services in the off-peak season. Current vessels and service frequency are designed to address peak demand, and certain routes (e.g. Dublin) are unlikely to be economic on a stand-alone basis.

A wide range of objectives and strategic concerns relate to the future of the ferry service, and all of them stem from the fact that the service is essential to the Isle of Man economy. The main aspects that we have considered are:

- the need for a set of suitable governance arrangements to limit future risks to the service, and well-designed public oversight and control over the level and allocation of profits earned by the sole operator of a ferry service (as well as over the additional financial windfalls from any new User Agreement);
- the need to guarantee long-term security of supply (in terms of the number of vessels required to guarantee service resilience, the range of connections, and access to ports—in particular in GB);
- the essential nature of the ferry service in enabling the trade of goods (as the high-level economic driver), as well as passenger traffic (as a secondary economic driver);
- how to draw on operator expertise within a suitable framework for maintenance and replacement of the vessel fleet;
- expenditure and liabilities for the Isle of Man Government;

- matching the service level to the demand and expectations of users, and the flexibility required to adapt to changes in demand and user requirements;
- clarity and transparency around any transitional arrangements to be made in the event that the terms of User Agreement are not met, or in the event of a change in operator.

In our assessment of the optimal future set-up, we have divided the total market into two segments: ports; and ferry services.

There are two key conclusions regarding the future of the ports serving the various Isle of Man connections:

- from the perspective of short and long-term security of port access for freight and passengers, investment is required to secure at least one facility in GB (more than one facility may be required if freight and passengers cannot be handled in one location). In relation to the proposed new facility in Liverpool, care should be taken to ensure it can handle the longest ferries possible compatible with Douglas' current and potential future maximum capacity ('DouglasMax');
- notwithstanding that, the long-term flexibility of supply of ferry services would benefit from capacity expansion at Douglas to allow significantly larger ferries to use the port year-round. This would expand the harbour's flexibility for many generations to come by recalibrating DouglasMax, and enable new options for ferry service provision in the much longer term through removal of a key barrier to route growth and therefore economic growth, acting as a catalyst to remove barriers across the network.

As far as the ferry services themselves are concerned, we conclude that:

- there is a need for at least one, if not two, daily freight connections throughout the year (one of which is a night-time connection); passenger demand is much more seasonal than freight, and it peaks around the major events as well as in the summer. Certain passenger segments also demand frequent daytime connections.
- the pattern of services (including the number and type of vessels required, and the choice of vessel speed) should be re-defined to ensure a more appropriate balance between the economics of the market and political trade-offs. This process will be enhanced by, but does not have to wait for more flexible capacity to be achieved at the ports;
- services require a suitable level of resilience, meaning that an economic back-up vessel is required to deliver a consistent reliability of service throughout the year (in particular for freight);
- the most appropriate ferry operating model is either a negotiated concession (i.e. an extension of the current User Agreement), potentially supplemented by the establishment of an overarching economic regulation framework; or a form of franchise (where the provision of services is tendered, and the vessels are provided either by the operator or by the state) or Joint Venture. In any scenario that involves departure from the User Agreement, the transition arrangements would need to be carefully chosen to maintain service levels and island employment in the interim period; these range from letting the current User Agreement run its course to negotiating its earlier termination (which may require asset purchases by the government).

We conclude that the actions to be taken regarding ports and ferry services, and the trade-offs these permit in relation to both the scope of ferry services, and the choice of how the government specifies those services, offer a strong foundation for decision-making. In particular, they would help to achieve the delicate balance of allowing the state to have sufficient control over the way in which ferry services are specified, and drawing on operator expertise to ensure efficiency and appropriate levels of service quality.

To bring absolute clarity to that decision making, further analysis of the Isle of Man Steam Packet Company's profitability, of the cross-subsidy in the system, and, hence, a revised set of ferry services could usefully be undertaken. We also recommend testing the value for money case for investing in long-term flexibility in port infrastructure. The Department should also consider re-running its market testing exercise with clarity over its appetite for re-negotiating the earlier termination of the current User Agreement, with a view to ascertaining the likely and unfettered appetite from other operators to bid for operating services, or entering into a Joint Venture with the government.

1 Introduction

1.1 Background

Oxera Consulting LLP has been commissioned by the Isle of Man Government Department of Infrastructure to undertake an assessment of the current ferry service on the island. This assessment is required by the Tynwald on the basis of a resolution passed in July 2016, which stated:

[t]hat an independent economic appraisal is required which shall assess:

- (a) the requirement for a ferry service;
- (b) comparison with other similar ferry services;
- (c) service level requirements;
- (d) vehicle and operational requirements;
- (e) commercial issues including length of contract and other potential models;
- (f) associated financial issues.¹

As part of this work, we have assessed the current ferry services operated by the Isle of Man Steam Packet Company ('IOMSPC'), as well as all other means of transport for both passengers and freight to and from the island. The main context for the resolution itself, as well as the report, is the proposal of a new long-term Strategic Sea Services Agreement, which would replace the current Linkspan User Agreement ('User Agreement') between IOMSPC and the Isle of Man Government.² In the remainder of this report, we refer to this as the 'extension of the User Agreement'.

We have relied heavily on information provided by the Department of Infrastructure, as well as selected information provided by IOMSPC under a non-disclosure agreement. While we do not present any such information in this report, it has nonetheless been used to inform our conclusions. We have also conducted a range of stakeholder interviews with officials, consumer and business representatives, and Members of the House of Keys, who have provided valuable input and perspectives.

1.2 Overview

The remainder of this report is structured as follows:

- section 2 presents the facts in relation to the current ferry, air and load-on-load-off (Lo-Lo) freight services, for both freight and passengers;
- section 3 analyses an extensive set of comparable ferry services in order to identify elements of the ferry set-up, and the wider regulatory framework, where the Isle of Man arrangement is noticeably different from those of other island economies;
- section 4 considers what the optimal level of service to the island might be, and looks at various port and vessel ownership and management models;

¹ Tynwald debate of 19 July 2016.

² Our understanding of the offer is based on 'Strategic Sea Services Agreement—Isle of Man Steam Packet Company offer' dated May 2016, as well as discussions with both the Department of Infrastructure and IOMSPC.

- section 5 lays out the wider strategic options for ferry provision that are available to the Isle of Man Government, and provides an indicative estimate of the economic benefits from each option;
 - section 6 concludes by summarising the main findings of the report;
 - Appendix A1 contains the detailed overview of the individual comparators;
 - Appendix A2 explains more thoroughly the economic modelling underpinning the option assessment.
-

2 Competitive assessment of the ferry service

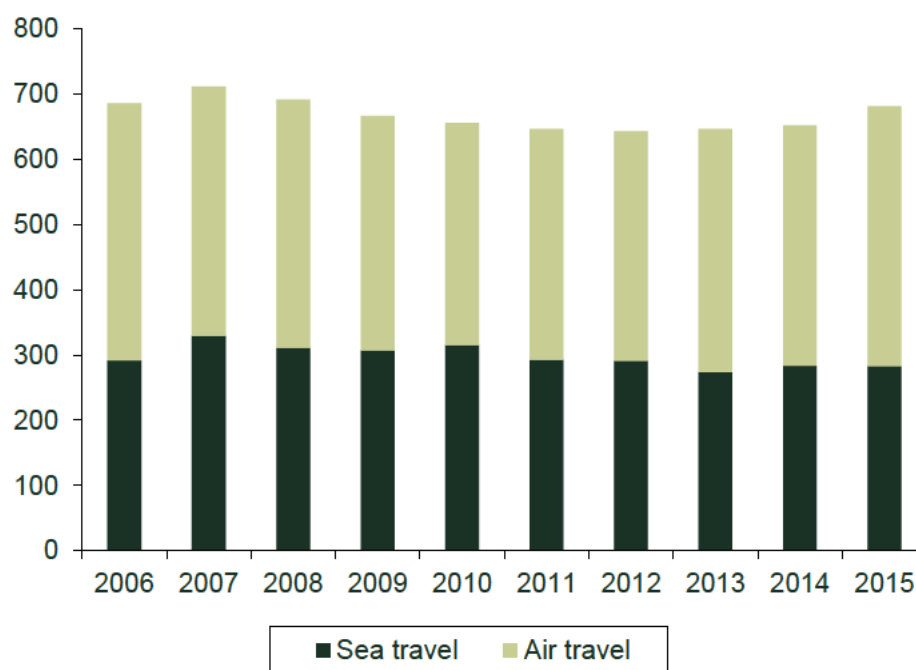
We start by presenting a detailed assessment of how passengers and freight travel to and from the island, which involves a detailed investigation of the demand, supply and competition for both freight and different types of passenger traffic. By looking at the degree of substitutability between ferry services and other options for passenger/freight transport, prices, competitors and barriers to entry/exit, we are able to identify where there are segments of the market where the ferry operators hold market power, and/or where their conduct is constrained by competition.

2.1 Passenger traffic (incl. vehicles)

2.1.1 Demand

Total traffic volumes of passengers arriving at the Isle of Man by any means of transport fell from approximately 700,000 in 2007 to approximately 650,000 in 2012, and have since been growing at a rate of approximately 2% per year (see Figure 2.1).

Figure 2.1 Isle of Man total annual passenger arrivals ('000, 2006–15)



Note: Departure levels are very similar to arrival levels.

Source: Oxera analysis, based on Isle of Man Government (2016), 'The Isle of Man in Numbers 2016', March, data tables.

Sea passenger volumes fluctuated between 270,000 and 330,000 annually during the 2006–15 period, and the overall share of sea passengers was between 42% and 48% of all arrivals, averaging 44% over the decade (see Figure 2.2 below). In our analysis we have excluded cruises, which are relatively small in terms of volume, but are growing steadily; annual arrivals grew from 1,600 to 6,000 in the 2006–13 period, and estimates predict that they may reach 10,000 by 2022.³

³ G.P. Wild (International), 'An examination of the position of the Isle of Man in the cruise market and projections in respect of any deep water berth development', ES Table 2-3, July 2014

Figure 2.2 Isle of Man total annual passenger arrivals (% , 2006–15)

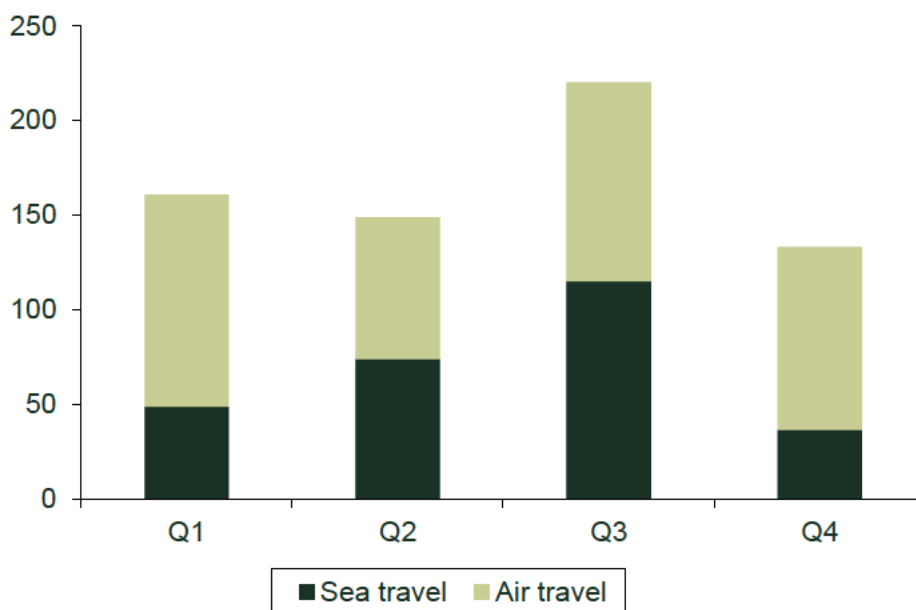


Note: Departure levels are very similar to arrival levels.

Source: Oxera analysis, based on Isle of Man Government (2016), 'The Isle of Man in Numbers 2016', March, data tables.

The demand for transportation on and off the island is seasonal, and is geared towards the summer period that coincides with Q3 (see Figure 2.3).

Figure 2.3 Isle of Man average quarterly departing passengers on scheduled routes ('000, 2015)



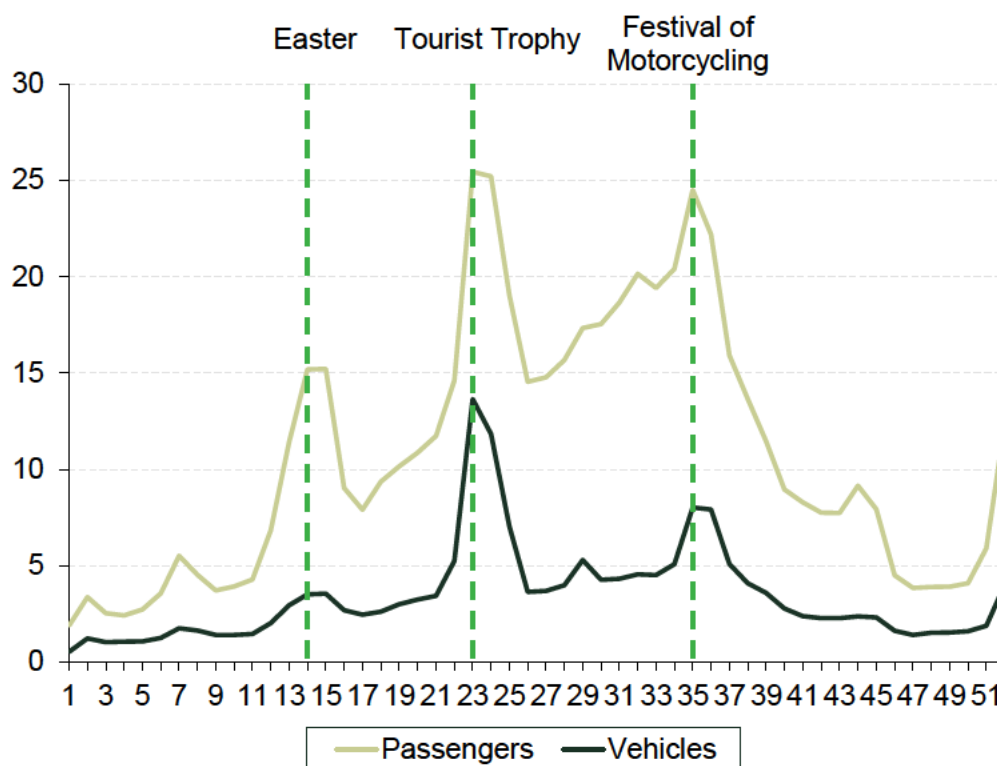
Note: Similar patterns and levels can be observed throughout the 2006–15 period.

Source: Passenger Survey Annual Report 2015.

More specifically, the demand for sea transport peaks in early June for the Tourist Trophy (TT), and over Q3 for the major summer tourist season and the

Festival of Motorcycling (see Figure 2.4). All of the peaks are driven by increased visitor traffic.

Figure 2.4 Isle of Man passengers and vehicles arrivals by sea per week ('000, 2015)



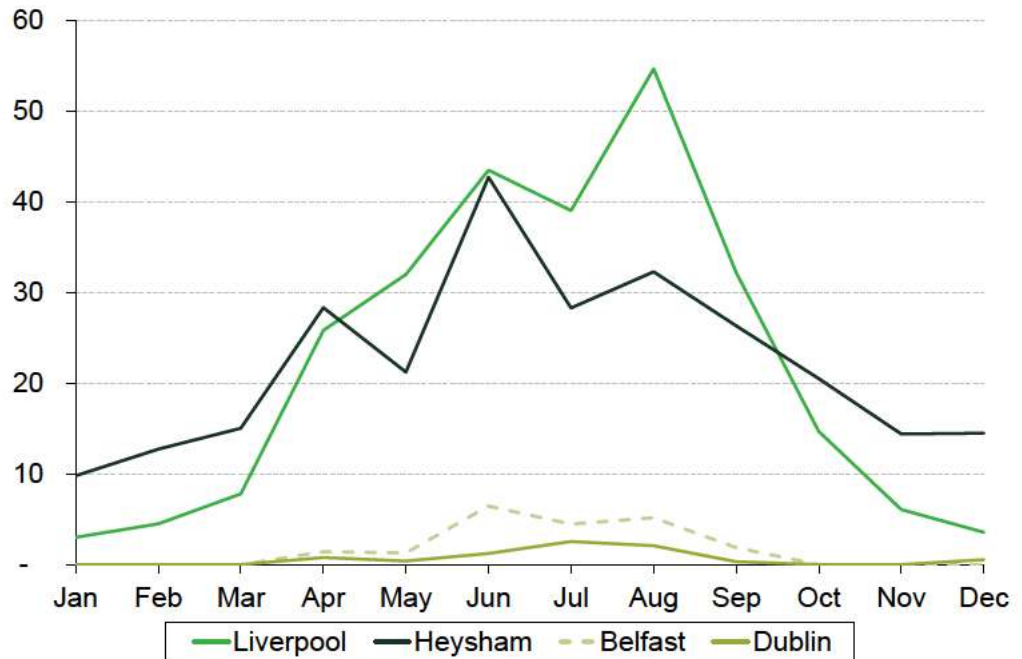
Source: IOMSPC management reporting documents.

For instance, during the 2015 TT approximately 42,000 visitors arrived at the Isle of Man, of whom 70% arrived by ferry.⁴ Of those, nearly half came with a motorcycle, a quarter came with another vehicle, and the remainder travelled on foot.

The main demand for sea connections comes from routes to and from GB and in particular Liverpool and Heysham, as shown on Figure 2.5. Overall, during 2015, approximately 266,000 passengers travelled to and from each of these two ports in GB; approximately 21,000 travelled to and from Belfast, and 8,000 travelled to and from Dublin.

⁴ Isle of Man Government Department of Economic Development, 'TT Visitor Survey 2015'.

Figure 2.5 Total passengers carried by destination by month ('000, 2015)

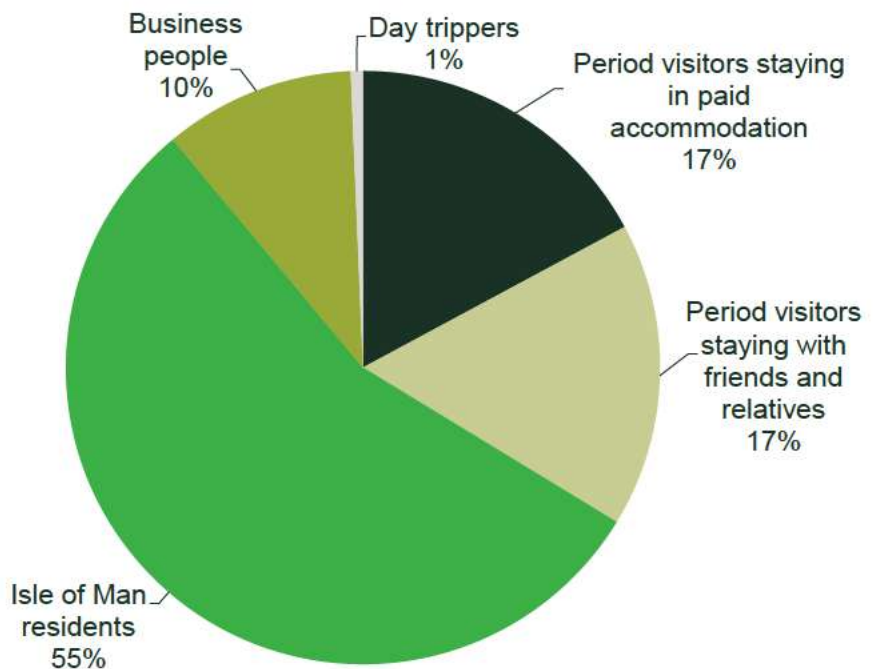


Note: Birkenhead volumes are included with Liverpool; Lame volumes are included with Belfast.

Source: Oxera analysis, based on Isle of Man monthly Harbours' traffic summary documents for 2015.

Over the whole year, just over half of those travelling are Isle of Man residents, as shown on Figure 2.6. Period visitors represent approximately one-third of travellers, and business visitors 10%.

Figure 2.6 Isle of Man scheduled passenger departures by type (%)



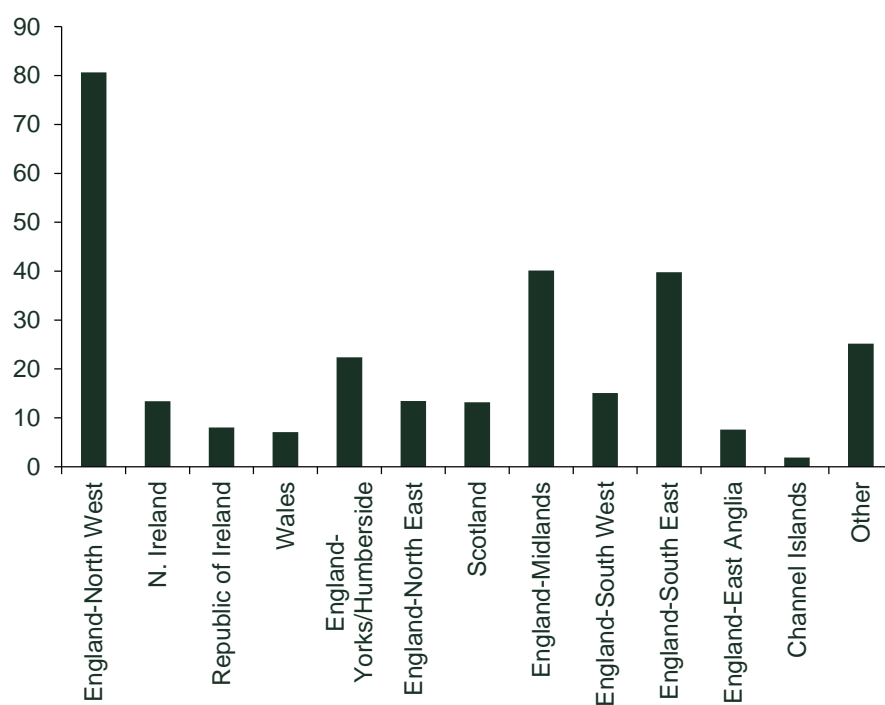
Note: Annual averages taken across the period of 2006–15. Scheduled departures exclude cruise passengers, visiting yachtsmen and some charter flights.

Source: Oxera analysis based on Isle of Man Government (2016), 'The Isle of Man in Numbers 2016', March, data tables.

In terms of means of transport, residents tend to use air transport more than sea links. During 2015, 62% of residents' travels were undertaken by air, while visitors' travels were divided almost evenly between air and sea journeys.⁵

Out of a total of approximately 288,000 visitors, most come from nearby areas of Great Britain, such as North West England—as shown in Figure 2.7.

Figure 2.7 Isle of Man visitors by area of residence ('000, 2015)



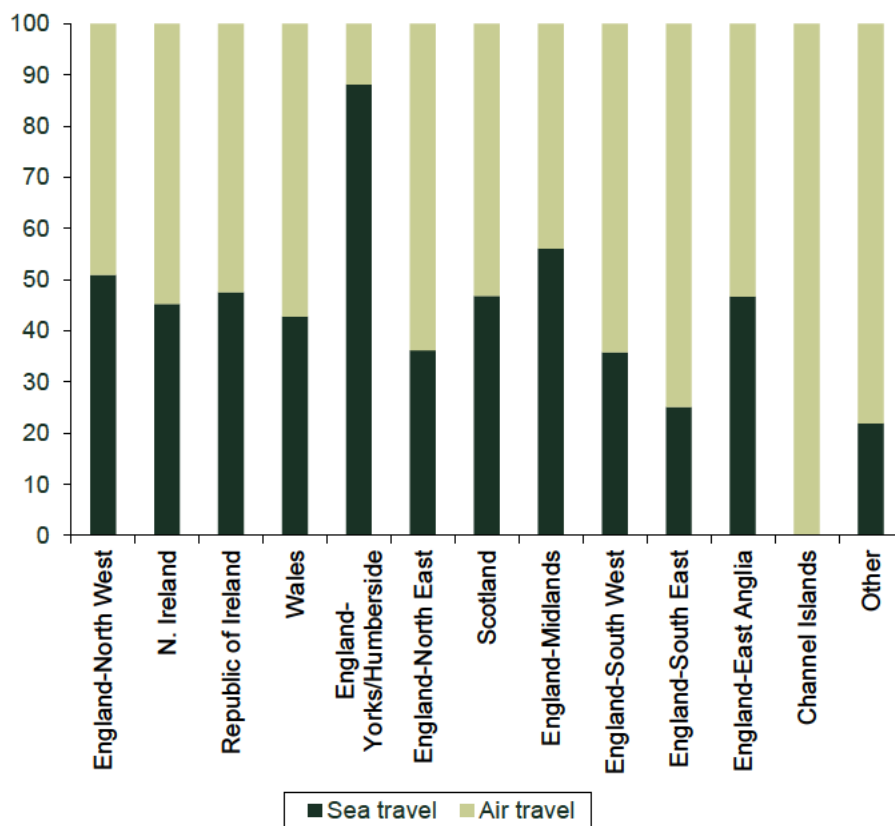
Note: Chart shows visitors' scheduled departures by air and sea in 2015.

Source: Oxera analysis based on Passenger Survey Annual Report 2015.

While visitors coming from further afield were more likely to travel by plane, air travel seems to be relatively common even for the shortest journeys from North West England or Ireland, as shown in Figure 2.8.

⁵ Oxera analysis, based on Passenger Survey Annual Report 2015.

Figure 2.8 Distribution of Isle of Man visitors by mode of travel and area of residence (% , 2015)



Note: Data for Yorkshire/Humberside has been verified.

Source: Oxera analysis, based on visitors' scheduled departures in Passenger Survey Annual Report 2015.

When choosing the mode of transport to use to travel off-island, travellers have quoted cost as the predominant constraint, followed by practicality, nature of the destination, and travel time.⁶

2.1.1 Supply

Current ferry fleet

All regular ferry connections are currently operated by IOMSPC, using two primary vessels: MV Ben-my-Chree, a ro-pax ship that carries passengers as well as serving as a primary freight traffic vessel, and which operates year-round; and HSC Manannan, a fast craft aimed at foot and vehicle passengers, which operates between April and November. MV Arrow currently acts as a back-up vessel to cover periods of dry-docking or breakdowns, as well as to provide additional peak capacity. Table 2.1 gives more detail about each vessel.

⁶ Isle of Man Social Attitudes survey 2016, p. 23.

Table 2.1 Details of IOMSPC vessels

	Length (m)	Speed (knots)	Passenger capacity	Car capacity	Trailer capacity
MV Arrow	122.3	17	12	–	84
MV Ben-my-Chree	124.9	18	630	275	90
HSC Manannan	96	43	820	200	18

Note: Freight-only services are discussed in section 2.2.

Source: Information from Isle of Man Department of Infrastructure.

Sea connections

The Isle of Man is connected to several ports in Great Britain (Liverpool, Heysham and Birkenhead), as well as Belfast in Northern Ireland and Dublin in the Republic of Ireland. The map in Figure 2.9 shows the current passenger connections (although not all connections are operated year-round).

Figure 2.9 Current passenger connections from the Isle of Man



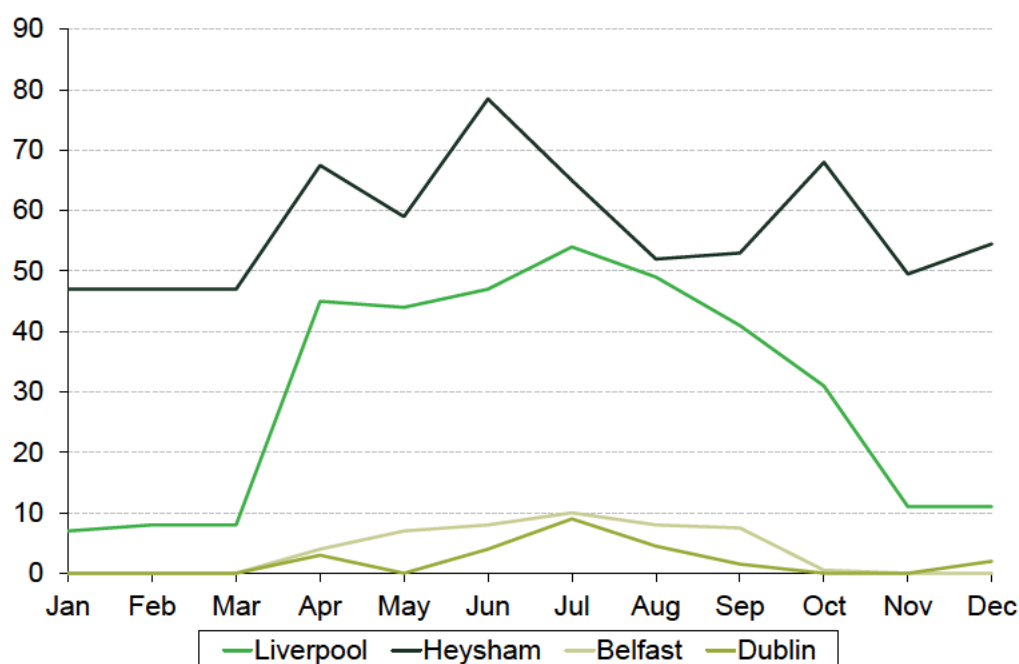
Note: Daily services vary. Services to Belfast and Larne are not marked separately.

Source: IOMSPC website.

The frequency of individual services, and hence the available capacity on different routes, varies significantly across the year by destination and vessel. For instance, services to Belfast and Dublin are not operated during the winter months (between October and April, except for occasional December

connections). Heysham connections usually operate twice a day throughout the year, and are linked primarily to freight traffic. This is illustrated in Figure 2.10.

Figure 2.10 Number of monthly sailings by destination (2015)



Note: Winter (November–March) sailings to Liverpool arrive at Birkenhead.

Source: Oxera analysis, based on Isle of Man Department of Infrastructure documents.

Depending on which vessel is being used, as well as the prevailing weather conditions, journey times to individual destinations can vary. For instance, in summer the connection to Liverpool is approximately 1h30min faster than in winter, due to the use of faster craft (which represents a journey time saving of around one-third).

Liverpool and Birkenhead are served exclusively by Manannan and Ben-my-Chree, respectively. Ben-my-Chree is the main vessel in Heysham, with very occasional Manannan sailings. Dublin and Belfast are served by a combination of the two vessels throughout the year.

Table 2.2 Indicative ferry times to each destination

	Liverpool	Birkenhead	Heysham	Dublin	Belfast
Journey times	2h45m	4h15m	2h–3h45m*	2h55m*	2h45m*

Note: Journey times vary depending on tidal and weather conditions and the vessel used. * Shorter journey times reflect travel time assumptions using the Manannan, although we understand Heysham is served by the Manannan only in exceptional circumstances.

Source: IOMSPC website.

Passenger ferry services have not experienced direct competition from any other operator in recent times. The only entry occurred in 1978 by Manx Line, which was subsequently taken over by Sealink.⁷ IOMSPC and Sealink/Manx Line effectively merged in 1985.

⁷ Isle of Man Department of Infrastructure: Report on Liverpool Landing Stage/Strategic Sea Services Agreement (July 2016).

Air connections

In terms of air traffic, the Isle of Man is connected to several UK airports, as well as Dublin, via regular rotations. These are marked on the map on Figure 2.11.

Figure 2.11 Map of air connections between the Isle of Man and other major airports



Note: Gloucester refers to the former Staverton Airport.

Source: Oxera Analysis, based on flight timetables.

Journey times and fares

On average, any ground transport option (which necessarily involves a ferry) takes considerably longer than flying for most destinations considered. This suggests that substitutability between the two is low in most cases as time constraints will be the primary consideration, with the exceptions of Liverpool, Dublin and Belfast, where cost considerations may also be a relevant factor. This is shown in Table 2.3.

Table 2.3 Approximate journey times between the Isle of Man and a range of selected cities in the summer

Route	Foot passenger using trains and ferry	Foot passenger flying and using public transport	Vehicle passenger driving	Foot passenger flying and renting car**
Liverpool	03:10*	02:05	02:55*	01:45
London City	05:20*	02:40	06:30*	02:20
Manchester	03:50*	02:00	03:25*	01:40
Birmingham	04:50*	02:00	04:30*	01:45
Dublin	03:15	02:00	03:10	01:40
Belfast	03:00	01:55	02:55	01:35
Glasgow	06:10	02:05	06:30	01:45
Newcastle	06:15	02:10	05:45	01:50
Gloucester	05:55*	02:25	05:20*	02:05

Note: Ferry sailing durations are taken from the IOMSPC website and refer only to a single craft (slow or fast). On routes other than Liverpool/Birkenhead the website does not offer a choice in terms of which vessel to use. Belfast and Dublin refer to the use of Manannan and Heysham to the Ben-my-Chree. Journey is calculated as city centre to city centre. For example: bus from city centre to train station—train to airport—flight—bus to city centre. The respective transport durations are summed up, waiting time is excluded except for air travel where 30 minutes has been added to each journey for time spent prior to departure/following arrival. * Foot passenger and driving times are calculated for Liverpool, London, Manchester, Birmingham and Gloucester by assuming travel by the faster Liverpool ferry (Manannan). During the winter Manannan is replaced by the conventional ferry, increasing journey times by 90 minutes. ** Foot passenger taking public transport to airport and renting a car on the Isle of Man for the day (7:30–22:00), three months in advance.

Source: Ferry durations: <https://www.steam-packet.com/>; flight durations: <https://www.skyscanner.com/>; public transport, car and walking durations: <https://www.rome2rio.com/>; car rental: <http://athol.co.im/>.

Travelling via ferry as a foot passenger is on average approximately 35% less expensive than taking a flight, which represents a clear trade-off for less time-sensitive customers.⁸ A car journey is on average approximately 10% less expensive than flying, assuming two passengers, or potentially significantly less expensive with more than two passengers.⁹ Additionally, a ground vehicle can be used to carry significantly more luggage than the permitted airline allowance, rendering sea travel the only viable option if this is a requirement.

These costs are compared in Table 2.4.

⁸ Average refers to a weighted average by passengers' area of residence. See Table 2.4 for more details.

⁹ However, the ferry ticket represents a major cost of car travel. It is composed of a large fixed base ticket price for the vehicle and driver, and relatively low additional charges for each additional passenger. Moreover, fuel consumption does not increase proportionately with the number of people carried. These facts indicate that the total costs of car travel do not change substantively with the number of passengers. The consequence is that driving alone is more expensive than flying, while a four-person car pool is a more cost-effective option.

Table 2.4 Total indicative price comparison of selected journeys

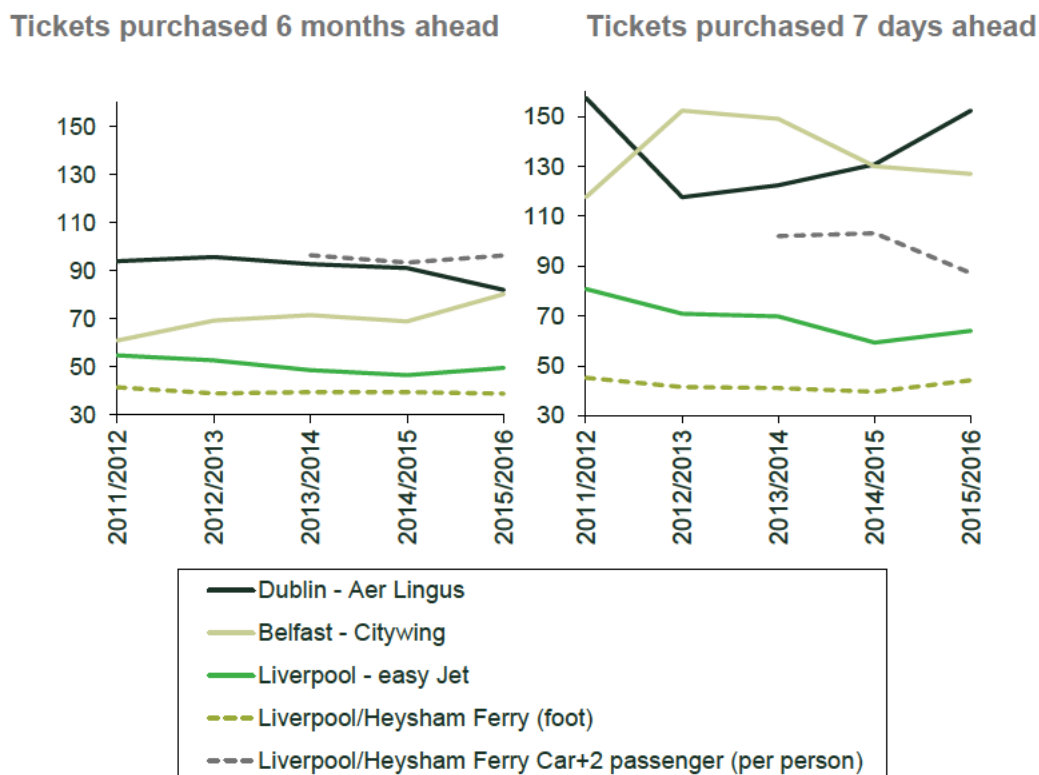
Route	Foot passenger using trains and ferry	Foot passenger flying and using public transport	Vehicle passenger driving (two people in car, per person)	Foot passenger flying and renting car (per person)*
Liverpool	£45	£55	£90	£70
London City	£90	£165	£125	£180
Manchester	£50	£80	£95	£95
Birmingham	£80	£100	£110	£115
Dublin	£40	£90	£75	£105
Belfast	£65	£95	£60	£110
Glasgow	£70	£180	£120	£195
Newcastle	£100	£150	£110	£165
Gloucester	£120	£140	£115	£160
Average**	£70	£110	£100	£120

Note: Prices for Liverpool and Heysham ferry services, and airfare information, are based on information provided, while fares for Dublin and Belfast routes are calculated by Oxera based on average fares indicated online for a range of off-peak dates. Journey is calculated as city centre to city centre. For example: bus from city centre to train station—train to airport—flight—bus to city centre. The respective transport fees are summed. For cars we assume £1.12/litre fuel cost, a 15% non-optimal driving offset, 35mpg, and two people. The cost is then calculated for the total driving distance using <http://journeyprice.co.uk/>. Airfares used do not include additional costs for checked luggage. * Foot passenger taking public transport to airport and renting a car on the Isle of Man for one day (7:30–22:00), three months in advance. The lowest price economy-sized car is used (Nissan Pixo Visia, £41.50). Fuel consumption from additional usage not included, and fee is counted for two people. **Cities are associated to areas of residence (Figure 2.7), then the fees are weighted by the proportion of people coming from those respective areas. Since Manchester and Liverpool are in the same region, we allocate half of the passengers from NW England to each city, respectively.

Source: Flight and ferry tickets: Oxera analysis based on airfare and ferry monitoring information provided by the Office of Fair Trading and Oxera research; Belfast ferry: <http://www.travelsupermarket.com/>; Dublin ferry: <https://www.steam-packet.com/>; public transport: <https://www.rome2rio.com/>; car journey cost: <http://journeyprice.co.uk/>; car rental: <http://athol.co.im/>.

Overall, ferry prices compare favourably with airline prices even when long-term advance booking is taken into account. This trend has remained in place over the last five years, as shown in Figure 2.12.

Figure 2.12 Annual average ferry and airline ticket price evolution on selected routes (£, 2011 – 16)



Note: Annual averages run from the beginning of October to the end of September.

Source: Data collection by Oxera from service providers' websites (IOMSPC, Aer Lingus, Citywing, easyJet) over time. Published prices available only on date of collection.

Cost and travel time considerations suggest there may be a trade-off between shorter travel times by air but potentially lower cost by sea; however, these trade-offs become more or less significant depending on the route chosen and whether travelling by foot or with a vehicle. Without information on how passengers view these trade-offs, it is difficult to definitively conclude whether air travel imposes a significant competitive constraint on ferry services in specific routes or overall. In the section 2.2, we consider the market for freight services.

2.2 Freight

2.2.2 Demand

Like other island economies, the Isle of Man is heavily dependent on ferry traffic for the provision of almost all its goods. There are two main routes for the transport of goods:

- the load-on load-off (Lo-Lo) service, where containers and palletised freight are put on a boat by a crane, taken off at destination, and subsequently transferred from portside to a suitable unloading facility. This is typically used for non-time-sensitive items, or bulk items;
- the roll-on roll-off (Ro-Ro) service, whereby trailers and freight trucks are driven onto ferries and driven off the ferries at destination. This mode of transport accounts for approximately 98% of total freight (by lane-metres,

although noticeably less by weight).¹⁰ It is particularly important for time-sensitive deliveries due to the noticeably shorter loading time and higher frequency of sailings compared to Lo-Lo, since trucks can drive immediately to grocery stores and other outlets upon disembarking.

Overall, the freight profile is not as seasonal as the passenger profile, and remains relatively consistent throughout the year.¹¹ From interviews with local business representatives, we understand that the Isle of Man economy relies on at least once-daily freight supply, which typically arrives in the early morning and is used in particular to stock those shops that offer fresh goods supply. The same supply model is used for manufacturing and construction, and is often referred to as 'just-in-time' deliveries. There are no major warehousing facilities on the island that would allow for extensive stockpiling of goods.

2.2.3 Supply

Routes and operators

There are currently two suppliers of shipping companies to and from the Isle of Man:

- IOMSPC, which operates a Ro-Ro service on board its Ben-my-Chree vessel, which sails predominantly between Heysham and Douglas (as well as between Birkenhead and Douglas in winter, and on occasional trips to Northern Ireland and the Republic of Ireland);
- Mezeron Limited Freight Services ('Mezeron'), which operates Lo-Lo services between Ramsey on the Isle of Man and Glasson Dock (in England) and Belfast (in Northern Ireland).

Figure 2.13 shows a map of these connections.

¹⁰ Based on information received from Department of Infrastructure. If we were to assume that one trailer is approximately 20t in weight, Ro-Ro services would account for approximately 90% of total freight weight.

¹¹ Based on confidential freight volumes received from Department of Infrastructure.

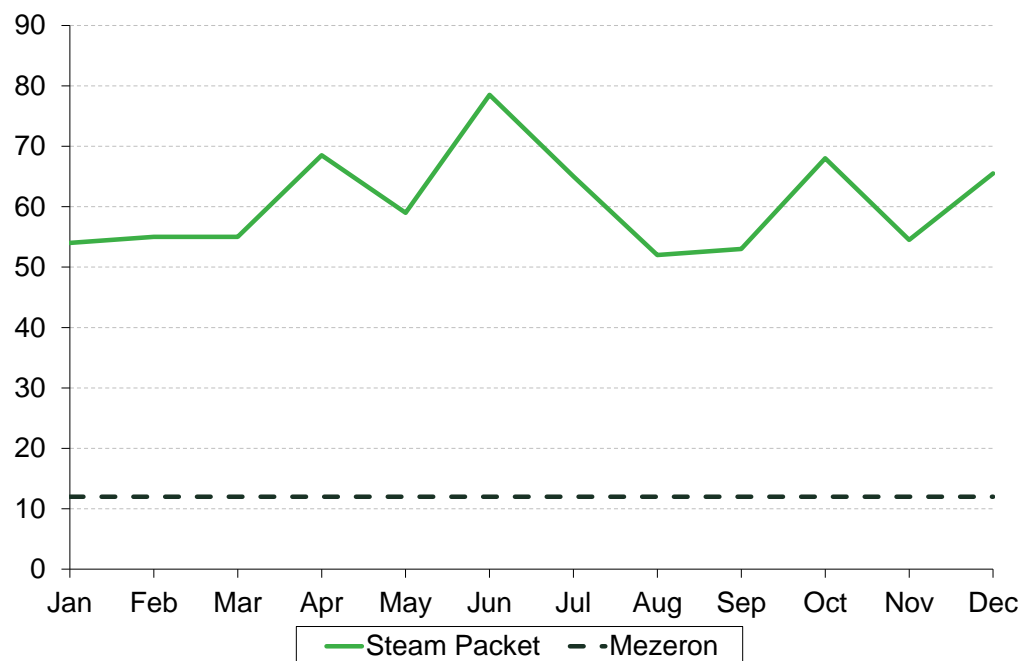
Figure 2.13 Freight routes map by operating companies



Note: Only primary freight routes are indicated. Some freight is carried on winter sailings from Birkenhead.

Source: Mezeron and IOMSPC websites.

Over a year, IOMSPC Ro-Ro freight services tend to average at least 55 journeys per month, corresponding to at least two services a day. In contrast, we understand that Mezeron operates three Lo-Lo services a week. This is shown in Figure 2.14.

Figure 2.14 Frequency of freight services by month and provider (2015)

Note: IOMSPC services include sailings to Heysham and Birkenhead; Mezeron services sail to Glasson Dock and Belfast. Three services per week are assumed.

Source: Oxera analysis, based on information from the Department of Infrastructure.

Unlike passenger traffic, the freight market has seen some entry in recent years. In particular:¹²

- Merlin Manx Containers operated a three-times-a-week Lo-Lo service around 1990, initially using chartered boats equipped with self-discharging cranes, and later a shore-side tracked crane. The service reduced to a weekly weekend call using a container ship that served Liverpool to Belfast during the working week. This was discontinued due to losses;
- we understand that there were another two smaller entrants between 1992 and 2008, neither of which resulted in a long-term challenger;
- in 2010/11, Mezeron started operating a competing Lo-Lo service into Douglas through a joint venture with a haulier, using chartered Eastern European ships, and undercutting IOMSPC. One major haulier and some retailers signed up with the challenger service, but subsequently returned to using IOMSPC after being offered significantly discounted freight charges (understood to be approximately 40%).¹³ As a result, Mezeron withdrew the Douglas service and returned to operating only a Lo-Lo service into Ramsey.¹⁴

2.3 Vessel substitutability

At present, the vessels that are used to serve the different connections to and from the Isle of Man form part of a relatively small pool of 'bespoke' vessels in

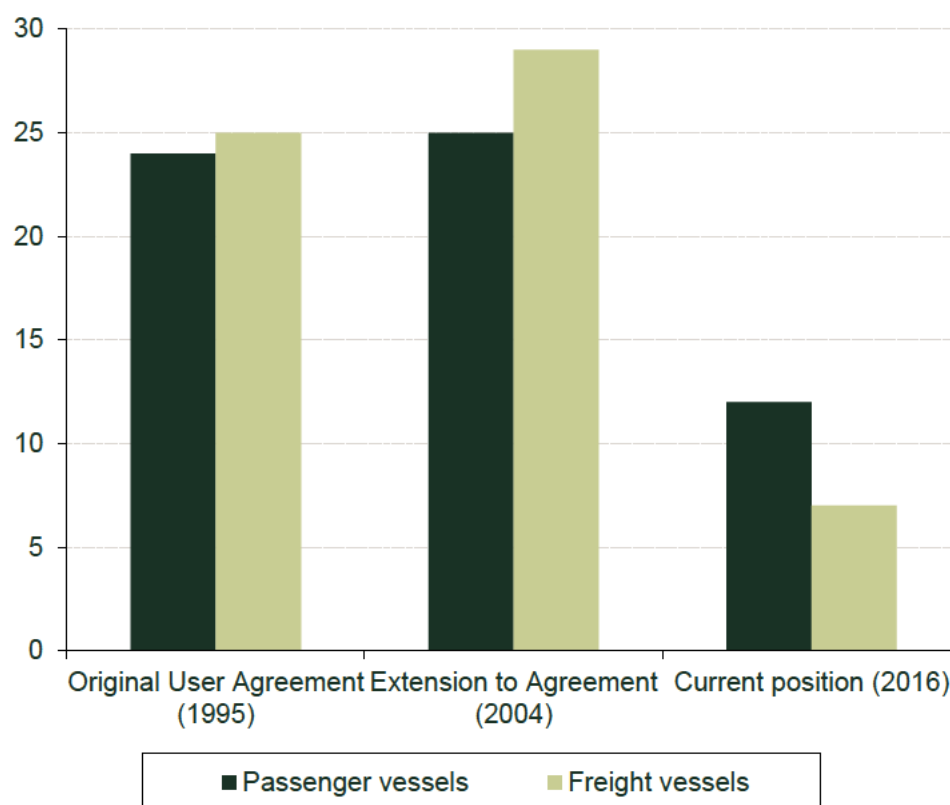
¹² Based on interviews with the Isle of Man Department of Infrastructure.

¹³ We have been unable to trace the full business or consumer impacts of this change. Based on the interviews we understand that the retail prices for instance did not adjust downwards in response to this change, suggesting that the benefits may have been absorbed by the hauliers or retailers.

¹⁴ We understand that another reason was the difficulty with same day deliveries being difficult to handle in Douglas harbour (based on an interview with IOMSPC).

operation in Europe.¹⁵ Over the last 20 years the number and availability of such vessels has decreased significantly, in particular as smaller vessels were replaced over time by new larger vessels. This trend is shown in Figure 2.15.

Figure 2.15 Number of European vessels of a specification similar to Ben-my-Chree, Manannan and Arrow



Note: The figure shows vessels that could be chartered, assuming they are available. Caledonian MacBrayne vessels are excluded due to their small size. The 2016 passenger vessel figures consist of five fast craft (including HSC Manannan, HSC Jonathan Swift, HSC Condor Liberation, HSC Condor Rapide, HSC Normandie Express), three ferries operating for NorthLink to Orkney and Shetland (MV Hamnavoe, MV Hjaltland, MV Hrossey), one operating to the Channel Islands (MV Commodore Clipper), two French-owned ferries operating from Newhaven to Dieppe (MV Seven Sisters and MV Cote' D' Albatre, although it is unclear whether these would meet the capacity restrictions at Douglas), and the MV Ben-my-Chree. The 2016 freight vessel figures consist of one freighter operating to the Channel Islands (Commodore Goodwill), two freighters operating to Orkney and Shetland (MV Helliard and MV Hildasay), the MV Clipper Ranger, MV Ivan, and MV Arrow.

Source: Isle of Man Department of Infrastructure.

Numerous factors affect the suitability of vessels for use on a particular connection. These span the most fundamental metrics such as length, beam or turn radius (and hence compatibility with the respective ports), as well as the number or strength of thrusters (essential for berthing in strong winds or rough water), compatibility of mooring or ramp arrangements, and crew certification. Timing issues can also prevent quick deployment of substitute vessels. Most importantly, we understand that all of the compatible vessels are currently in use

¹⁵ Based on interviews with independent ship brokers and the Isle of Man Department of Infrastructure.

on other routes, and their availability for short and/or long term charters is very limited.¹⁶

This implies that the degree of substitutability of the existing vessels, and in particular Ben-my-Chree, with other craft is considerably more limited than in previous years.

2.4 Overall summary

Based on the analysis presented above, we conclude that:

- the foot passenger market (i.e. passengers travelling without vehicles) appears competitive—air connections offer a faster and reasonably priced alternative to ferry services, even for short distances (e.g. from Liverpool, Dublin or Belfast);
- ferry services have a monopoly over passenger vehicular traffic, with no available alternatives for travellers wishing to use their own vehicle,¹⁷ high barriers to entry, and no historical evidence of competition other than the Manx Line/Sealink service of 1978 to 1985;
- the Lo-Lo freight segment is operated by a single provider, but certain competitive pressures remain due to its small size, some substitutability with Ro-Ro freight, and a lack of restrictions on additional operators to enter the market;
- despite having only a single supplier, the Ro-Ro freight segment is contestable, and freight charges have been suppressed at least for a portion of the users since the last competitive entry around five years ago. Further entry into this segment would appear possible, but it is likely to reduce the profits available for cross-subsidisation of passenger services (this is explored further in the following sections).

¹⁶ Based on own research and information from interviews with Department of Infrastructure and IOMSPC.

¹⁷ The only (imperfect) alternative is renting a vehicle on the island, which enables flexibility of travel by sea or air.

3 Regulatory frameworks in ferry markets

3.1 Need for regulation

As with other ferry markets serving small islands, the market for elements of ferry services on the Isle of Man can be characterised as a natural monopoly—high fixed costs, both per service and per operator, result in high barriers to entry in the market (in other words, replicating the current service is likely to be commercially unviable). The investment costs of running a service include the purchase or charter and maintenance of vessels and corresponding infrastructure on the landside. The costs of providing services include high fixed costs due to staffing and fuel—variable costs per passenger or per unit of freight are low by comparison. The proportion of total costs that are fixed also suggests that there are high barriers to entry in the market, which suggests that the market may benefit from some form of regulation.

A range of options are available to the Isle of Man Government, from state ownership to measures that encourage competitive outcomes; these options and their strengths and weaknesses are discussed in section 5. There may be opportunities to create competitive conditions in some segments of the market that are more profitable—for example, services during peak periods (TT Races, summer, Festival of Motorcycling). However, this is likely to distort any current cross-subsidisation of services between peak and off-peak periods or routes (and, at least in the short term, may be subject to limitations on the pool of available vessels).

Because of barriers to entry, it may not be possible for the market to be served by open competition, which suggests that, regardless of the model used in the Isle of Man market, some level of regulatory oversight may be required to ensure that objectives in the public interest are met.

There are three distinct stakeholders in the regulation of ferry services on the Isle of Man; the key requirements for each group are listed in Table 3.1, along with other potential objectives (note that ‘operator’ applies equally to ferry operators and port operators).

Table 3.1 Key stakeholder objectives

	Government	Users (passengers and freight)	Operator
Primary objectives	<ul style="list-style-type: none"> • safeguard a vital strategic asset • modern, cost-effective, well run operations • minimum/no contribution from the public purse 	<ul style="list-style-type: none"> • regular, reliable operations • lowest possible prices • appropriate quality services 	<ul style="list-style-type: none"> • certainty of strength and length of the regulatory framework • maximisation of financial returns • independence from undue political interference
Secondary objectives	<ul style="list-style-type: none"> • reasonable (not excessive) operator profitability • adaptability to changing market/demand conditions • appropriate level of investment into service quality • allowing the trade to flourish 	<ul style="list-style-type: none"> • protection of vital routes • assurance of control over lifeline service 	

Source: Isle of Man Government (2016), 'Report on Liverpool landing stage/Strategic Sea Services Agreement', July.

The objectives sometimes conflict (for example, the public need for a regular service might not be in line with commercial viability). A regulatory framework would seek to outline the responsibilities of each party and balance the competing priorities of the different stakeholders.

3.2 Current regulatory framework

The Isle of Man Government has granted IOMSPC preferential licensed access to its linkspan at Port of Douglas to operate passenger and freight ferry services between Liverpool/Heysham and Port of Douglas.¹⁸ This access is granted in return for price and service guarantees based on the User Agreement established in 1995.

The User Agreement, which was most recently updated in 2004, includes numerous specifications for the IOMSPC service delivery, as outlined in Table 3.2. The service requirements have been gradually expanded over time. Overall, IOMSPC has delivered at least the required specification, and in many areas it has exceeded the required minima.

¹⁸ Oxera understands that winter services are operated to Birkenhead in place of Liverpool due to the weather and current vessel compatibility (Ben-my-Chree does not fit at the current Liverpool facility).

Table 3.2 Comparison of User Agreement provisions with current service levels

Category	Specification	Delivery today
Frequency and schedules	User Agreement includes specifications of minimum numbers of services to Liverpool (summer), Liverpool (winter), total winter services, and Ireland; and for fast craft services by number of services per week depending on the season. The agreement allows flexibility with regards to selection of other routes.	IOMSPC exceeds the specified number of services in some areas, and meets the minimum service levels in others.
Capacity	User Agreement includes specifications of minimum inbound freight capacity in metres per week, minimum annual growth in freight, and fast craft capacity in percentage terms; and for reasonable capacity to address demand around TT Races.	IOMSPC exceeds or meets the obligation in all areas.
Passenger fares	User Agreement requires the availability of a 'special offer fare'. Additionally, annual growth in the basket of fare revenue cannot exceed Manx RPI - 0.5% per year for 1995–2010, or Manx RPI from 2010 onwards.	IOMSPC exceeds the 'special offer fare' condition and complies with the fare revenue specifications.
Freight fares	User Agreement caps the growth in the basket of freight fares at Manx RPI.	IOMSPC exceeds this requirement, with recent reductions in fares.
Investment	User Agreement specifies minimum levels of investment over three periods (1995–2005, 2005–12, 2005–15) in £m.	IOMSPC exceeds the requirements in all periods.
Staff	User Agreement specifies that IOMSPC must include an Isle of Man presence in management.	IOMSPC exceeds this requirement in both Isle of Man management and also in employment.
Service	User Agreement includes other specifications for: <ul style="list-style-type: none"> • branding requirements; • maximum tonnage age; • disability access on vessels; • minimum marketing expenditure (in the UK and in total); • maintenance of the Victoria Pier linkspan. 	IOMSPC meets or exceeds all requirements, and also contributes community assistance within the Isle of Man.

Source: User Agreement Compliance Report 2016.

The User Agreement requires IOMSPC to carry out internal compliance checks in order to ensure that the conditions are met. As it is a legally binding agreement, the Department of Infrastructure can require IOMSPC to comply with the conditions, or remedy any breaches within a reasonable period of time.

The User Agreement has evolved since the 1995 terms; the last two periods of major change saw many increases in terms of capacity or service frequency. A significant amount of the new proposed investment is directed towards replacing existing vessels, with the consequence of some increases in capacity but no changes to the number of services/routes (see Table 3.3 which includes IOMSPC's proposed terms for an extension of the User Agreement).

Table 3.3 Comparison of minimum service requirements

	1995 Agreement	2002 Extension	2004 Extension	Proposed Extension
Freight capacity (inbound)	2,600 metres	7,000 metres	7,800 metres	10,000 metres

Service frequency (GB Ports)	382 return sailings	764 return sailings	936 return sailings	(assumed no change)
Summer period frequency Liverpool port range	3 return sailings/wk end May–Begin September	7 return sailings/wk end May–Begin September	Daily service April–3rd week October	(assumed no change)
Annual services East Coast of Ireland	63 return sailings	63 return sailings	63 return sailings	(assumed no change)
Fast Craft Capacity	110% previous years carryings June–September	110% previous years carryings June–September	115% previous years carryings June–September	(assumed no change)
Freight capacity in excess of previous years carryings	No provision	Plus 10% more lane meterage	Plus 12½% more lane meterage	Increase the inbound guaranteed freight capacity of the IOMSPC sailings to 10,000 lane metres per week from the current level of 7,800 (+28%).
Special offer fares	No provision	Minimum 250,000 seats per year	Minimum 50% of previous years carryings	Minimum 85% of previous years carryings
Standard Fares and charges	Manx RPI minus - ½% (on a weighted basis)	Manx RPI minus - ½% (on a weighted basis)	Manx RPI minus - ½% to 2010, Manx RPI from 2010 (on a weighted basis)	Manx RPI (on a weighted basis)
Investment by company	£20m (minimum)	n.a.	£26m (minimum)	Proposed £65m investment in a new ro-pax vessel and a nearly new or refurbished fast craft earlier than would be possible without an extension. The offer includes other proposals which are not considered capital expenditure/ investment ¹
Back-up vessels	No requirement	No requirement	No requirement	Year-round availability of a back-up vessel capable of replacing any of the current vessels
Standard of vessels	High standard (no detail)	High standard (no detail)	Benchmarked against UK passenger ferry operators	Intention is to replace both Ben-my-Chree (2019/21) with a vessel built for purpose and Manannan (2022/23) with nearly new or newly refurbished vessel
Fast Craft Provision	Optional by Company	Optional by Company	Now a requirement	Replace the Manannan in 2022/2023 with a nearly new or newly refurbished fast craft vessel.
Day Trip Excursion	No requirement	No requirement	Now a requirement if suitable vessel available	(assumed no change)

Note: ¹ Proposed offer includes a third vessel, which is intended to be MV Arrow, a vessel currently chartered by IOMSPC, or Ben-my-Chree, which is owned by IOMSPC, and does not

constitute additional capital investment. Other elements of the offer include concessions for special offer fares and other initiatives which are not capital investments. We understand the proposal includes the introduction or maintenance of a third vessel; while this is not a capital investment, we recognise that this represents an additional operating cost to IOMSPC.

Source: Isle of Man Government (2015), 'User Agreement: Briefing for Strategic Sea Services Working Group', 26 October, slides 9–11; and IOMSPC (2016), 'Strategic Sea Services Agreement – Isle of Man Steam Packet Company offer', May.

IOMSPC's proposals extend also to other contractual provisions, such as commitment to guarantee Manx employment on the vessels, commitment to marketing spend or transparency over the consultation process in the event of planned service changes.

3.3 Set-up of comparative ferry services

In this section, we review the individual elements of the regulatory frameworks in ferry markets. We do this by, firstly, explaining conceptually why a particular element is relevant, and secondly comparing the set-up on the Isle of Man with the set-up of comparable services.

3.3.1 Overview of relevant comparators

In order to assess other regulatory frameworks used in similar ferry markets, we have considered the following comparators, which are all ferry operators providing lifeline services to small islands. No two ferry services are identical, and the range of companies investigated below is wide—rather than attempting to identify the best individual comparator, we look at trends observed across the group as a whole. These companies represent several of the operating models that can exist within the ferry industry.

Table 3.4 lists the operators, regions and number of vessels in each market.

Table 3.4 Overview of comparators

Operator	Market	Total number of vessels	Total number of routes	Comparison to Isle of Man
Condor Ferries	British Isles	Two high-speed vessels, one conventional ro-pax, one freighter	Four routes (including Jersey–Guernsey link)	Reasonable comparator for Isle of Man, given demand patterns and current arrangement based on a contract specifying services to be delivered by a single operator. (See Box 3.2 for more on the performance of Condor Ferries.)
NorthLink Ferries	Scotland/UK	Three conventional ro-pax vessels, two freight vessels	Five routes	Operators are supported by government subsidies, unlike on the Isle of Man
Isles of Scilly Steamship	UK	One ro-pax vessel, two freight vessels (one long-range, one short-range), one fast craft	One route to the mainland	Private company with majority of shareholders resident on the Isles of Scilly
Isle of Wight Ferries	UK	Three operators (Wightlink, Red Funnel, Hovertravel): five high-speed (pax) vessels, three regular-speed pax vessels, nine ro-pax vessels	Six routes in total	Multiple operators suggest there is sufficient demand in the market for competition, which may be due to the lack of transport options by air. This suggests the market is somewhat different from the Isle of Man
Caledonian MacBrayne	Scotland (Clyde and Hebrides)	Over thirty	Twenty-six routes	Operators are supported by government subsidies, unlike on the Isle of Man
Destination Gotland	Sweden	Four fast ro-pax vessels (two larger and two smaller), one reserve freight vessel	Two regular routes and one summer route	Operators are supported by government subsidies, unlike on the Isle of Man
BornholmFærgen	Sweden/Denmark	One fast craft, two conventional ferries	Three routes	The operator is partially state-owned
Jadrolinija	Croatia	Over thirty	Over thirty	State-owned
BC Ferries	British Columbia (Canada)	Over thirty	Twenty-four routes	Was previously a Crown corporation, and recently turned into a publicly owned company

Source: Oxera analysis, based on a range of online sources, government documents, and regulatory publications.

The following subsections analyse the individual elements of the regulatory frameworks. Detailed research is provided in Appendix A1.

3.3.2 Contract length, including breaks and extensions

The ferry market is characterised by large, upfront capital investments in vessel purchases and maintenance. Operators that purchase or make lease

arrangements for their own vessels are likely to prefer longer contract terms to allow them more time to recover their upfront costs and reduce concerns over asset stranding. Outside of the regulation of ferry markets, the European Commission recognises the role that upfront investments may play in extending contract terms for public service operators in track-based transit modes.¹⁹ Contract extension provisions serve to lengthen the operators' timeframe for the recovery of investments, as long as the process and conditions for extensions are clearly outlined in the initial agreement. Contract lengths are also determined by the level of service offered; a greater service requirement may justify the need for a longer term to allow the operator time to recover investments in service level.

Where the investments are transferable (i.e. the contract is for the operation of services and the vessels are leased to the operator, or can be sold onward to the next operator), contract lengths can be shorter as recovery is not necessary.

Where the contract terms are shorter and investments are still required by the operator, the operator may expect a greater rate of return in order to be assured that its investment will be recovered within a shorter timeframe (or, alternatively, other provisions to prevent assets being stranded upon contract termination).

Contracts in Denmark for ferry operators are about five to six years in duration; contract periods for Condor Ferries are for seven years and those for Serco NorthLink Ferries are for six years.²⁰ In the case of NorthLink, there are no provisions for contract extension, and for Condor Ferries, the contract can be extended for a possible three years.²¹ The contract for Destination Gotland is expected to be renewed for a ten year period from 2017-2027; the operating is currently investing in a new ferry to be delivered in 2017.²² The British Columbia Ferry Service Inc. was created from what was formerly a Crown (government-run) corporation in order to introduce a level of protection from political influence; the first service contract runs for 60 years with four-year regulatory review periods.

In addition, any provisions for early termination of a contract should be outlined (including the process and conditions under which this is justified), to reduce the risk of uncertainty. Any agreement should include clear arrangements to ensure a smooth transfer of services from the provider to another provider at the end of the contract period, in order to reduce the operator risk from uncertainty and to ensure recovery of the investment made. While the proposed extension by IOMSPC includes the possibility of seven-year break provisions (or, conversely, equally timed contract extensions), it is unclear under what circumstances this would occur, how it would be undertaken, and what the transition arrangements would be. Without further clarity around when and how a break clause is exercised, there is a risk that the extension would be exercised in practice as an extended agreement until 2040, which would be exceptional given that contract

¹⁹ The European Commission requires that the 'duration of public service contracts shall be limited and shall not exceed 10 years for coach and bus services and 15 years for passenger transport services by rail or other track-based modes.' Additionally, 'the duration of the public service contract may be extended by a maximum of 50 % if the public service operator provides assets which are both significant in relation to the overall assets needed to carry out the passenger transport services covered by the public service contract and linked predominantly to the passenger transport services covered by the contract.' See European Commission Regulation 1370/2007, Article 4, paras 3–4.

²⁰ Baird, A.J. (2012), 'Comparing the efficiency of public and private ferry services on the Pentland Firth between mainland Scotland and the Orkney Islands', 23 June.

²¹ States of Jersey (2014), 'Operating agreement between the Harbour Master of Jersey and Condor Limited' para. 6.4.

²² Rederi AB Gotland (2015), 'Annual Report 2015', pp 6 and 10.

lengths in most other ferry markets are for a substantially shorter period (even in arrangements that involve investments).

3.3.3 Vessel ownership and management

The Isle of Man economy depends on freight access to GB. Because vessels are essential in the delivery of freight, vessel ownership (either full or part-ownership) would give the Isle of Man Government control over nationally important assets. It would therefore allow the government to focus the User Agreement on the operation of services, rather than larger investment decisions. The disadvantage of a model involving vessel ownership is the capital investment required to purchase them (although the prices will likely depend on the availability of outside buyers and demand for vessels of these sizes). Another disadvantage is that, once the vessels are owned by the Isle of Man Government, there is reduced flexibility in investing in new vessels should the requirements of the island change. Lastly, government may lack the expertise to buy and/or operate ferries, which an alternative ownership model (e.g. part-ownership via a Joint Venture with a private operator) would be able to mitigate.

In Clyde and Hebrides, vessels are owned by Caledonian Maritime Assets Ltd (CMAL), which is wholly owned by the Scottish government. Ferries that serve the Scotland Northern Isles routes (Serco NorthLink) are owned and leased by a third party. For the island of Gotland, the Swedish National Public Transport Agency (Rikstrafiken) decided to tender separately for the provision of ferries and the operation of ferry services.²³ In most comparator markets, such as the British Isles (Condor Ferries), Isle of Wight (Red Funnel, Wightlink and Hovertravel), Bornholm (BornholmFaergen), Gotland (Destination Gotland), and British Columbia (British Columbia Ferry Services Inc), the operators own their vessels. The evidence from other markets does not point to a preferred model of vessel ownership; the example of Gotland suggests there has been consideration for the separation of the supply of vessels from their operation, while the remaining cases present a mix of government and operator-owned vessels.

3.3.4 Port facility ownership and management

The benefits of port ownership are similar to the benefits of vessel ownership: allowing an operator to control the port, both on the Isle of Man and at important terminals in GB, would reduce the Isle of Man Government's bargaining position in the event of any disagreement. This was the case in the past when the linkspans were owned by IOMSPC.²⁴ Any discussion of port facility ownership should note the potentially significant purchasing costs involved.

In the Isle of Wight and British Columbia, ports are operator-owned, while in other markets (e.g. Jersey), they are government-owned. In Clyde and Hebrides, ports and vessels share the same owner (Caledonian Maritime Assets Ltd); in the British Isles, ports are typically privately owned by a third party.

3.3.5 Investment

The design of the User Agreement will have implications for the incentives for the operator to improve or innovate on service offerings. Incentives to achieve further efficiency or cost savings are built into the price control approach (discussed further in section 4); however, building in incentives to encourage

²³ Although the current operator uses vessels owned by its parent company.

Baird, A.J. and Wilmsmeier, G. (2011), 'Public tendering of ferry services on Europe', Transport Research Institute (TRI), Edinburgh Napier University n. 49(2011), pp. 90–111.

²⁴ Based on correspondence with Department of Infrastructure.

flexibility in addressing the future direction of the market, rather than focusing the regulatory framework on cost, will allow the operator to explore other ways of serving the market that may result in large public benefits.

Beyond efficiency, incentivising investment in non-cost factors, such as service quality or customer satisfaction, requires the operator to engage with:

- customers, to understand what elements of service quality are important;
- the government/regulator, to outline how these quality improvements are monitored/rewarded, through pre-established key performance indicators (KPIs).

Investments in non-price factors may pose a risk for both the government or regulator and the operator; it may be unclear prior to the investment if consumers will respond or benefit significantly. However, customer engagement and the establishment of clear KPIs will reduce these risks to the operator as well as the risk to the government/regulator of service being artificially over-specified (or 'gold-plated').

An overview of comparators suggests that there is no clear precedent for providing effective incentives. Other sectors, such as water in England and Wales, are beginning to adopt an approach that includes incentives for customer engagement, and GB electricity networks are being regulated under an approach that incentivises efficient long-term investments.²⁵ However, other ferry markets are recognising that investments in service quality can be beneficial—for example, Bornholm's ferry procurement process has evolved from a tender that was based solely on 'lowest price' to one based on the 'economically most advantageous application', which includes ferry quality.²⁶

3.3.6 Prices/fares

Before analysing the specific prices and fares of IOMSPC services, it is important to understand the way in which these prices can change over time within the current (as well as the proposed extension of) the User Agreement, as well as the established norms of price regulation.

There are two broad approaches to price control regulation.

- **Rate of return regulation.** This approach sets the price that the regulated firm can charge to allow it to earn a specified rate of return, and no more. The regulator can achieve its objective of ensuring that firms do not make excessive profits, while still incentivising them to invest and supply the regulated product/service. However, it means that firms do not have incentives to operate efficiently, since they do not gain by reducing costs.
- **Price cap (RPI – X).** This is a price-setting rule where RPI is the retail price index and X presents the expected annual gain. The regulator sets (maximum) prices directly by predicting the levels of efficient costs and demand, and adjusts prices for inflation based on the RPI. By letting the firm profit-maximise within a set price, incentives for efficiency are improved. However, the efficiency incentive produces an incentive to lower quality.

Other difficulties with a price-cap approach include how to account for 'cost pass-through' components, set initial prices (especially given volatile demand),

²⁵ See Ofwat (2015), 'Towards Water 2020 – policy issues: customer engagement and outcomes', July; and Ofgem, 'Network regulation- the RII model', <https://www.ofgem.gov.uk/network-regulation-riio-model>.

²⁶ Baird, A.J. and Wilmsmeier, G. (2011), 'Public tendering of ferry services on Europe', Transport Research Institute (TRI), Edinburgh Napier University n. 49(2011), p. 97.

and provide incentives for large sunk investment. Regulators therefore often adopt a hybrid approach that combines price-cap and rate-of-return regulations.

The choice of index for a price-cap approach

As described above, in a price-cap approach, the initial price set by the regulator is adjusted for inflation for the later periods based on a price index. The current User Agreement allows IOMSPC to raise fares by a maximum of the Manx RPI at around 0.5% per year. Since the Consumer Price Index (CPI) has gained in popularity over the RPI in recent years,²⁷ it is important to consider how each index would affect the fare level (see Box 3.1 below).²⁸

Box 3.1 Impact of different inflation measures

Table 3.5 discusses the differences across three price indices—the Manx RPI, Manx CPI and UK CPI.

Table 3.5 Differences across price indices

Index	Demographics	Basket of goods	Geography	Formula
Manx RPI	Majority of Isle of Man households, excluding top earners and pensioners (75% income from state benefits)	Includes mortgage interest payments, council tax, estate agent fees and television licences	Includes expenditure by the relevant households both within the Isle of Man and abroad	Suffers from the 'formula effect' and results in artificial upward bias to the inflation rate
Manx CPI	All households and visitors	Includes university accommodation fees and tuition fees	Within the Isle of Man	Is not prone to the same upward bias as the RPI
UK CPI	(As above)	(As above)	Within the UK	(As above)

Note: In response to the government's recent consultation, several businesses have emphasised that moving away from the Manx RPI would have significant disruptive impacts, as their commercial contracts are linked to the RPI. Others have responded that linking contracts, benefits and wages to the artificially high RPI creates a strain on resources.

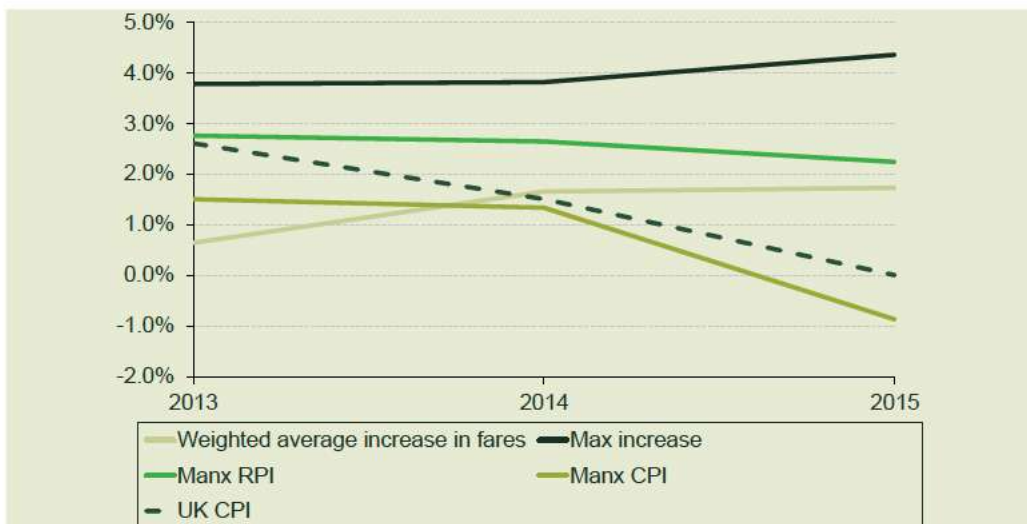
Source: Isle of Man Government (2016), 'Consultation on the Future of the Manx Retail Prices Index (RPI)', Economic Affairs, Cabinet Office, April.

The two figures below illustrate where the weighted average fares and changes in fares sit relative to the three price indices above. Manx RPI is consistently the highest index, and allows fares to grow faster than indexing using Manx CPI or UK CPI. The wedge between Manx RPI and Manx CPI is significant; UK CPI falls between the two. Figure 3.1 also indicates that IOMSPC fares have not increased relative to Manx RPI in recent years.

Figure 3.1 Changes in fares compared to price indices (2013-15)

²⁷ The UK has switched from RPI to CPI as the main measure of inflation and delisted RPI as a UK National Statistic in 2013.

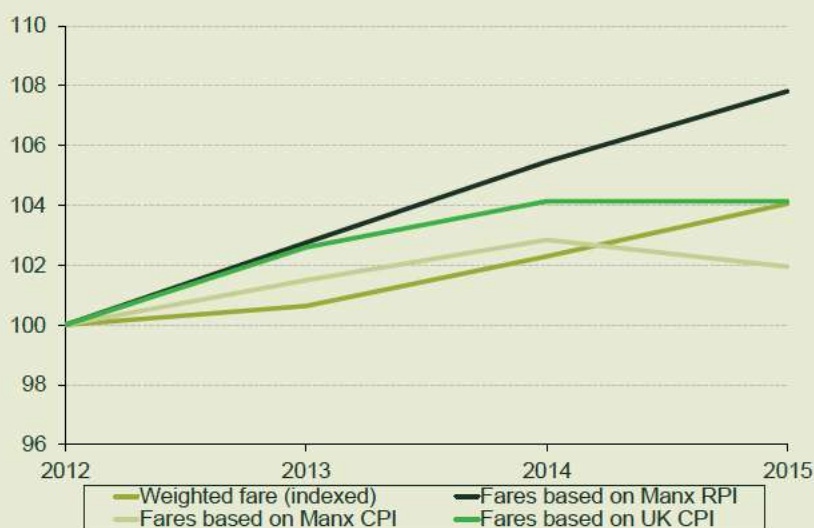
²⁸ Isle of Man Government (2016), 'Consultation on the Future of the Manx Retail Prices Index (RPI)', Economic Affairs, Cabinet Office, April



Note: The Max increase refers to the maximum increase observed in any individual fare category within a specified year. Increases in fares are weighted by forecast revenue of each traffic type, fare type and tariff.

Source: Fare data 2012–15 from IOMSPC. Manx RPI and CPI from Isle of Man Government (2016), 'The Isle of Man in Numbers 2016', Economic Affairs, Cabinet Office, March. UK CPI from Office for National Statistics, available at <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7g7/mm23>, accessed 28 September 2016.

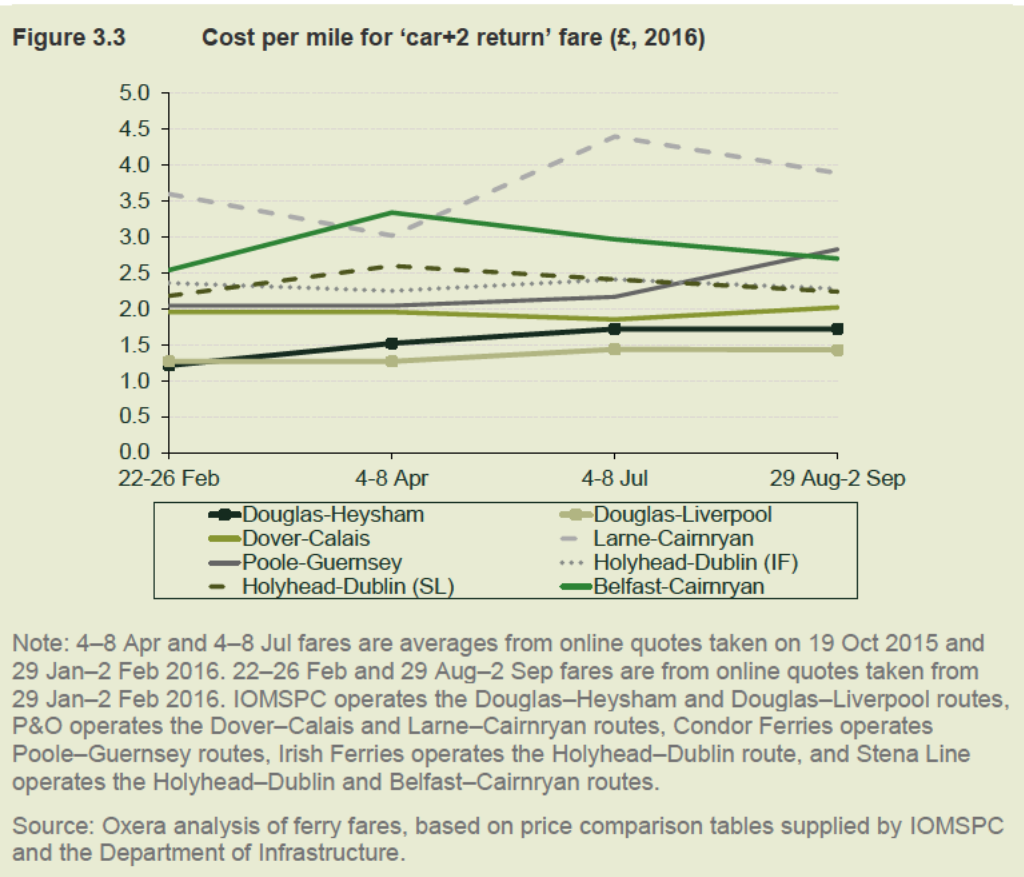
Figure 3.2 Actual weighted average fares and fares based on various price indices (2012-15)



Note: Average fares are weighted by forecast revenue of each traffic type, fare type and tariff.

Source: Fare data 2012–15 from IOMSPC. Manx RPI and CPI from Isle of Man Government (2016), 'The Isle of Man in Numbers 2016', Economic Affairs, Cabinet Office, March. UK CPI from Office for National Statistics, available at <https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7g7/mm23>, accessed 28 September 2016.

Compared with other ferry services, IOMSPC ferries (Douglas–Heysham and Douglas–Liverpool routes) consistently have the lowest fare per mile for the service including two passengers and a car in 2016. This is illustrated in Figure 3.3.



Incentives under different approaches to price controls

A price-cap approach places stronger incentives on the operator to achieve cost efficiencies, as they are exposed to the risk of lost profits from underperformance. However, because not all costs are controllable by the operator, there are ways to integrate elements of both approaches. The government could explore options to share the risk from demand volatility with the operator (discussed in section 3.3.11); one way in which this currently happens is through the fuel surcharging mechanism, which reduces the risk to IOMSPC of changes in fuel prices (which is considered an uncontrollable cost element). Risk-sharing of fuel prices is also used in other ferry markets, such as in Bornholm.²⁹

Some comparator operators are regulated under a price-cap approach, including Condor Ferries, Serco NorthLink, and British Columbia Ferry Services Inc.³⁰ The Condor Ferries agreement includes a form of risk-sharing where returns above or below a certain threshold can justify adjustments to the schedule or price limits.³¹

Caledonian MacBrayne's routes were subject to a trial of a new form of price control between 2012 and 2014 called the Road Equivalent Tariff, which delinks the price of ferry services from the cost of operation by setting tariffs based on

²⁹ Baird, A.J. and Wilmsmeier, G. (2011), 'Public tendering of ferry services on Europe', 2011, Transport Research Institute (TRI), Edinburgh Napier University n. 49(2011), pp. 90–111.

³⁰ Discussions suggest that Serco NorthLink might move to a Road Equivalent Tariff model in the future. See Transport Scotland (2011), 'Scottish ferry services: draft plan for consultation', December, chapter 3, para. 29.

³¹ Condor Ferries must ensure that its return on average capital employed falls within certain bounds, or make adjustments to price or schedules. See 'Operating agreement between the Harbour Master of Jersey and Condor Limited', 2014.

the cost of travelling an equivalent distance by road.³² Without support from government subsidies, as is currently the case for Caledonian MacBrayne, this would present a significant risk to the operator.

Pass-through of benefits

Another consideration concerns the mechanisms in the User Agreement that allow the benefits of price control incentives to be shared with users; it is important to balance the incentives to the operator to achieve efficiency savings and undertake investment with the objective of price regulation to deliver benefits to consumers. The length of the price control determines how long the operator can retain any efficiency savings: the shorter the price control period, the more quickly the framework can deliver savings to consumers by incorporating them into reduced fares.

However, this can risk the appetite of the operator to invest in the service. If the proposed extension contained no break points, there would be a risk that users would not be able to experience as much of the benefit from efficiency savings as would be the case in regulatory frameworks with shorter review periods. Our understanding is that the current negotiating position involves seven-year-long review cycles (either break- or extension points within the contract), which should offer an appropriate balance of risk and reward for the operator.

The proposed extension includes both the continuation of Manx RPI indexing (which allows fares to grow faster than other indices), and a commitment to greater availability of special offer fares, as well as an explicit revenue sharing mechanism if the services outperform the current business plan (such gains are to be invested in additional special fares, representing a potential upside for the users).³³ On balance, and largely due to the Manx RPI indexing, it is unclear whether consumers will benefit from this agreement.

Other measures taken in comparator markets include trigger mechanisms on operator profitability—in the case of Condor Ferries, any indication that the operator's return on capital is outside of an accepted band triggers the opportunity for a price or schedule adjustment.³⁴ Another mechanism is the claw-back used in Clyde and Hebrides to ensure that any public subsidy above a pre-determined profit level to Caledonian MacBrayne (including the operator's return) is repaid by the operator.³⁵

Overall, given the general regulatory trends away from RPI indexation, any long-term agreement would ideally be based on a CPI index. To the extent that current IOMSPC costs are RPI-linked, an option would be to include a transition period such that the index base changes at a pre-agreed point in time (e.g. the first contract extension/break-point).

3.3.7 Minimum and delivered service level

Lifeline services require a specification that operators will provide services outside of what would be commercially profitable (i.e. on a frequency or schedule that results in lower than optimal utilisation, or services outside of peak seasons). This may be required in cases where there is an argument for public

³² Council of the Isles of Scilly (2011), 'The Isles of Scilly strategic transport framework', August, appendix D.

³³ It is worth noting that the proposed extension to the User Agreement features revenue share in case of over-delivery against the IOMSPC business plan, but does not feature any provisions in the case of under-delivery against the plan (e.g. via explicit subsidies or concessions on the allowed price increases etc.). This means that IOMSPC is internalising a number of risks, e.g. wider economic shocks, changes in passenger travel preferences etc.

³⁴ 'Operating agreement between the Harbour Master of Jersey and Condor Limited', 2014, para. 12.5.2.

³⁵ 'Public service contract between the Scottish Ministers and CalMac Ferries Ltd.', Section 4.5.

benefit. It requires a balance between provision of a suitable service level, and an awareness that higher service specifications will raise costs and subsequently fares (see the cross-subsidisation discussion in section 4.2).

There are trade-offs in terms of how stringent an authority may want to be regarding minimum service specifications. Limited specification, consisting of a relatively low base level of service for freight and passengers, will result in greater commercial flexibility for the operator. This may be preferable in cases where there is high variation in demand for services, because it provides greater control to the operator to determine what level of service is suitable for the market. This may reduce the risk to the operator by allowing greater opportunities to change costs based on changes in demand. Less specification would also be consistent with enabling the operator to deploy its intellectual property to devise commercially beneficial service improvements.

A high minimum specification would reduce the flexibility of the operator to adapt services to meet changing demand, and would increase operator risk³⁶— however, the benefit is that this could provide the government or regulatory authority with greater control, and a greater assurance that a high level of service will be consistently delivered. For example, NorthLink Ferries must comply with an outlined timetable, reducing the operator's freedom to adapt service levels.³⁷

Additionally, any agreement should outline clearly the process for intervention in the case of underperformance against the minimum service level, including the terms that lead to intervention and the level of intervention, in order to prevent risk from uncertainty.

It is unclear how specific comparator agreements are in terms of the destinations/ports that operators are expected to serve. In principle, the agreement may specify which routes are operated, or it may let the operator determine what is most commercially viable. IOMSPC currently serves routes both to GB and to Belfast and Dublin. The User Agreement currently requires IOMSPC to operate a minimum of 63 return sailings to the east coast of Ireland; data from IOMSPC suggests that these services are unprofitable and cross-subsidised by other services to Liverpool and Heysham. A future User Agreement may seek to improve the profitability of the operator by reducing this minimum service level requirement, which would improve the flexibility of the operator to meet demand. However, reducing the requirement would come at the cost of security of access to the Irish market, which may be important for some businesses on the island.³⁸ It may be particularly important to consider the implications of keeping or removing an Irish sailing requirement in light of potential future changes to the UK's relationship with the EU; access to Ireland, while currently unprofitable,³⁹ may become important for security of EU access in the future.

Public perception about the operator's performance relative to a minimum standard is also important, as was highlighted by Condor Ferries' response to past delays, cancellations and mechanical issues (see Box 3.2).⁴⁰

³⁶ In circumstances where the service specification is tight, and volumes variable, costs become relatively fixed while revenues fluctuate. Operators will demand higher compensation under the contract as a consequence. In a tendered situation, this can also increase the risk of overbidding.

³⁷ Park Partners (2016), 'IoM Strategic review of the User Agreement', slide 59.

³⁸ Based on our interviews, we understand that some businesses that rely on freight access to Ireland would prefer a consistent, year-round service.

³⁹ Based on confidential information received from IOMSPC management.

⁴⁰ See Condor Ferries, 'How are we performing?', <http://www.condorferries.co.uk/performance/>.

Box 3.2 Condor Ferries' recent service delivery performance

In 2014, Condor Ferries signed a 10-year non-exclusive agreement to operate passenger, vehicle and freight services between the UK and Channel Islands. The agreement was intended to allow Condor to make significant investments in a new fast craft to replace the two of the existing vessels.¹

Services became vulnerable to the reduction in capacity and safeguards to ensure back-up options were available. The new vessel, the Condor Liberation, was first introduced in March 2015 and began suffering from mechanical faults and damage, resulting in multiple disruptions and cancellations.² The service disruptions were further compounded by poor public perception of how the issues were addressed. A lack of intermediate enforcement mechanisms – actions taken by the government without filing for termination of contract - in the operating agreement meant some drastic measures were considered; because the agreement did not include any mechanisms for imposing fines over the course of operation, the government considered the feasibility of terminating the contract and imposing a financial liability on Condor Ferries over a breach of contract.³ In October 2015, an independent report was issued by Houlder Ltd. assessing the safety, suitability and performance of the Condor Liberation.⁴ A remediation plan was also agreed between Condor Ferries and the Chief Ministers of Jersey and Guernsey to address the multiple issues around not only the disruption due to mechanical faults, but also related issues such as the need to improve customer service, enhance risk planning from vessel breakdowns, and greater resilience during peak periods.⁵

The issues faced by Condor highlight the potential benefits of embedding penalty and incentive mechanisms within an operating agreement to include safeguards to ensure public satisfaction with the services. This provides the operator and the government with a clear framework for addressing any potential issues in meeting minimum service levels, and focuses the discussion on restoring service levels rather than a potential termination of contract.

Source: ¹ States of Jersey (2014), 'Condor signs operating agreement', 18 August.

² BBC (2016), 'Condor Ferries boss vows to 'regain public trust'', 3 May.

³ Jersey Evening Post (2015), '£20 million cost to Condor if States cancel contract', September 23.

⁴ Houlder (2015), 'Condor Liberation safety, suitability and performance', 15 October.

⁵ States of Jersey (2016), 'Condor Ferries agree remediation plan', 14 March.

While the option of terminating an agreement early through a break clause acts as a form of penalty for underperformance, other options are also available; it is advisable for any future agreement to consider a range of incentives to encourage compliance with a minimum service level, which might include mechanisms such as formal warnings, tiered financial penalties, or additional service requirements in subsequent regulatory periods. In addition, the process for deciding when each type of penalty should be implemented should be clearly outlined. For example, in the UK Civil Aviation Act, which sets out licence conditions for the regulation of UK airports, various enforcement mechanisms are tiered in terms of urgency, ranging from written notice (through a contravention notice, enforcement order, or an urgent enforcement order), to various financial penalties.⁴¹ A license revocation can occur should the licensee fail to comply with the enforcement mechanisms.⁴²

3.3.8 Operator debt level

The proposed extension to the User Agreement includes significant investments in two new or newly refurbished vessels at approximately £65m, in addition to the retention of a back-up worth £55m.⁴³ It is unclear from the proposal how IOMSPC intends to finance these investments, but we understand that the plans

⁴¹ Civil Aviation Act 2012, part 1, chapter 1, paras 31-47.

⁴² For example, see 'License granted to Heathrow Airport Ltd by the CAA under section 15 of the Civil Aviation Act 2012 on 13 February 2014', Section B2 (c)

⁴³ IOMSPC (2016), 'Strategic Sea Services Agreement: Isle of Man Steam Packet Company offer', May, p. 2.

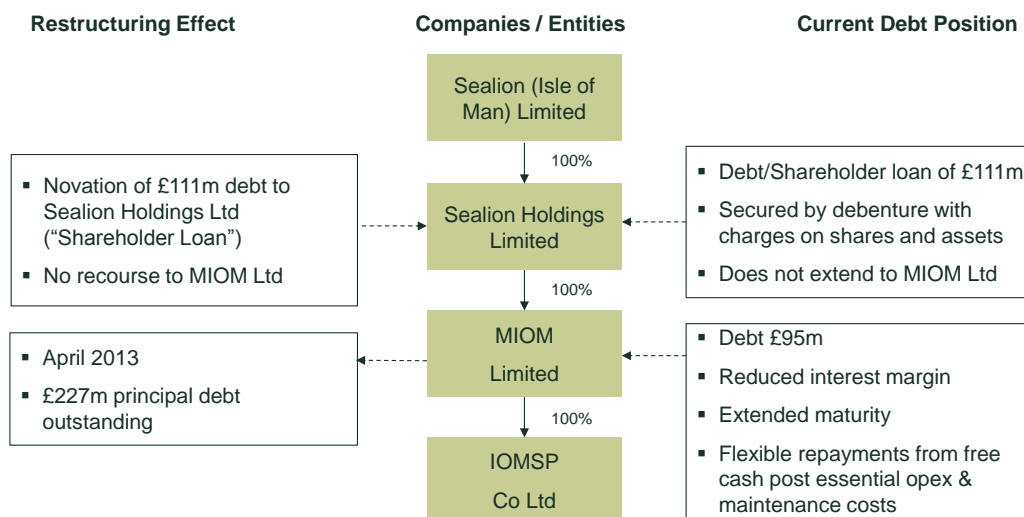
exclude any financial involvement from the Isle of Man Government. In other markets, operators have relied on a level of government support; Serco Northlink in the Scottish Northern Isles received a £243m subsidy from the Scottish Government over a six year contract starting in 2012, and CalMac Ferries Ltd. received a subsidy from the Scottish Government of approximately £105m in 2015.⁴⁴

We have been informed that IOMSPC is considering a range of financing options, including both debt and equity financing. The benefit of debt funding is its high availability for relatively low cost (compared to equity financing). In theory, it would also allow IOMSPC to retain a greater degree of managerial control than financing through equity, as equity financing involves trading a share of ownership in exchange for access to financing.

Availability of debt financing is not generally considered a constraint; the only consideration is that if IOMSPC were to continue to build up debt, there would be a risk that the government would be implicitly viewed as guaranteeing any debt, which could create incentives for IOMSPC to adopt a risky level of borrowing. In addition, given its history of varied previous ownership and debt restructuring, and the implications that this might have for the operation of the service, there may also be a lack of public support for such measures.⁴⁵ This consideration applies particularly if there is a perception that the revenues from a sole operator ferry service are used for excessive debt repayment as opposed to being reinvested in the service itself. Public opinion about the repayment of debt through what is regarded as a nationally important lifeline service may also deter IOMSPC from considering additional leveraging in this case.

Figure 3.4 presents the structure of ownership and debt for IOMSPC and its parent companies; the restructuring means that Sealion Holdings Ltd does not have recourse to MIOM Ltd in the event of default.

Figure 3.4 Current ownership structure and debt



Source: Information provided by IOMSPC.

⁴⁴ Part of the subsidy provided to CalMac Ferries Ltd. Was clawed back as operator return was above the maximum allowable rate. CalMac Ferries Ltd. (2015), 'CalMac Ferries Ltd. Directors' report and financial statements for the year ended 31 March 2015', 20 October, pp. 1 and 9.

⁴⁵ Park Partners (2016), 'IoM Strategic review of the User Agreement', slide 12.

As of October 2016, IOMSPC's accounts show debt of approximately £95m, all of which is due to be repaid by 2026.⁴⁶

In other markets, ferry operators are highly leveraged: British Columbia Ferry Services Inc. lowered its leverage ratio to approximately 78% in March 2016.⁴⁷

In addition, contractual restrictions in a future agreement could be implemented to prevent the ferry operator from being excessively leveraged. This is a practice that is currently employed in the UK's regulation of the national air regulation service provider, NATS (En route) plc (NERL), where a gearing target of 60% and cap of 65% were set for the second regulatory period. NERL is expected to notify the regulator if any shock results in the cap being exceeded, and to provide a justification (an unexpected event as opposed to financial restructuring or business underperformance) for a request to increase the cap temporarily.⁴⁸

3.3.9 Operator profitability

The degree of government or regulatory authority control over how profitable an operator is will depend on the type of price control imposed in the procurement. Because ferry operators sometimes undertake large investments in very specific vessel types, it is reasonable to expect that a higher rate of return will be required to compensate for the level of risk undertaken. This may be the arrangement in a case where an operator is expected to invest in its own vessels and the market is subject to significant volume risk. In the Isle of Wight ferry market, two studies have been undertaken by the UK Competition Commission, in 1991 and 2009.⁴⁹ The 2009 investigation found that Solent's 12% return on capital employed ('ROCE') was "substantial", but not so excessive as to be against the public interest'.⁵⁰

In some cases where there is a lower level of risk for the operator, it would be reasonable for the operator to expect a lower rate of return. In the case of Destination Gotland, a lower level of risk was assumed by the operator because the arrangement was on a 'net agreement'—i.e. the operator would be paid a fixed amount by the government and would collect revenues from capped prices for passengers, vehicles and freight.⁵¹ The Caledonian MacBrayne ferry operator, CalMac Ferries Ltd, receives government subsidies in return for a cap on its revenues at £1.5m per year.⁵²

Some terms will allow the government to share an operator's profits to a greater degree—for example, the agreement between Condor Ferries and the Channel Islands allows the regulatory authority to review and potentially terminate an agreement if the operator's return on average capital employed ('ROACE') is above a certain threshold for two years.⁵³

As shown in Figure 3.5, accounts for IOMSPC Group indicate the ROCE over the period of 2000–14 ranged from 4.2% to 21.8%, with an average of 13.6%,

⁴⁶ Based on interviews with IOMSPC management.

⁴⁷ Debt to equity ratio. BC Ferries, '2015/16 Annual report', p. 49.

⁴⁸ UK Civil Aviation Authority (2010), 'NATS (En Route) plc CP3 Price Control Review 2011-2014: CAA Decision', December, para. 26.

⁴⁹ The 1991 Competition Investigation was undertaken by the predecessor to the Competition Commission, the Monopolies and Mergers Commission.

⁵⁰ ROCE is a financial ratio used to measure a company's profitability. It is calculated as the ratio between a company's earnings before interest and tax as a proportion of capital employed
Office of Fair Trading (2009), 'Isle of Wight Ferry Services: Market Study Findings', October, para. 6.130.

⁵¹ Rederiaktiebolaget Gotland (2015), 'Annual Report 2015', p. 16.

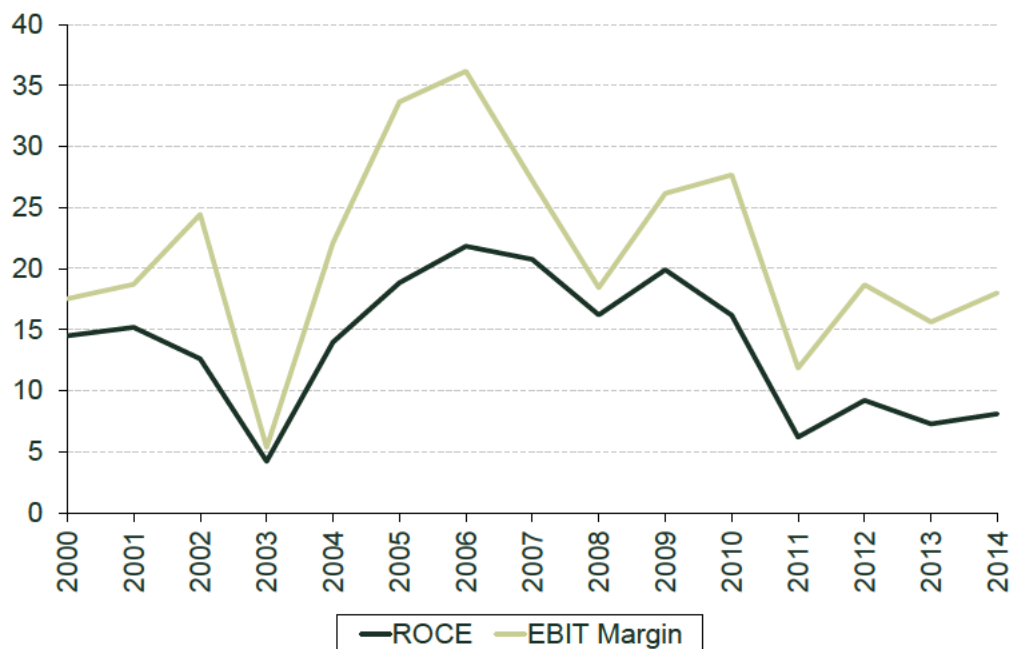
⁵² Park Partners (2016), 'IoM Strategic review of the User Agreement', slide 71.

⁵³ ROACE is a financial ratio used to measure a company's profitability. It is calculated as the ratio between a company's earnings before interest and tax as a proportion of capital employed, averaged over the financial year

Park Partners (2016), 'IoM Strategic review of the User Agreement', slide 60.

which is not substantially higher than those seen in the Isle of Wight.⁵⁴ However, we have not undertaken extensive profitability analysis during our study; we recommend that further work is necessary to understand the economic profitability of IOMSPC, and its drivers.

Figure 3.5 IOMSPC Group ROCE and EBIT margin (%), 2000–14)



Note: Based on interviews with IOMSPC, we understand that the 2015 and 2016 ROCE figures are below the 2011–2014 average of 7.7%. This could be linked to the fall in revenues driven by introduction of discounts on freight charges. Overall, the ROCE (as presented in the accounts) is understood to be lower than that of many comparators due to lower fares, high levels of capital employed (incl. spare vessel and spare parts) and small scale of operations. However, further analysis would be required to assess the appropriateness of IOMSPC's profitability relative to similar companies facing similar risks.

Source: IOMSPC Group Annual Reports 2000–14, filed with Companies House.

3.3.10 Ownership restrictions

We understand that, as part of the extension of the User Agreement, IOMSPC and its holding company have made a commitment to restrict the ability of the business to be sold. Specifically, the proposed agreement extension will contain a qualification requirement for the new owner, and potentially a form of consent for the Isle of Man Government in the transaction. To our knowledge, this represents a departure from existing market practice, where such restrictions do not often exist for private operators. Further clarification would be required about the effective control that this implies, in particular around the specific implementation of the ownership test.

Additionally, any restrictions on change of ownership may affect the future value of the company, both by restricting the number of potential bidders and by increasing the perceived costs and time required in order for a change of ownership to occur.

⁵⁴ Based on Annual Reports of the IOMSPC Group filed with Companies House.

3.3.11 Responding to changing demand patterns

The market for passenger ferry services in the Isle of Man is characterised by low average demand throughout the year with high demand over a short peak tourist season (see section 2). IOMSPC may be subject to additional future risk if it competes with airlines for passengers. It is unclear whether the recent growth of air travel is due to a displacement of demand from the ferry or from growth of different visitor markets, although there are some indications that the strength of growth in short-stay holiday markets (which are more reliant on air travel) may exceed that of family holidays, which are more reliant on ferry services.⁵⁵

Regardless of the risk of decline in demand for ferry services throughout the year, it is important for the island to have sufficient ferry capacity to serve the short period in which the TT Races take place; 7% of residents are directly employed in the hospitality industry and the event is overwhelmingly the largest visitor draw for the island.⁵⁶

3.3.12 Cross-subsidy

Other ferry markets may also require operators to deliver a certain standard of service, where not all elements of the service required are considered commercially profitable. If the operator is required to deliver both profitable and non-profitable elements of service, the costs from loss-making services may require cross-subsidy from the revenues of profitable services. This cross-subsidisation may be between users (passengers vs freight), routes, or seasons (peak vs non-peak).

Information received from IOMSPC confirms the presence of some cross-subsidisation of off-peak and Ireland and Northern Ireland services by the peak and GB routes (see also section 4.2). Analysis produced by Oxera to assess the market for ferry services in Jersey and Guernsey concluded that some level of cross-subsidisation was required in the absence of support from the government on services that are not commercially profitable.⁵⁷

The current User Agreement caps the growth in the fare basket at Manx RPI, which provides flexibility to IOMSPC to differentially change the prices in fare and freight charges across routes and times. We understand that the current proposal would change the cap to apply to all standard fares and freight charges, which would reduce the ability of IOMSPC to cross-subsidise services should future demand patterns change. Given the limited control over the shape and structure of the cross-subsidy under both the current and the proposed User Agreement, it may be beneficial to put specific provisions enabling such cross-subsidy into the contracts.

3.4 Overall assessment of regulatory frameworks

Table 3.6 summarises our overall conclusions about the Isle of Man regulatory framework for ferry services, as implied by the extension of the User Agreement being proposed by IOMSPC to the Isle of Man Government.

Table 3.6 Comparison of minimum service requirements

Category	Comparison with other markets	Comments	Suggested modifications
----------	-------------------------------	----------	-------------------------

⁵⁵ Isle of Man, 'Destination management plan 2016-2020', pp. 24–5.

⁵⁶ Isle of Man, 'Destination management plan 2016-2020', p. 9.

⁵⁷ Oxera (2009), 'The supply of ferry services: a policy assessment', prepared for the States of Jersey, June, section 4.2.

Contract length	X	<ul style="list-style-type: none"> • A proposed extension of the current terms to 2040 is significantly longer than the review periods in other markets • Long period of agreement justified only in the presence of significant, risky new investment 	<ul style="list-style-type: none"> • We understand the proposal currently being discussed may include breaks or renewal options in seven-year increments • However, the terms under which these break or renewal provisions are exercised is currently unclear • Additional transparency would be required regarding under what circumstances, and how, these provisions would be exercised
Vessel ownership	=	<ul style="list-style-type: none"> • In many other markets, the route operator owns the vessels, so the proposed extension is in line with most comparators • In some markets, the vessels are separately owned or ultimately government owned • There is a risk, because of an availability of appropriate vessels, in the reliance on operator-owned vessels for a lifeline service 	<ul style="list-style-type: none"> • Review other models of vessel ownership (see sections 4 and 5)
Port facility ownership	n.a.	<ul style="list-style-type: none"> • Port ownership is not an element of the proposal, but this is strategically important for the Isle of Man Government to consider in terms of the long-term risk of third-party ownership, given its reliance on freight from Heysham 	<ul style="list-style-type: none"> • Review other models of port ownership (see sections 4 and 5)
Investment/incentives	=	<ul style="list-style-type: none"> • Other comparators offer no precedent for evaluating investments • A significant level of investment in new vessels proposed by IOMSPC 	<ul style="list-style-type: none"> • Given the level of investment proposed, a review of other methods of investing in capacity and security of supply is required to ensure that the proposed extension is the best way to meet these objectives. Other models could be considered (see sections 4 and 5)
Prices/fares	=	<ul style="list-style-type: none"> • Current price cap model is in line to what comparators use. Other regulatory models that aim to reduce or control fares more aggressively include subsidies, which the Isle of Man Government may not prefer • Prices are currently capped as a total fare basket. Much of the demand risk is inherently borne by IOMSPC in the current agreement and proposed extension, which places some users at risk of cross-subsidising others in the event that demand patterns change over time. Other models use 	<ul style="list-style-type: none"> • Review other price control arrangements, or consider risk-sharing (such as the fuel surcharging mechanism) if change in demand is expected to present risks over time • Consider the use of alternative indices in a price cap model • There is currently no way of sharing benefits, except via cross-subsidy or Douglas port charges (which the state can then re-allocate)—an

		<p>indexing that blends local and UK indexes (Condor Ferries). Evidence suggests that Manx RPI rises faster than other indices, which has implications for fares, especially if the extension is in effect until 2040</p> <ul style="list-style-type: none"> • Pass-through of benefits is proposed through an extension of the special offer fares to 85% of passenger traffic and some proposals for sharing revenue growth through additional fare offers (which deals with an upside benefit, but leaves the operator with exposure to any downside risks) 	<p>alternative would be a shorter ferry contract period</p> <ul style="list-style-type: none"> • Consider an explicit universal service obligation definition and relevant rates • Develop a framework for assessing the impact of different fare reductions on users and on growth of the market • Provide greater transparency around the proposed revenue growth-sharing mechanisms
Minimum service level	=	<ul style="list-style-type: none"> • Proposed minimum service levels do not change the current User Agreement significantly • This covers aspects of service that are normally covered in comparator markets (frequency and scheduling), and that specify destinations • While this is necessary for a lifeline service, it also does not offer IOMSPC much flexibility if market conditions change 	<ul style="list-style-type: none"> • Review current minimum service levels in the User Agreement, and identify areas where flexibility in the future may be preferred • This could be in areas such as scheduling, frequency, or route choice
Operator debt level	X	<ul style="list-style-type: none"> • Gearing information is not available for most comparators • The proposed extension may require IOMSPC to accept a significant amount of debt • Regardless of industry practice, this is likely to be a concern given the previous debt history of IOMSPC (linked to past ownership changes) 	<ul style="list-style-type: none"> • Proposed extension includes an offer to include provisions regarding safeguards for operating company debt • Consider introducing conditions on operator gearing as a provision for debt control
Operator profitability	=	<ul style="list-style-type: none"> • Information does not indicate that IOMSPC's past profitability is significantly higher than that of other known operators (e.g. Isle of Wight) 	<ul style="list-style-type: none"> • See discussion on prices/fares
Ownership restrictions	=	<ul style="list-style-type: none"> • The proposal includes restrictions on future ownership in the event that the current owners choose to sell their stake in the company, including a test 	<ul style="list-style-type: none"> • Greater clarification is required around the test for change of ownership. This could include a requirement to pay users a dividend fixed in real terms at onward sale by the current owners within a number of years of the revised Agreement being signed.
Changing demand patterns	X	<ul style="list-style-type: none"> • The extension of the User Agreement to 2040, and the number of conditions within the User Agreement concerning frequency and destination of service, are likely to limit the ability of the operator to address changes in the market 	<ul style="list-style-type: none"> • Review current minimum service levels in the User Agreement, and identify areas where flexibility in the future may be preferred

- This could be in areas such as scheduling, frequency or route choice

✓ Performing well = On par with comparators X Below comparator standard

Source: Oxera.

The primary risk with accepting the proposed extension is the length of the agreement. All aspects of the agreement will have potential implications for users and the wider economy until 2041 if the seven-year break clause does not come into effect; and because of the significance of this commitment, it is important that the government evaluates all elements of the proposal with consideration for the potential risks. In general, areas for consideration are:

- **degree of control**—ownership, and the level of control that the Isle of Man Government wishes to retain in the long run;
- **financing**—this relates both to debt levels (and associated risks of default, and how financial distress on the part of the operator would be managed by the Government) and how users can benefit from onward sale by the current owners shortly after a new Agreement were signed;
- **assurance of consumer benefit**—how any profits from the operation of a lifeline service are reinvested in the island. The proposal does address this through special offer fares, but there is no certainty or transparency over what proportion of the overall monopoly profits are re-invested this way;
- **flexibility**—the impact of elements of the proposed agreement on the operator's ability to adapt in the event of long-term changes to the market.

It is important to consider the demand for ferry services and characteristics of the market separately from any current arrangement or proposal, in order to understand whether an extension is the best way to benefit the island. This is discussed next in section 4.

4 Optimal service level and ferry asset ownership

Abstracting from the current ferry service provision, this section focuses on how the optimal service level for the Isle of Man might look. We explore first the highly seasonal nature of demand for passenger services, and the relatively balanced need for freight services, and look at the various modes of ownership and operation of the respective ports and ferry services.

4.1 Nature of demand

The market for the provision of ferry services to the Isle of Man is characterised by:

- **a lifeline service**—while other transport options may exist for some passengers (air links are discussed in section 2), the Isle of Man relies significantly on freight transported from Heysham by ferry. There is no substitute for this in the foreseeable future. Even for foot passengers, travel to the island by air may not be an option for those participating in two of the island's largest events, where motorbike transport is required. Local residents may also consider travel to Liverpool by ferry essential for medical and health reasons (where air travel is not a feasible substitute);
- **highly seasonal demand for services**—capacity requirements for travel to/from the Isle of Man are determined by two weekend periods each year around the TT Races, with a smaller surge in demand in August for the Festival of Motorcycling. In the two weekend periods surrounding the TT Races, the utilisation of ferry services by foot and vehicle passengers reaches 100% on some sailings, compared with an annual average of approximately 35–40%.⁵⁸

Regardless of the identity of the service provider, these two factors describe a typical challenge for the set-up of most ferry services in island economies. For instance, the Isle of Wight ferry operators recognised their role in providing a 'lifeline service', and that this responsibility was managed through the frequency of services, which might not be justified on a purely commercial basis.⁵⁹ Similarly, the tender in Bornholm, initially based on price, evolved to include other elements of economic benefit, such as flexibility, security of supply, and ferry quality.⁶⁰

This section explores the available evidence to draw conclusions on the level of ferry services that may be required to adequately serve Isle of Man's current (and potentially also future) needs.

4.2 Cross-subsidisation between freight and passenger traffic

In many ferry services serving island economies, passenger traffic is provided at commercially unviable levels, and requires subsidisation from the more regular and typically more profitable freight service.

This is evident when the main users of the ferry services are considered separately:

⁵⁸ Even during the peak, the high capacity utilisation tends to be unidirectional, i.e. onto the island before the events and off the island once the events end. We have been informed by IOMSPC that during TT, for instance, the overall capacity utilisation of their sailings is approximately 60%.

⁵⁹ Office of Fair Trading (2009), 'Isle of Wight Ferry Services: Market Study Findings', October, para. 3.38.

⁶⁰ Baird, A.J. and Wilmsmeier, G. (2011), 'Public tendering of ferry services on Europe', Transport Research Institute (TRI), Edinburgh Napier University n. 49(2011), pp. 90–111.

- freight traffic serves as the island's main route for transporting perishable and time-sensitive goods (as opposed to bulky goods that can be moved by slower Lo-Lo services). It requires consistent capacity and frequency, in order to satisfy the wider logistics network set-up for just-in-time deliveries, and operates throughout the year. Night-time connections are preferable;
- local residents require connections to GB throughout the year, for reasons including visiting relatives, work, and entertainment. Timing (in particular daytime connections), reliability, frequency and speed of connections are of the essence;⁶¹
- visitors are particularly likely to require the service during the tourist season. This group requires high service capacity in the peak season, and availability of space for vehicles in particular.

Cross-subsidisation can occur in multiple ways (all of which are confirmed by a review of confidential information provided by IOMSPC):

- charging arrangements: lower freight charges typically mean higher passenger charges in order to cover fixed and indirect costs (or vice versa, as was evident in the Channel Islands in the past);
- frequency of service: higher frequency to accommodate passenger preferences means greater vessel operating costs, which may be borne by all users of the service;
- availability of different routes: a route that sees consistently low utilisation may be subsidised by freight and passenger fares on other routes;
- investment in (peak) capacity: the ability to accommodate TT traffic may mean a larger vessel than would otherwise be optimal, which would be more costly to run. The costs of this may be passed on in freight charges and/or passenger fares across the whole year. As visitors are less likely to be frequent users of ferry services, this additional investment in capacity may either be subsidised by local residents (in particular given that local residents constitute approximately half of total passengers—see section 2) or vice versa. Further analysis of IOMSPC's costs and revenues over time is required in order to draw a conclusion on whether there is a cross-subsidisation element due to capacity;
- investment in speed: a fast craft may be preferred by passengers, but typically has less capacity for freight. If operation of the fast craft does not break even, it is likely that the slow craft (especially their freight consignments) subsidise a passenger preference for speed.⁶²

While we have had access to some IOMSPC management accounts and information, the information in what follows is based on publicly available information that we have cross-checked against the confidential information to ensure the validity of our conclusions.

⁶¹ We consider price separately from the service level.

⁶² Modern fast craft can carry sufficient freight to be a viable back-up for the existing ro-pax vessel, but only in certain benign weather conditions (i.e. typically outside of winter months).

4.3 Evidence for public demand in the Isle of Man

4.3.1 Freight

Frequency

As far as businesses and freight are concerned, many sectors of the Isle of Man economy require at least one freight delivery a day (at present this is the night-time Heysham service that, for example, brings in the goods for store shelves in the morning).⁶³ This would appear to be particularly relevant for grocery retailers and the construction industry. The additional daytime freight service tends to be used for carrying less time-sensitive goods, as well as returning empty loads ahead of subsequent inward shipments.

Routes

At present, the vast majority of freight volumes arrive through Heysham, which is well connected to major logistic centres in GB, and offers a relatively short-distance connection with Douglas. In the medium to long term there may be potential for the main service to be re-located to another port in GB.

Capacity

Current available freight capacity is between four and six times larger than actual shipped volumes when passenger vehicle traffic is excluded, which would imply an actual capacity utilisation over the year of around 20–25%.⁶⁴ However, given that the vessel vehicle space is interchangeable between freight and passenger vehicles, the actual utilisation of 'free cargo space' after passenger traffic is taken into account would be closer to 50% annually, and significantly more in peak periods.

Source: Oxera analysis, based on available IOMSPC schedules and freight information from the Department of Infrastructure.

Lo-Lo freight

At present, Lo-Lo freight represents approximately 2-10% of the total freight transported onto the Isle of Man.⁶⁵ The service carries less time-sensitive or heavy consumables, many of which could be transported via the Ro-Ro service, although Lo-Lo is more efficient. There is also a small proportion of goods for which Lo-Lo remains the only means of transport—such as bulky construction materials.

4.3.2 Passenger travel

- While air travel is available, an ongoing ferry service would remain the only means of transport for many passenger groups, including: visitors travelling to the island with their own vehicles, in particular for the TT Races or the Festival of Motorcycling;
- families travelling by car to the island for short and long holiday breaks: the Destination Management Plan indicates that 70% of visiting families travel to the Isle of Man by ferry.⁶⁶ Local residents use the ferry service primarily in order to travel by car (approximately 73%); options for vehicle travel may be a

⁶³ Based on interviews with Chamber of Commerce representatives and other key stakeholders.

⁶⁴ IOMSP current freight volumes vary between 50 and 600 lane metres per sailing, depending of time of day and month. Based on confidential freight volumes data received from IOMSP and the Department and Information.

⁶⁵ As measured by lane metres (lower end of the scale), or weight (higher end of the scale).

⁶⁶ Isle of Man 'Destination management plan 2016-2020', p. 25.

similar reason why families visiting the island also overwhelmingly use the ferry service;⁶⁷

- time-sensitive travellers in periods where weather disruptions (such as fog or wind) result in cancelled flights but not cancelled ferry services;
- local residents who cannot travel by air for health reasons.

The most important considerations among ferry users are reported to be reliability of service, price, and frequency of service.⁶⁸

Frequency, routes and capacity utilisation

In the case of passenger transport, it is slightly more difficult to disentangle frequency of services and their respective routes (while, at least in the medium run, freight traffic should be substitutable between different nearby ports, passengers may be less willing to substitute)—for this reason, we have considered them together.

There is currently an almost twice-a-day service between Douglas and Heysham throughout the year, with a ‘basic’ service to Liverpool in the winter months followed by very frequent connections in the April–October period.

Increases in frequency are normally accompanied by decreasing load factors (the degree to which capacity on a particular service is utilised). Across the current IOMSPC services, annual capacity utilisation is approximately 37%.⁶⁹

This load factor varies between the individual destinations, as well as over time. Over the whole year, the Liverpool and Birkenhead services have the highest load factor at just under 50%, followed by Belfast (37%), Heysham (31%) and Dublin (26%).⁷⁰ However, during the year there is considerable variation in these load factors, as shown in Figure 4.1, with particular peaks around Easter, the TT Races, and the Festival of Motorcycling.

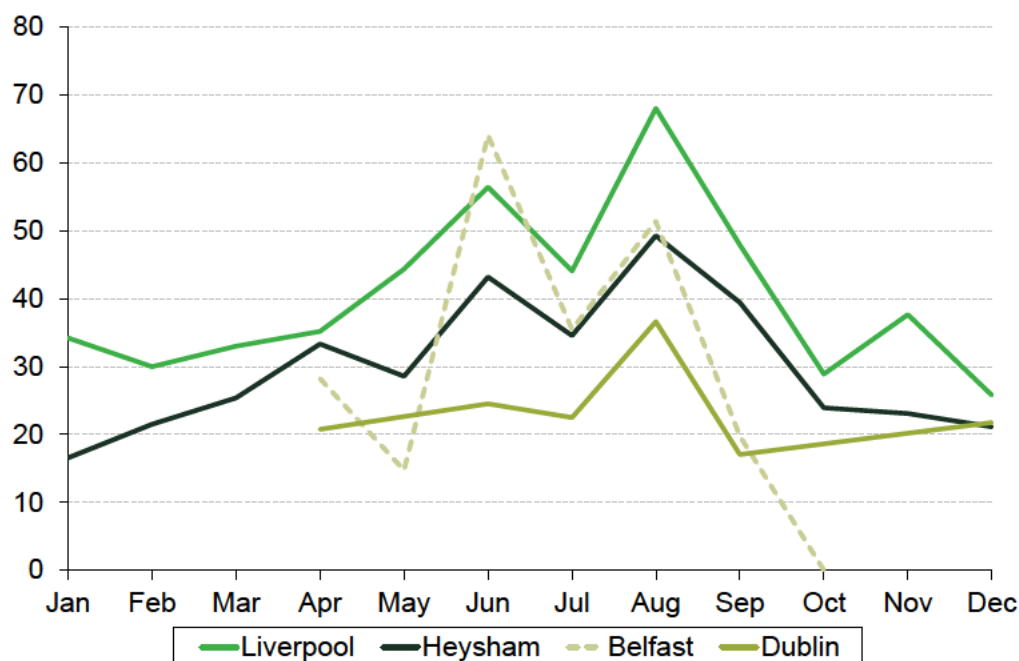
⁶⁷ Isle of Man Department of Infrastructure (2016), ‘Response to the consultation on ferry services’, February, p. 4.

⁶⁸ Isle of Man Department of Infrastructure (2016), ‘Response to the consultation on ferry services’, February, p. 5.

⁶⁹ Based on interviews with IOMSPC management.

⁷⁰ Oxera estimates. See note to Figure 4.2 for methodology.

Figure 4.1 Approximate passenger capacity utilisation across various routes, by month (% , 2015)



Note: It is assumed that all services are served by Ben-my-Chree, except Liverpool, where the breakdown of sailings to Liverpool (Manannan) and Birkenhead (Ben-my-Chree) is available. As a result, values could be overestimated for some destinations served by Manannan in the summer months.

Source: Oxera analysis, based on available IOMSPC schedules and Douglas Harbour's traffic reports.

There are likely to be a range of reasons why the Liverpool route performs particularly well, such as having a conveniently located terminal, a large hub generating visitor and business travel, or many friends and family connections. Surveys also confirm that the direct route to the centre of Liverpool (rather than Birkenhead) is preferred, due to the ease of onward/inward connection.⁷¹ The Dublin route, on the other hand, appears to be utilised much less, and we understand that its existence is due more to its cultural and historic significance than to commercial motives.

As an aside, when viewed on a stand-alone basis, all of the passenger connections, perhaps with the exception of certain peak weekends, are likely to fall short of the 'break-even' load factor for IOMSPC. This suggests that, unless such connections are coupled with freight transport, it is not likely that they would be offered by a purely commercial, passenger-only service. This would also suggest a degree of cross-subsidisation between the peak periods and off-peak periods.

This shows that, as far as passenger services are concerned, Liverpool is the most utilised route (even though, as shown in section 2, Liverpool and Heysham have very similar annual levels of passenger traffic), and Dublin is fairly consistently the least utilised.

⁷¹ Isle of Man Government (2016), 'Response to the consultation on ferry services', February.

4.4 Implications for fleet composition

4.4.1 Resilience

An economy that depends on daily shipments of goods and equipment requires not only frequent services of the correct capacity, but also a highly resilient service that is capable of functioning irrespective of the weather, scheduled vessel maintenance, and unexpected breakdowns. For this reason, the presence of back-up vessel(s) that would be capable of being deployed to fill a gap in the regular service is critical (albeit not at any cost) to ensure delivery of a consistent level of service throughout the year (particularly as the fleet ages and becomes more prone to possible breakdowns).

4.4.2 Optimum ferry sizes

The choice of ferry size represents a trade-off between several dimensions, including manoeuvrability in bad weather conditions and vessel capacity vs speed. It is generally understood that while passengers prefer faster services, vessel speed is inversely related to vessel size and journey comfort.⁷² Additionally, larger vessels offer greater capacity for peak periods.

At the moment we do not have concrete information on the trade-offs in terms of vessel size and operating costs, although we understand from industry experience that smaller fast craft, while representing a significant reduction in terms of vehicle capacity relative to a ro-pax, have significantly higher fuel costs.⁷³ The optimal size of the vessel will need to balance the need to meet demand during peaks while managing to control operating costs on a year-round basis. A full appraisal of the trade-offs would require access to detailed cost information and vessel specifications, as well as further information on the passenger value placed on non-price journey elements such as comfort.

4.4.3 Craft speed

We understand that passengers prefer shorter travelling times, and craft speed may influence the perceived substitutability between flights and ferry services. However, fast craft (due to their size and design) are less resilient to bad weather conditions, and tend to incur higher operating costs. One area of further analysis might be an assessment of the trade-off between the estimated monetary benefit to the island from travel time saved due to increased speed, and the additional cost. As with vessel sizing considerations, a full appraisal of this trade-off would require further information on operating costs as well as on the passenger value placed on journey times and reliability.

One option to consider further would be the service pattern and resilience associated with two larger, all-weather vessels (as opposed to the three at IOMSPC's current disposal). This would increase capacity utilisation and may improve the overall economics of the market, and any 'dividend' emerging from this process could be spread between users and taxpayers as appropriate.

4.5 Ownership and contracting models

Control and ownership are closely linked, and different contracting models are in place in order to align the individual incentives of the various stakeholders. In this section we consider the different models and conclude on an optimal structure for both ports and vessels, given the Isle of Man's current position.

⁷² Buxton, I. L. and I. S. Toghias (1999), 'The comparison of conventional and fast ferries', *Society of Naval Architects and Marine Engineers*, 10 January, section 2.4.5

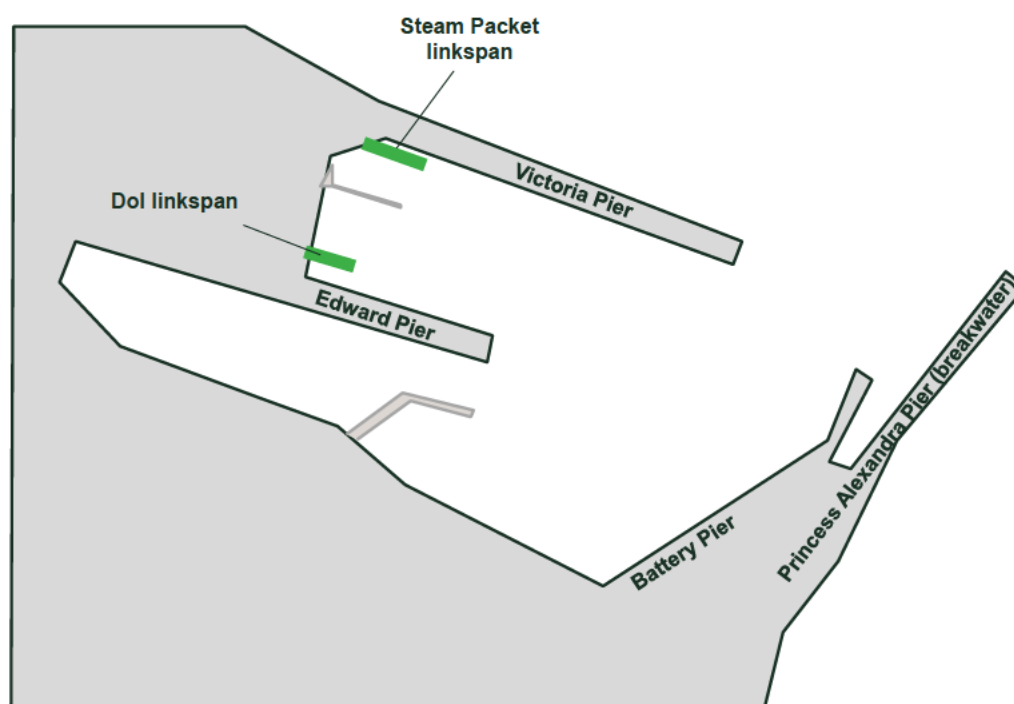
⁷³ See Oxera (2009), 'The supply of ferry services: a policy assessment' June, section A1.1.2

4.5.1 Port facilities

Adequate access to ports (and associated facilities, including access channels and any necessary pilotage and dredging) at both ends of the ferry journey is critical to a successful ferry operation. It may also have impacts on the ferry operator, since the port's incentive to attract tourism and traffic may be offset by its need to act commercially—the balance of these objectives will differ across the different ownership models.⁷⁴

The Douglas port is owned and operated by the government. Figure 4.2 below presents the current port layout. There are currently two ferry linkspans in the port: the IOMSPC linkspan just off the Victoria Pier, which serves the Manannan fast vessel (as well as being able to serve the Ben-my-Chree in certain low tide conditions); and the Department of Infrastructure-owned linkspan by the Edward Pier, which is subject to the current User Agreement. The agreement grants IOMSPC near-exclusive use of this linkspan, with very limited allowance for external usage per year.⁷⁵ We understand that the IOMSPC linkspan is subject to a siting licence between the Department of Infrastructure and IOMSPC; the current license is due to expire at the end of the current User Agreement.⁷⁶

Figure 4.2 Diagram of Douglas harbour



Source: Oxera, based on materials provided by the Department of Infrastructure.

At present, the Isle of Man has three main ferry connections with GB (Liverpool, Birkenhead and Heysham), with the most critical question being over the future of the Liverpool connection. Routes outside of GB include Dublin and Belfast,

⁷⁴ This issue is the subject of a current debate in the Channel Islands, and in particular in Jersey, where port facilities have been practically state-owned since the beginning of 2016. See, for instance, a past consultation on the issue, available at <http://www2.jersey.com/business/press/pressreleases/Pages/PressReleaseDetails.aspx?PressReleaseItemId=1192>.

⁷⁵ Up to 12 sailings, based on information from the Department of Infrastructure.

⁷⁶ We understand that the linkspan may not be removable from the harbour, even upon conclusion of this agreement, and hence IOMSPC is likely to be able to access the port using this linkspan in the future regardless of the evolution of the User Agreement. Confirmation of this would require legal advice.

although, given relative volumes of traffic, the key focus is on GB port connections (see section 2).

It is important to note that the agreements to operate from specific ports outside the Isle of Man are currently signed between the IOMSPC and the individual ports. While IOMSPC is required to operate to specific port ranges under the current User Agreement, the service level, charges and other contractual terms are all negotiated by IOMSPC.

Table 4.1 lays out the various options of ownership and management of all port assets.

Table 4.1 Various ownership and operating models for the port facilities in GB

Model	How it would work?	Advantages	Disadvantages
Full state ownership and operation	State purchases facility/facilities in GB (terminal, landing stage and marshalling area) via an operating lease	<ul style="list-style-type: none"> Long-term strategic security of connection Control over level of service Depending on location, allows for consolidation of passenger and freight traffic Currently relatively cheap, given low interest rates Control over access charges to achieve a number of objectives (i.e. limit ferry company profitability, achieve tourism target volumes) 	<ul style="list-style-type: none"> Lower incentives for over-performance against set requirements Full state control might not be possible, given the need for hinterland and ocean-side access services Port access charges fall under the scope of UK competition legislation, and the Harbours Act Responsible for long-term asset liabilities
State ownership with a management contract	As with full ownership, except that the contract for facility management can be granted to the ferry operator or an independent company	<ul style="list-style-type: none"> Would provide the benefits of private-sector operation with long-term supply security for the island Currently cheap, given low interest rates Opportunity to set access charges to limit ferry company profitability 	<ul style="list-style-type: none"> GB-located asset(s) might require the contractual relationship to meet state aid rules, and port charges to meet UK competition rules
Long-term commercial contract	Long (5+ years) commercial agreement with appropriately long break clauses	<ul style="list-style-type: none"> Distances the Isle of Man Government from asset management liabilities Has provided long-term stability of services Various incentives can be included in the contract to benefit Isle of Man passengers and residents 	<ul style="list-style-type: none"> Port provider still has the opportunity to cause security of supply issues for the island No opportunity to use port charges to recycle the profitability of (especially freight) ferry services
Short-term commercial contract	Short-term contract, or long-term contract with a relatively short-term break clause (up to one year)	<ul style="list-style-type: none"> Distances the Isle of Man Government from asset management liabilities Incentives can also feature in such a contract 	<ul style="list-style-type: none"> Short-term nature of contract provides little comfort regarding security of supply

Source: Stakeholder interviews and Oxera analysis.

The option of state ownership and management of the new Liverpool facility by IOMSPC has been suggested as part of the proposed User Agreement extension.⁷⁷ The other options have been mentioned or debated at various points by Tynwald or the Strategic Sea Services Working Group.⁷⁸

⁷⁷ 'Strategic Sea Services Agreement—Isle of Man Steam Packet Company offer' dated May 2016

⁷⁸ Minutes of the Strategic Sea Services Working Group.

The individual ownership and management options rank differently against the various objectives of the key stakeholders—as summarised in Table 4.2.

Table 4.2 Various port facility operating models assessed against different stakeholder objectives

Model	User outcomes	Government objectives		Port operator objectives	
	Reliability, price, frequency	Cost	Long-term stability	Certainty	Returns and independence
Full state ownership and operation	Meets objective	Does not meet objective	Meets objective	n.a.	n.a.
State ownership with a management contract	Meets objective	Does not meet objective	Meets objective	Meets objective	Potentially meets objective
Long-term commercial contract	Meets objective	Meets objective	Potentially meets objective	Meets objective	Potentially meets objective
Short-term commercial contract	Potentially meets objective	Meets objective	Does not meet objective	Does not meet objective	Meets objective

Meets objective
 Potentially meets objective
 Does not meet objective

Note: The operator objectives in the table refer to the port, not the ferry operator.

Source: Stakeholder interviews and Oxera analysis.

The most obvious way for the Isle of Man to have long-term, strategic security of connections to the island would be through direct ownership, either through full state ownership/operation or state ownership with a management contract, of a permanent landing stage outside of the island. Given the importance of connections to GB, from both a freight and a passenger perspective, Liverpool would be a suitable location for such a stage, in particular if it was feasible to use it as a freight terminal as well as a passenger terminal (this is explored further in the next section). This would also decrease the Isle of Man's dependence on the Peel Group as sole owner and operator of its GB ports.

Nonetheless, strategic security is required for both freight and passenger traffic—if one facility cannot perform both roles, ownership of two facilities could be considered. This would also offer an added resilience benefit on the port side.

Once this is achieved for the main (strategic) connection(s), further state ownership would seem excessive for the other routes, and they could therefore be operated under standard (albeit preferably long-term) commercial agreements.

4.5.2 Ferry services

On the ferry services side, there are even more alternative ownership and management scenarios to consider. We explain these briefly below, and outline the practicalities, advantages and disadvantages of each in Table 4.3.

- **Full state ownership:** the vessels and the service would be under complete state control; the state would set the level of service, quality standards, etc. Such a set-up typically results in the removal of any performance and financial incentives from the system.

- **Company limited by guarantee:** this is similar to full state ownership, but typically with a lower buy-out cost, and has the same incentive challenges. A company limited by guarantee does not have shareholders; in contrast, it has members who agree to guarantee the company debts up to a nominal fixed sum. Profits are typically reinvested in the company. A company limited by guarantee retains some of the incentives for innovation and investment of a commercial operator.
- **Partial state ownership:** the government would purchase equity in IOMSPC while allowing it to continue operating as a private company. This would allow IOMSPC to retain its incentives to operate on a commercial basis while (depending on the size of the equity stake) allowing the government some control over operating decisions.
- **Regulated utility:** a regulatory body would be established independently from the government to enforce legislation regarding the operation of services, as well as to monitor compliance. This could be a newly created regulator or the establishment of a mandate to the Office of Fair Trading to oversee the provision of ferry services. Such a legislation can impose the need for a licence to provide the service, which can then make compliance with the licence a condition of being allowed to hold it. In this model ferry services can be provided by a state-owned or a privately-owned company.
- **Negotiated concession:** the government would award a contract to an operator based on certain conditions being met. This is the current arrangement with IOMSPC and would comprise an extension of the User Agreement.
- **Franchise/open public tender:** this is a competitive tender process where the government could outline a minimum service level in the franchise terms. Either the franchise could require operators to supply vessels, or the government could acquire vessels, in which case the franchise licence would be for the operation of the vessels only.⁷⁹
- **Joint Venture:** the government would partner with a company providing ferry experience, enabling both to be liable for the provision and development of the service. The arrangement would allow flexibility in terms of vessel ownership.
- **Fully commercial outcome:** upon completion of the current User Agreement, the government would allow the market to determine which routes and services are delivered with minimum intervention.

Table 4.3 summarises our analysis of how the different ownership models could work, and their advantages and disadvantages.

Table 4.3 Various ownership and operating models for ferries

Model	How it would work?	Advantages	Disadvantages
Full state ownership	Purchase of IOMSPC or other vessels upon conclusion of the current User	Government has full control over service level, prices, investment, etc.	Incentives to innovate and invest limited relative to private sector operation

⁷⁹ We understand that the Department of Infrastructure conducted a light-touch market testing exercise in the last two years, and received very few responses, of which only IOMSPC met all of the contractual conditions. In light of our recommendations on expanded capacity and flexibility we would recommend undertaking this testing exercise again (see recommendations in section 6).

	Agreement, or an early transfer of ownership Full financial and operational responsibility in the hands of government	Government cost of capital being lower than that of the private sector should make any debt repayment cheaper	Potential delay until 2026 High asking price at present Potential for inefficient service provision (driven by political rather than commercial principles) Investment in small items subject to bureaucracy and short-term funding considerations Difficulty for the state to act as regulator, operator and equity-holder at the same time
Company limited by guarantee	Private limited company without shareholders Buy-out of IOMSPC and conversion of its status (or set-up of a new company upon termination of the current User Agreement)	Any surpluses re-invested in the business or used to fund fare reductions Preserved incentives for commercial operation Long-term stable ownership, with government able to set policy objectives	High asking price at present Incentives to innovate and invest limited relative to private sector operation State guarantee on debt may offset management incentives and lead to inefficient outcomes Potential issues surrounding the current and future levels of debt and its funding costs (exacerbated versus other models)
Partial state ownership	State purchases a portion of equity in IOMSPC	With suitable share and governance arrangements, ability to influence main operating decisions Allows the government to develop a better understanding of the IOMSPC business	High asking price at present Difficulty for the state to act as regulator, operator and equity-holder at the same time
Negotiated concession (i.e. extension of User Agreement)	Direct award of the contract to IOMSPC	Ability to preserve otherwise unprofitable routes via movement of funds between services Smooth transition to the new level of service	Continued service operation by the incumbent No consultation with the wider market on the possible alternatives Decisions taken now have long-term ramifications under the terms requested by IOMSPC
'Regulated utility' model	Creation of a politically independent regulatory body (either new or associated with the Office of Fair Trading) Regulatory body responsible for implementing legislation that licenses	Provides the operator with regulatory stability and insulation from political interference	Requires additional resources to establish regulator

	the utility provider (IOMSPC)		
Franchise/open public tender	Competitive tender for services from 2026 onwards, with services explicitly specified in franchise documentation Option for government to purchase vessels and franchise only their operation	Enables movement of funds between profitable and unprofitable services Potentially lower capital requirements Flexibility to operate government-owned vessels, or for the franchisee to provide their own	Risk that there will be no suitable bidder Often beset by overbidding issues Transition issues, with current IOMSPC arrangement coming to an end Risk of insufficient interest
Joint Venture	Upon conclusion of the User Agreement, set up a Joint Venture arrangement with a suitable partner	Flexibility with set-up regarding vessel ownership A degree of government control over service provision	Transition issues, with current IOMSPC arrangement coming to an end Potential governance issues, but can have better incentive structure for operator than in a franchise
Fully commercial outcome	Upon conclusion of the User Agreement, services to be provided only by commercial operators, without government intervention	Free market outcome with competition for Lo-Lo freight	Likely to lead to the removal of many uneconomic routes Services likely to focus on freight rather than passengers Capacity likely to fall, including in the peak season, with adverse wider economic impacts

Source: Stakeholder interviews, previous consultancy reports commissioned by the Isle of Man Government, and Oxera analysis.

This multitude of options is reflected in the wide range of operating models used by ferry operators across the world. For example, British Columbia Ferries is backed by a guarantee from the government of British Columbia and the national Canadian government; NorthLink, Caledonian MacBrayne, as well as Jadrolinija are state-owned and Destination Gotland operates franchises.

The various ownership and operating models rank differently against the identified objectives of users, the Isle of Man Government and the operator, as shown in Table 4.4.

Table 4.4 Various ferry operating models assessed against different stakeholder objectives

Model	User outcomes	Government objectives		Operator objectives	
	Reliability, price, frequency	Cost	Long-term stability	Certainty	Returns and independence
Full state ownership	Meets objective	Does not meet objective	Meets objective	n.a.	n.a.
Company limited by guarantee	Meets objective	Does not meet objective	Meets objective	Potentially meets objective	Meets objective
Partial state ownership	Meets objective	Potentially meets objective	Potentially meets objective	Does not meet objective	Potentially meets objective
Negotiated concession	Potentially meets objective	Meets objective	Potentially meets objective	Potentially meets objective	Potentially meets objective
Regulated utility	Meets objective	Meets objective	Meets objective	Potentially meets objective	Potentially meets objective
Franchise	Meets objective	Potentially meets objective	Meets objective	Potentially meets objective	Potentially meets objective
Joint Venture	Meets objective	Potentially meets objective	Potentially meets objective	Meets objective	Potentially meets objective
Fully commercial outcome	Does not meet objective	Meets objective	Does not meet objective	Meets objective	Meets objective

Meets objective
 Potentially meets objective
 Does not meet objective

Source: Stakeholder interviews and Oxera analysis.

The three/four most suitable shortlisted options from our analysis are:

- negotiated concession—which in practice would mean the extension of the User Agreement with the incumbent operator (IOMSPC);
- regulated utility—which would mean that the state enacts legislation (and possibly creates a regulatory body) to monitor the operator against certain requirements. This option allows for a stronger level of government control over the delivery of service while still providing some protection from political interference;
- a franchise or Joint Venture—whereby the state would specify the range of services that are required and would select an operator for the medium term (e.g. 5–10 years) following an open tender; this option might involve state ownership of the vessels or the operator using their own.⁸⁰

There may be important differences between a concession agreement, a franchise, and an operating licence from a legal standpoint; the considerations described in Table 3.3 would require the government to be fully informed about any such differences in order to ensure that our recommended amendments (especially in terms of gearing and ownership restrictions) are legally implementable.

⁸⁰ Since the vessels are highly specific and not easily transferable to other routes or services, their value outside of the current agreement may be very limited. As a result, the price that the government would need to pay upon termination of the User Agreement is likely to be significantly lower than the contemporary vessel valuation.

For example, the current User Agreement imposes conditions on IOMSPC in exchange for rights to use a piece of infrastructure owned by the Department of Infrastructure, and it is unclear how far this agreement can extend in terms of imposing requirements on debt and ownership structure. There may also be other restrictions that can be incorporated into a licence arrangement, which would not be incorporated under a franchise or concession approach.

Our assessment has not considered the extended period of transition that may be implicit in these scenarios. Contractually, IOMSPC holds the current concession until 2026, and to our knowledge only failure to deliver the required service level could lead to the contract being broken prematurely.⁸¹ In order to achieve one of the alternative models shortlisted above, we consider that there are two options open to the Government:

- allow the User Agreement to expire in 2026. There is a risk that, over this period, the management of IOMSPC would seek to maximise profitability by providing the minimum service level under the current Agreement. IOMSPC would also be able to use its own linkspan at Douglas after the Agreement has expired (as the Agreement only covers access to the Department's linkspan);
- terminate the User Agreement early, perhaps through buying out IOMSPC (including its linkspan at Douglas). Such a strategy would enable a move to a franchise or Joint Venture with less risk that service levels would deteriorate, or that IOMSPC would continue to provide services after the Agreement expires (which, in turn, would pose difficulties for the public tender process).

⁸¹ Unless IOMSPC does not exercise its option to extend the agreement, or otherwise steps away from the service, neither of which are likely. Based on interviews with various stakeholders within the Department of Infrastructure and IOMSPC.

5 Scenarios for ferry service provision

5.1 Overview of the strategic decisions

The available options regarding the Isle of Man ferry services can be split into two broad categories:

- ownership and operation of the port facilities (at both ends of each route, and in particular in GB);
- ownership and operation of the vessels.

Table 5.1 summarises the key strategic issues that currently shape the overall market outcome. They are explained in more detail below.

Table 5.1 Key strategic issues concerning ferries and ports

	Priority issues	Secondary issues
Ports	No long-term strategic security/control over ports handling either passenger or freight traffic in GB Liverpool landing stage at the end of its life; negotiations over a new site Capacity limitations at Douglas limit flexibility of service supply	Dependence on Peel Ports Group for all current facilities in GB Dredging issues at Heysham Lack of bus access ramp at Belfast
Ferry services	IOMSPC offer on extension of the current User Agreement Availability of the back-up vessel to guarantee or increase system resilience Fair profits/shareholder returns and governance structure	Service capacity expansion/adjustment Service quality/offering Review of the available routes Post-Brexit connectivity Future vehicle running and compliance costs

Source: Stakeholder interviews and Oxera analysis.

As far as the ports are concerned, the main issues are as follows.

- **No long-term security in GB.** Access to all connecting ports in GB (Liverpool, Birkenhead and Heysham) is currently arranged on a contractual basis, with both sides able to give each other up to a year's notice. This poses a risk in terms of needing to discontinue the service and seek alternatives, which, given the relatively short-term nature of break clauses, and the relatively long time that freight provision (for example) would need in order to re-adjust to different connecting facilities, could lead to service disruptions or loss of quality of service in the medium term.
- **Liverpool facility.** The current ferry terminal can accept the fast service only, and the contract ends at the end of 2016, with a possible three-year extension. The facility is at the end of its economic life and may be converted to accommodate cruise ships. An alternative site has been identified, at a land purchase cost of approximately £3.5m, that could provide similar or superior facilities to the existing landing stage and give the government complete control over the course of the 200+ year-long lease.⁸² It is located further away from the centre (~800m), and will in the future be able to accommodate vessels up to the 'Heysham-max' length of 142m, but it may be prohibited from carrying unaccompanied freight (unless special agreements are reached with Liverpool authorities, and sufficient additional space is found

⁸² Based on interviews with the Department of Infrastructure.

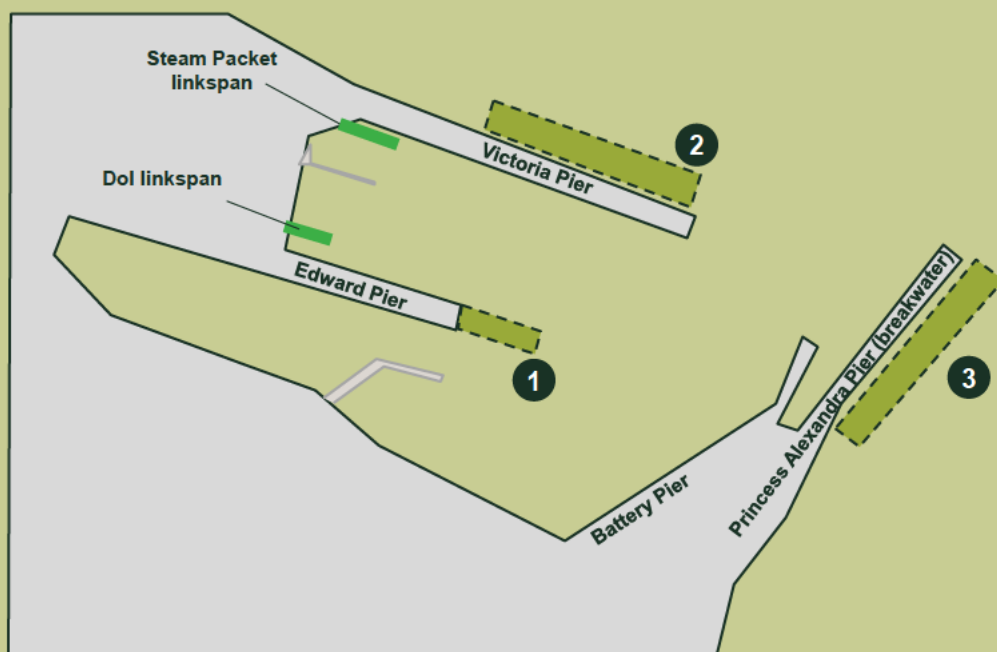
for a freight marshalling area, which would add to the purchase and development costs).

- **Douglas capacity.** The port at Douglas has a 125m maximum length restriction—i.e. Ben-my-Chree is the longest vessel type that can currently be used at the port. This limits both the operator's and the harbour's ability to attract and use other vessel types, thus limiting the flexibility of the supply of ferry services. Furthermore, while there are two linkspans in Douglas, only one can accept Ben-my-Chree.⁸³ There are a range of expansion options that would add further capacity or flexibility in the port, and would require a capital outlay of between £5m and £50m (and potentially more)—some of these are shown in Box 5.1 below.

⁸³ This linkspan is owned by the Department of Infrastructure, and access to it is granted to IOMSPC under the User Agreement.

Box 5.1 Range of Douglas expansion options

The diagram below shows the range of expansion options currently being considered within the harbour.



The individual options are as follows.

- 1: Expansion of the Edward Pier and additional dredging in the harbour to allow for vessels up to the 'Heysham-max' length of 142m (up from 125m at present). The project is estimated to cost approximately £5m–£6m, although the flexibility it adds to the harbour would appear limited (due to the relatively low number of 142m-long ro-pax vessels in the vicinity of the Irish Sea).
- 2: Construction of a ferry/cruise facility or a new linkspan on the outside of the Victoria Pier (two alternative positions are shown in the diagram). Being able to accommodate ferries of a length of approximately 180m–190m would allow Douglas to cater for the majority of other ferries operating in the Irish Sea. There are also plans for this space to be used for cruise ships, which do not require a linkspan, for a cost of approximately £16m–£20m. We understand that this side of Victoria Pier is usable only in mild water conditions, and an extension of the Princess Alexandra Pier breakwater may be required if it is to be used year round (not shown in the diagram).
- 3: Deep sea cruise facility on the outside of Alexandra Pier, including an additional floating breakwater. We understand that the expected cost would be £50m, and that there are significant engineering challenges with the project as well as concerns about the stability of the structures required (e.g. a pontoon dock). Major engineering works would also be needed to create the required access facilities.

Source: Oxera analysis, based on interviews with Department of Infrastructure.

- **All current connecting ports in GB are operated by Peel Group.** Current facilities at Heysham, Birkenhead and Liverpool are all owned and operated by the Peel Group, which puts it in a strong negotiating position over port access as a whole, as well as over access charges. These costs are likely to be passed on to service users (within the bounds of allowed price increases), thus posing a threat to fares and charges. There are alternative locations that could be developed in the medium to long run (such as Fleetwood, which is owned by Associated British Ports; or Holyhead, which is operated by Stena Line Ports Ltd).⁸⁴

⁸⁴ The locations mentioned have been mentioned during our interviews with IOMSP, Department of Infrastructure, as well as business representatives. Other alternatives should also be considered.

- **Other issues.** We understand that there are some dredging issues in Heysham that have resulted in service delays and cancellations in recent years. Given the importance of freight and the Heysham connection, this further demonstrates the need for a more resilient freight service. While there are coach access options at the Dublin berth, there are ramp limitations in Belfast, which means that no coaches can come from Northern Ireland to the Isle of Man, and passengers are forced to embark on foot.⁸⁵

The main issues in the vessel/ferry category are as follows.

- **New User Agreement proposal.** IOMSPC's current User Agreement runs until 2026 (including the extension). The renewed offer (details of which are given in section 3) would extend service provision up to 2041. This is time-sensitive, with a response required by early 2017. We understand that this timing might be driven by the timing of debt coming to maturity in one of the holding companies above IOMSPC.⁸⁶
- **Back-up vessel and service resilience.** Currently, IOMSPC charters a third vessel (Arrow) to provide back-up during scheduled service and breakdowns of the other two vessels, as well as to provide additional capacity in peak periods. We understand that this vessel is due to be sub-let more extensively from 2017 onwards, due to high rental costs (£2m/year). Nonetheless, given the need to provide a service of set frequency throughout the year, it seems essential for the ferry operator to have a back-up vessel in order to guarantee the required quality of service under the current User Agreement. As the other vessels continue to age, unplanned breakdowns are likely to become more frequent, and a reliable back-up for Ben-my-Chree seems essential particularly in the winter months (Manannan can provide back-up services in benign sea conditions only).
- **Fair profits/shareholder returns and governance structure.** While this is a product of all the other market dynamics, it is important both economically and politically that the operator makes reasonable, but not excessive, returns. Currently, the only means of influencing the distribution of economic rents arising from market power in the market is a system of price capping (according to the Manx RPI formula), fuel surcharges (which allow for prices to move up and down with fuel cost movements) and Douglas port charges. Further measures, or different ones, could be considered. On the governance side, the main concern (from the state's perspective) is that the operators' shareholders' incentives are to continue to invest in the service, rather than engage in extraction of short-term value at the expense of users of the service.
- **Capacity.** As demonstrated in section 4, the current capacity of ferry services is very much angled towards the peak periods, with little capacity utilisation in the rest of the year. Re-profiling the available capacity, by a combination of vessel size changes and added flexibility to service the peaks, may be a more cost-effective option in the long term (and should be explored further).
- **Routes.** While certain routes are both strategically important and highly utilised (such as the freight connection to Heysham, and the passenger

⁸⁵ This would not appear to be a major issue, since the Dublin facility has a bus ramp and is within two hours' driving range, and is understood to carry very little bus traffic. Based on interviews with the Department of Infrastructure.

⁸⁶ Based on a review of company accounts and interviews with various stakeholders. IOMSPC informed us that other major factors were: prospects of foreign exchange movement following the UK's decision to leave the European Union (although the offer was made prior to the referendum), time to build new vessels and the urgency of negotiation of arrangements in Liverpool.

connection to Liverpool), many of the other routes seem less economic. Equally, other potential routes have been considered in the past (such as Holyhead) and may offer a more effective long-term solution.

- **Service quality/offering.** From our interviews, we understand that the range of passenger services on board the current vessels can vary significantly, and may need to be revised to better cater for changing passenger needs (for example, in terms of lounges or business traveller services).
- **Post-Brexit connectivity.** Given the current uncertainty about the way in which the UK will exit the EU, it is worth thinking of the advantages of connectivity with the Republic of Ireland to provide access to EU-based trade. While we understand these services to be uneconomic at present, their value in the post-Brexit future may rise, meaning that there is an important consideration regarding whether they should be retained.
- **Future vehicle running and compliance costs.** Since 2015 (and from 2020 in the Irish Sea), there have been new EU rules on the level of sulphur dioxide that vessels are allowed to emit, and requirements concerning suitable exhaust cleaning systems.⁸⁷ This will increase the operating costs of the existing fleet, in particular Ben-my-Chree, since we understand it is prohibitively expensive to retrofit it with the required exhaust cleaning systems.⁸⁸

5.2 Assessment methodology

Each of the scenarios we have considered is evaluated from the perspective of:

- the likely cost to service users and/or the state: it is important to understand that any service other than the fully 'commercially rational' service would involve additional costs that would need to be recovered by the operator in some way—such as by cross-subsidising from profitable services (instance of recycling of monopoly rents), raising prices, or requiring a subsidy;
- the likely impact on both the users of the service, and the economy as a whole: depending on the service speed and route, travellers may lose or gain utility linked to their value of time, as well as their overall productivity (business travellers tend to be less productive while in transit). The wider economy impacts include the re-allocation of employment to or away from tourism, as well as agglomeration effects linked with changing the concentration of business co-location. (Our methodology for calculating these effects is laid out in more detail in Appendix A2.)

While some of the scenarios that we have considered involve changes to the number of vessels within the operator's fleet, we have not received information from IOMSPC on the costs of running different vessels and the likely impact that their removal would have on fares or charges. We would recommend analysing this more fully in due course.

5.3 Scenarios

As a reminder, our analysis so far indicates that:

⁸⁷ Directive 2012/33/EU, based on European Commission, 'Transport Emissions', <http://ec.europa.eu/environment/air/transport/ships.htm>.

⁸⁸ Based on interview with IOMSPC.

- from the perspective of the long-term security of port access for freight and passengers, investment is required in securing at least one facility in GB;
- the long-term flexibility of supply of ferry services would benefit from capacity expansion at Douglas;
- there is a need for at least one, if not two, daily freight connections throughout the year; passenger demand is much more seasonal, and peaks around the major events as well as in the summer;
- services require a suitable level of resilience, meaning that an economic back-up vessel is required to maintain a consistent reliability of service throughout the year;
- the most appropriate ferry operating model would seem to be either a negotiated concession (i.e. an extension of the current User Agreement), potentially with an added layer of rate-of-return or similar regulation; or a form of franchise (where the provision of services is tendered, and the vessels are provided either by the operator or by the state).

On the port side, we consider securing long-term base(s) for freight and passenger operations in GB a necessity, and hence its (their) costs are included in every scenario. Furthermore, although not strictly speaking required at present, expansion of capacity in Douglas adds both flexibility and resilience to a set of essential services, and hence despite its uncertain costs it is considered in any eventuality as the economically preferred option.⁸⁹ This would resolve the key issues identified with respect to the ports (strategic security in GB, and Douglas capacity/ flexibility—see Table 5.1).⁹⁰

On the ferry side, there are multiple ways in which the key strategic issues with the service can be resolved (back-up vessel and system resilience, fair shareholder returns and governance arrangements, and the timing of the current User Agreement)—albeit to different extents. The shortlisted options are listed below in two broad groups, according to whether the current User Agreement is extended: options 1–3 assume that it is, while options 4–6 assume it is not.

- **1: Extension of the User Agreement in its present form**—continuation of the negotiated concession, with the option of additional services (run by other operators) to Douglas in peak times if the port capacity is expanded sufficiently. This represents the least effort and the fastest option at present, but does not fully address governance issues or the concerns about the level of operator return.⁹¹
- **2: Extension of the User Agreement and tightening of certain clauses**—as (1) above, but allowing for added control for the state, for example

⁸⁹ We have not conducted a full cost–benefit analysis for each of the individual expansion options, but in order for Douglas to have full flexibility over the current and likely future vessel supply, adding a new linkspan that is capable of handling ferries of 180m–190m would seem to provide the greatest resilience (albeit also at an uncertain cost, as the option that we are suggesting has not been subject to engineering studies). This is a clear next step that we would encourage the Department of Infrastructure to consider.

⁹⁰ There are a number of limitations linked with the expansion plans in the very short term. Among others, Heysham-max length is significantly shorter than the proposed extension (142m versus 190m), and we understand that there are also relatively few vessels that would be available for a short term charter to cater for the Isle of Man peaks in tourist demand. Nonetheless, the proposed expansion of flexibility is not a short term investment, but rather a forward-looking statement guaranteeing long term security of supply; given the general trend of larger vessels being used to provide ferry services in the region, expanding capacity to enable supply-side substitution is vital from service resilience perspective.

⁹¹ Based on our understanding of the state of the negotiations between the Department of Infrastructure and IOMSPC as of 5 October 2016.

regarding fare and charges levels and evolution, flexibility with the service specification, adequate break clauses and penalties for service levels, etc.

- **3: Extension of the User Agreement and introduction of a formal regulatory regime**—as (1) above, but with control provided via a formal regulatory regime, and potentially a stand-alone regulator with enforcement powers over and above the current Isle of Man Office of Fair Trading. This ‘regulated utility’ option requires less contractual specificity at the level of the User Agreement, and instead would use the legislative route to impose an overall framework for the provision of services across either all monopoly markets across the Isle of Man, or just specifically the ferry services. The main issues in this model would be timing (if the legislative process is lengthy, it is unlikely that a company would sign the Agreement with legislation pending), and the transition arrangements before introduction of the regime.
- **4: Move to a commercially rational service**—abandoning the User Agreement (upon its termination, or earlier if feasible), and reliance on commercial service provision across the year. This would run a high risk of service levels being significantly lower than they are today, albeit with potentially lower user prices, and could encourage competition in particular in the peak periods. It is likely that this model would be feasible only upon termination of the current User Agreement (in 2026), and even then the most likely operator would be IOMSPC (as it holds a siting licence on its current linkspan that expires at the end of the User Agreement but may continue to be used beyond that term).⁹²
- **5: Move to a franchised or Joint Venture model for ro-pax services**—entering into a formal, renewable franchise agreement upon termination of the current User Agreement, with the potential for the state to own the vessels. The Isle of Man could issue an open tender to provide the service (or to partner with the Isle of Man Government to develop services), either as the current User Agreement nears termination (for example, in 2022), which would give potential new operators sufficient time to prepare their fleets, or earlier. If there is a strong expectation that the prospective franchisees would want to simply manage state-owned vessels, it would be prudent for the state to explore either acquiring IOMSPC vessels, or commissioning new ones, prior to going out to tender.
- **6: Move to a franchised or Joint Venture model for all ferry services**—as (4), but with the inclusion of the current Lo-Lo service as part of the franchise, in order to fully leverage the profits from freight operations on and off the Isle of Man. This option would require a higher capital outlay (in the form of buying out the Mezeron and IOMSPC operations), but would potentially enable further value added services.

Table 5.2 outlines the shortlisted options and explains their advantages and disadvantages, together with the likely costs and benefits.

Table 5.2 Overview of the feasible scenarios

No.	Scenario	Detail	Costs to government	Impact on users	Impacts on Isle of Man economy ¹
1	Extend current User Agreement and service in line with IOMSPC	Service level in line with current	GB facility/facilities	Discounted fares for	+£2m per year Upside if additional

⁹² We recommend seeking legal advice on this matter.

	proposals (= negotiated concession)	provision (incl. resilience) Ability for the state to claw back some monopoly rents through port charges	Potential Douglas expansion	regular travellers	commercial services offered
2	As (1), but put in place further contractual restrictions	Fare and charge increases benchmarked on CPI/other measure Excessive leverage limitations Added flexibility/control for the state	GB facility/facilities Potential Douglas expansion	Discounted fares for regular travellers More control over fare increases Potentially lower fare level (if negotiations successful)	+£2m per year Upside if additional commercial services offered
3	As (1) or (2), but with a formal regulatory regime	Added transparency on allowed returns	GB facility/facilities Potential Douglas expansion Regulatory framework set-up (e.g. a new government body)	Discounted fares for regular travellers More control over fare increases, potentially lower fare levels More vessel/quality investment	+£2m per year Upside if additional commercial services offered Upside if positive impact of regulation on other sectors
Let current User Agreement with IOMSPC run its course, and then...					
4	Move to a basic, commercially rational service with a 2x daily freight-focused service	Additional peak capacity can be provided by commercial operators (following Douglas expansion) Potential loss of resilience	GB facility/facilities Douglas expansion	Savings from removal of vessels to be re-distributed in lower fares. Users bear more risk of future fare increases	–£8.5m per year (or –£6m if commercial service is provided) ²
5	Move to a franchised model for ro-pax	Ability to specify the exact service level desired (incl. resilience)	GB facility/facilities Potential cost of vessel acquisition Potential Douglas expansion	Potentially lower fares and charges due to more direct state control More input into quality levels	Potentially similar to today
6	Aggregate all ferry assets (ro-pax, pax and Lo-Lo), and offer all as one major franchise	Ability to specify the exact service level desired (incl. resilience)	GB facility/facilities Cost of vessel acquisition for pax, ro-pax and Lo-Lo Potential Douglas expansion	Lower prices through more effective redistribution of monopoly rents in freight	Potentially similar to today

Note: ¹ Impacts on the economy are measured against the status quo. ² Average of the three alternative service specifications considered. For details of the calculation, see Appendix A2.

Source: Oxera analysis.

The various models offer different trade-offs between costs to the government and impacts on users and the wider economy.⁹³ Overall, the relatively most attractive options would seem to be:

- extension of the User Agreement following re-negotiation of some of its key provisions (model 2)—this would allow for an immediate move to the new service provision, with added safeguards that resolve the most pressing issues; this could be supplemented with more formal regulation of either ferry services specifically, or natural monopolies more widely, if issues surrounding excessive returns are revealed by further analysis (model 3).
- a franchised or Joint Venture model for ro-pax vessels, potentially with state ownership of the vessels (model 5), which could give added flexibility over the choice of the operator while preserving the correct incentives for all key stakeholders. The major potential issues would still be around: (a) the timing of the implementation (with the risk of a diminished service according to a strict interpretation of the current User Agreement following any announcement that it will not be renewed), which might encourage parties to come to the negotiating table earlier; and (b) vessel and linkspan ownership, whereby a smooth asset transfer from IOMSPC is needed.

The other shortlisted options either seem prohibitively expensive (e.g. the all-ferry franchise, model 6), provide insufficient security over service (e.g. the commercially rational model, model 4), or offer insufficient control to the state and thus could be seen as too risky (e.g. signing the currently proposed User Agreement, model 1).

Once the high-level strategy for provision of the ferry services is established, there may be ways in which to deliver further against certain service objectives. For instance, increased resilience at an optimised cost could be achieved by pooling back-up vessels between operators with compatible vessel needs (which could be via contractual arrangement, joint vessel ownership, or even joint service ownership between the Isle of Man and other locations). We have not assessed these options as part of the present report.

⁹³ Impacts presented here are annualised, whereas the costs are for the complete project. A full appraisal of the different options would take into account the likely future.

6 Summary and further research

Overall, our assessment has shown that there is a considerable degree of market power in the provision of ferry services to the Isle of Man, in particular with regard to Ro-Ro freight and passengers travelling with vehicles, for whom IOMSPC vessels represent the only means of travel. Given that there has been no entry into the market on the passenger side in the last 30 years, and only short-lived competition by a rival Ro-Ro operator on the freight side, we conclude that the passenger vehicle market is currently a natural monopoly, and the Ro-Ro freight segment is contestable (i.e. prices are suppressed due to the threat of entry).

Today's ferry services to the Isle of Man can be characterised by significant excess capacity for both freight and passenger services outside of the two peaks around the TT and Festival of Motorcycling. Current vessels and service frequency seem to be designed to deal with peak demand, and certain routes (e.g. Dublin) are understood not to be economic on a stand-alone basis. More generally, there is likely to be significant cross-subsidy between the freight and passenger services carried by IOMSPC (and potentially also between peak and off-peak seasons).

A wide range of objectives and strategic concerns relate to the future of the ferry services, all of which are due to the services being an economic lifeline of the Isle of Man economy. The main aspects that we have considered are:

- the need to guarantee long-term security of supply (in terms of the number of vessels required to guarantee service resilience, the range of connections, and access to ports—in particular in GB);
- the essential nature of the ferry service in enabling the trade of goods (as the high-level economic driver), as well as passenger traffic (as a secondary economic driver);
- the need for a set of suitable governance arrangements to limit future risks to the service, and well-designed public oversight and control over the level and allocation of profits earned by the sole operator of a ferry service (as well as over the additional financial windfalls from any new User Agreement);
- how to draw on operator expertise within a suitable framework for maintenance and replacement of the vessel fleet;
- expenditure and liabilities for the Isle of Man Government;
- matching the service level to the demand and expectations of users, and the flexibility required to adapt to changes in demand and user requirements;
- clarity and transparency around any transitional arrangements to be made in the event that the terms of User Agreement are not met, or in the event of a change in operator.

In our assessment of the optimal future set-up, we have divided the total market into two segments: ports; and ferry services.

There are two key conclusions regarding the future of the ports serving the various Isle of Man connections:

- from the perspective of short and long-term security of port access for freight and passengers, investment is required to secure at least one facility in GB (more than one facility may be required if freight and passengers cannot be

handled in one location). In relation to the proposed new facility in Liverpool, care should be taken to ensure it can handle the longest ferries possible compatible with Douglas' current and potential future maximum capacity ('DouglasMax');

- notwithstanding that, the long-term flexibility of supply of ferry services would benefit from capacity expansion at Douglas to allow significantly larger ferries to use the port year-round. This would expand the harbour's flexibility for many generations to come by recalibrating DouglasMax, and enable new options for ferry service provision in the much longer term through removal of a key barrier to route growth and therefore economic growth, acting as a catalyst to remove barriers across the network.

As far as the ferry services themselves are concerned, we conclude that:

- there is a need for at least one, if not two, daily freight connections throughout the year (one of which is a night-time connection); passenger demand is much more seasonal than freight, and it peaks around the major events as well as in the summer. Certain passenger segments also demand frequent daytime connections.
- the pattern of services (including the number and type of vessels required, and the choice of vessel speed) should be re-defined to ensure a more appropriate balance between the economics of the market and political trade-offs. This process will be enhanced by, but does not have to wait for more flexible capacity to be achieved at the ports;
- services require a suitable level of resilience, meaning that an economic back-up vessel is required to deliver a consistent reliability of service throughout the year (in particular for freight);
- the most appropriate ferry operating model is either a negotiated concession (i.e. an extension of the current User Agreement), potentially supplemented by the establishment of an overarching economic regulation framework; or a form of franchise (where the provision of services is tendered, and the vessels are provided either by the operator or by the state) or Joint Venture. In any scenario that involves departure from the User Agreement, the transition arrangements would need to be carefully chosen to maintain service levels and island employment in the interim period; these range from letting the current User Agreement run its course to negotiating its earlier termination (which may require asset purchases by the government).

We conclude that the actions to be taken regarding ports and ferry services, and the trade-offs these permit in relation to both the scope of ferry services, and the choice of how the government specifies those services, offer a strong foundation for decision-making. In particular, they would help to achieve the delicate balance of allowing the state to have sufficient control over the way in which ferry services are specified, and drawing on operator expertise to ensure efficiency and appropriate levels of service quality.

Further research and actions

The purpose of this report has been to review the current ferry market and suggest potential options for alternative service set-up, while considering the indicative impacts on the Isle of Man economy. The following areas of work would appear to be particularly relevant in verifying the conclusions drawn above, as well as aiding the selection of the most appropriate course of action:

- understand more formally the degree of cross-subsidy between freight and passenger traffic inherent in the IOMSPC operation—in order to enable an informed discussion about service levels and the trade-off between passenger fares and freight charges;
 - formally analyse IOMSPC's profitability and compare it against that of other operators and the benchmark cost of capital, in order to establish what 'fair profit' is in this context, and IOMSPC's current and future profitability;
 - hence, investigate more thoroughly the need for, and optimal specification of, services across each of the routes, including the economics of the fast service—in order to establish the optimal fleet and service composition. This will require analysis of the costs of serving existing (and potentially alternative) UK and Ireland destinations using alternative vessel types at minimum and enhanced service levels, in order to inform political trade-offs. One option would be to include this as part of a new market testing exercise. This work will be supported by, but does not need to be dependent on decisions on the recommended port capacity investments;
 - develop an investment appraisal in relation to year-round berthing for ferries of up to 190m (and smaller cruise vessels) at the Victoria Pier, and any associated works required (for example) to extend the Princess Alexandra Pier breakwater—in order to understand the value for money case for such long-term flexibility;
 - continue discussions with Liverpool and Peel Group regarding the ability to use the new terminal facility as a primary (daytime and night-time) passenger, and possibly freight, terminal—in order to achieve the long term strategic security of access to Great Britain. This should include the option to match vessel length to the recommended capacity expansion at Douglas, in order to benefit from the flexibility this would create;
 - define options for adjusting price controls and the governance clauses within the proposed extension to the User Agreement—in order to achieve the best possible outcome for the Isle of Man Government in the negotiations;
 - define what a ferry services USO could look like and develop a suitable protection mechanism that guards its financeability;
 - investigate options, costs and transition arrangements with respect to terminating the current User Agreement early, in order to unlock some of the other operating models before 2026; in particular, consider repeating the market testing exercise;
 - investigate legislative or other options for the establishment of formal economic regulation of natural monopolies (including ferry services)—in order to facilitate full oversight and control over the User Agreement, if an open tender/Joint Venture route were not chosen.
-

A1 Detailed comparator tables

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Channel Islands	Condor Ferries	Limited company operation through an agreement, but the rights are not granted to one operator exclusively. In theory, another operator may enter the market provided that it is prepared to meet the same standard of service, although this has not occurred in practice. The harbour-master of Jersey will not proactively seek or encourage a prospective entrant unless in an emergency, or if the operator is not able to properly perform	Vessels: two high-speed (passenger, vehicle, freight); one conventional (passenger, freight); one conventional (freight). Four routes (including an inter-island route)	Vessels are owned by Condor Ferries	Port ownership is mixed: some are owned by a trust (Poole), and some are owned by a municipal body (Portsmouth, Jersey and Guernsey)	Lower freight charges being subsidised by higher passenger fares	Seven years. Provisions for renewal: no later than 12 months before termination. (No information about renewed contract length)
Scotland Northern Isles	Serco NorthLink Ferries	Private company that participated in an open tender; Serco Group is using the vessels and branding of its predecessor, NorthLink Ferries Ltd, and is subsidised in accordance with a grant agreement with the Scottish Ministers. The grant covers the projected cumulative difference between operating costs and revenue, plus the operator's return for that service year shown in the base case, together with the projected fuel liability	Vessels: three ships (passenger and vehicle); two freight ferries. Five routes	Vessels are chartered from the lessor party, Royal Bank Leasing Limited	Port ownership is a mixture of trust ownership (Aberdeen, Lerwick, Scrabster) and municipal ownership (Hatston Pier, Stromness)		Six years

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Isle of Wight	Red Funnel	Three private companies. Slim prospects for new entrants due to high entry barriers—inaccessibility to port facilities on the island	Vessels: three high-speed (passenger only); three medium-speed (passenger and vehicle). Two routes	Vessels are owned by the operator	Red Funnel owns the terminals on the island; Southampton terminals are owned by Associated British Ports Holdings Ltd		
	Wightlink		Vessels: six passenger and vehicle ferries; two high-speed (passenger only). Three routes	Vessels are owned by the operator	Wightlink owns the land and terminal buildings on the island, as well as those of some mainland ports; some mainland ports are owned by local governments		
	Hovertravel		Vessels: three passenger ferries. One route	Vessels are owned by the operator	Both Ryde and Portsmouth ports are owned by municipal groups		

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Isles of Scilly	Steamship	Private company operating under an agreement. The Isles of Scilly Council intends to establish a partnership with Steamship in the short/medium term; it provides £19,900 annually towards running the off-island freight service. The Council intends to procure new vessel and tender services in the long term	Vessels: one passenger; one cargo vessel. One route to mainland	Vessels are owned by the operator	Penzance port is municipally owned; Hughtown port is privately owned		
Scotland (Clyde and Hebrides)	Caledonian MacBrayne	Ferry company wholly owned by Scottish Ministers; it won an open ferry tender, and the operator is receiving a Scottish government subsidy and has a claw-back mechanism (the operator shall return to the Scottish government any profit above the £1.5m pre-agreed profit level)	31 vessels (passenger and vehicle). 26 routes	Vessels are owned by Caledonian Maritime Assets Ltd (CMAL), which is wholly owned by Scottish Ministers	Ports are owned by Caledonian Maritime Assets Ltd (CMAL), which is wholly owned by Scottish Ministers		Eight years
Canada	BC Ferries	A publicly owned independent operation subsidised by the government of British Columbia and the government of Canada under a contract; BC Ferries has an exclusive contract for the subsidised services, but other operators can be authorised to operate on other ferry routes	34 vessels. 24 routes	Vessels are owned by the operator	Terminals are owned by the operator		60 years; each regulatory period (known as a Performance Term) is for a four-year period

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Bornholm	Faergen	Operated under a public service contract via tendering. The parent, Danske Færger, is 50% owned by the Danish state. Subsidies paid by the Danish state in accordance with the public service contract are based on net cost contracts; the operator receives the income from tickets	One fast ferry; two conventional ferries. Three routes: Rønne/Ystad (Sweden); Ronne/Køge (Denmark); and Ronne/Sassnitz (Germany)	Vessels are financed by the operator, but the operator is 50% owned by the state	The port of Rønne is privately owned by Rønne Havn A/S. The Board of Directors is largely elected by local council, or has employer and trade ties with Bornholm		Tender in 2009 was for a five-year contract, with an option for a one-year extension

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Gotland	Destination Gotland	The service has always been run privately, but since 1971 the state has provided funding for a more extensive service than the market could otherwise sustain, especially during the off-peak winter season. The delivery model currently used is a gross contract model—i.e. a tender where the government paid the winning bidder/operator to run a public service contract mandating a certain service level. The first round received no bids, and the second round in 2006 received only a bid from the incumbent. Additionally, the model has a high subsidy rate, with government subsidies at €46.4m a year in 2009 for two routes	Five vessels (M/S Visby, M/S Gotland, HSC Gotlandia, HSC Gotlandia II, M/S Gute). Two regular routes (Visby/ Nynäshamn; and Visby/ Oskarshamn), and one summer route (Visby/Öland)	Destination Gotland's parent company, Rederi AB, owns the ferries, which are rented and operated by Destination Gotland. The public service authority altered the third round to tender for the provision of vessels and the operation of vessels separately. The present agreement remains in force until 31 January 2017. In 2014, Destination Gotland concluded a new agreement with the Swedish Transport Administration from 1 February 2017 to 31 January 2027. The service is operated using four fast ferries, of which the two larger vessels are in service all year round and the two smaller vessels support the spring and autumn service and the high-frequency service during the summer period	Gotland regional authority. A recent project to build a new terminal was financed with help from the EU	Since the group profit was positive in 2015 (440m SEK), the ferry business appears to be in some way cross-subsidised by the tanker, hotel and shipyard business of the parent company (see 'Profitability')	Current contract from 2009 to 2015, and extended by two years to 2017. New contract to be signed from 2017 to 2027

	Operator	Regulatory framework	Number of vessels/routes	Vessel ownership	Port ownership	Evidence of cross-subsidisation	Contract length
Croatia	Jadrolinija	The operator is 60% state-owned, and less profitable routes are subsidised by the state. However, the government intends to allow competition for routes in 2017	The operator serves 30+ destinations using 30+ vessels	Some vessels are hired by the operator, while others are operator-owned			In Croatia, the operator is still protected from international competition until the end of 2016, but with market liberalisation beginning in 2017, existing arrangements may be replaced with a more competitive outcome. The current operator (Jadrolinija) intends to compete for its continued right to operate services, and will expect some extension of a concession from the typical five or six years to over ten years, as the operator is investing in new vessels

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
Channel Islands	Condor Ferries	Agreed on replacement of one high-speed vessel; the agreement-specified service requirements are not expected to change substantially in the foreseeable future; Condor will design and schedule its vessel maintenance programme	Maximum prices set in accordance with existing price thresholds, to be revised each year in accordance with existing customs and practice. The adjustment is based on a weighted mixture of Jersey, Guernsey and UK RPI. If Condor Ferries earns a ROACE above or below certain established thresholds, there is scope for the adjustment of schedules and prices	Minimum service schedule of two seasons specified in the agreement (winter: from the end of October half-term school holidays to the start of the school Easter holidays; peak: rest of the year), provided that no entrant has commenced the provision of the designated services. Base service schedule also specified in the agreement, and is applicable after a new entrant provides the designated services	Flexible; currently no entrant, and service level is above the minimum	Based on ROACE but redacted; EBIT 25% (2007). ROACE is subject to certain limits (tramlines), which will determine whether adjustments to schedules and/or prices are required	

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
Scotland Northern Isles	Serco NorthLink Ferries	The contract between the Scottish government and Serco NorthLink represents a government investment of £243m over six years. The grant from Scottish Ministers may be deducted if the operator has failed to meet any of the performance measures for reliability and punctuality	The initial fares schedule was published by the predecessor. For subsequent years, tariffs are index-linked (this year's CPI over the previous year's CPI) unless modified by the Scottish Ministers or the Scottish Ministers approve an alternative structure proposed by the operator	Scheduled timetables specified in the contract. Key service elements include 90-minute services from Scrabster to Stromness, security of supply of services for time-sensitive freight, and an improvement in the overall passenger experience, including improved catering, hospitality and customer care facilities	The operator must comply with the timetables except during a period of scheduled unavailability or a relief event, and no sailing is required during Christmas and New Year. Serco NorthLink has been able to modify the frequency of the Scrabster to Stromness sailings since winning the contract	Serco Group, which is the parent company of Serco NorthLink, had significant issues in 2013–15 with the delivery of many of its public service contracts in law enforcement, health and transport. The resulting reputational damage led to a significant drop in share price and a change in management in 2014. Shortly after, the group announced that it was pulling out of a number of areas due to its inability to make profits, highlighting security of supply issues in contracting lifeline services to a private operator with certain profitability targets	
Isle of Wight	Red Funnel	Continued to invest in the vessels and ports		Scheduled timetables published and adjusted by the operators		EBIT 16% (2006)	'High'

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
	Wightlink		Fixed fares are published on website yearly; advanced fares are available; dynamic online booking fares are responsive to demand level; average revenues per customer trip (yields) have increased by less than the rate of inflation			EBIT 21% (2007)	
	Hovertravel						
Isles of Scilly	Steamship	Cornwall Council leads the implementation of the Isles of Scilly Link Project, which is funded by the Department for Transport; both vessels are licensed to operate until 2018	Minimum single-trip fares are published on website; there are special day-return prices	Fixed schedule: passenger ferry operates between March and October, sailing up to six days per week; freight vessel operates all year round three times per week		2014–20 Strategic Economic Plan: Continued decline in passenger numbers since 2002 (10% annually)	
Scotland (Clyde and Hebrides)	Caledonian MacBrayne	Scottish Ferries Plan, published at the end of 2012, proposed public investments in excess of £300m over the period until 2022 in vessels, ports and infrastructure, the majority of which pertain to the Clyde and Hebrides routes. In 2014–15, the spend on the Clyde and Hebrides Ferry Services network was approximately £106m	Road Equivalent Tariff (RET) bases ferry fares on the cost of travelling the equivalent distance by road (passenger/car)	Published timetables on website (winter Nov–Mar, summer)		'a small net operating profit 2015/16 - 6 months'	

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
Canada	BC Ferries		The BC Ferry Commission regulates ferry fare levels. Price cap: initial 2.8% over previous year's price for major routes, otherwise by 4.4%; subsequent price caps to be set at a specified rate equal to the British Columbia consumer price index minus a productivity factor for the route group	Minimum service requirements are set by the government of British Columbia; The service contract defines for each route the core service requirements, which consist of the hours of operation, number of round trips per day during peak and off-peak periods, total number of round trips to be delivered, etc.	Flexible	EBITDA \$268.5m (2016). A regulated return on equity of 12.7% was allowed for Performance Term 3— i.e. April 2012 to March 2016	Leverage ratio of 77.8% and a debt service ratio of 3.1
Bornholm	Faergen		The tendering authority in Denmark regulates the maximum and average ticket price for all tickets per ticket group	Minimum number of trips per day specified in the contract	Provisions for fuel surcharges on oil price		

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
Gotland	Destination Gotland	A recent project to build a new terminal was financed with help from the EU	The agreement between Destination Gotland AB and the Trafikverket is a 'net agreement', whereby Destination Gotland keeps passenger income as well as remuneration from Trafikverket for operating the traffic. Revenues are regulated based on maximum prices set for passengers, vehicles and freight	Anyone who carries out regular sea transport between Gotland and the Swedish mainland must call at a mainland port at least five times a week year-round; this is a requirement of the route PSO. The purpose behind this provision is to hinder anyone from carrying traffic only during periods when there is a great demand (i.e. summer tourists), to the detriment of the contracted services—i.e. 'cherry picking'. Trafikverket also has a focus on eco-friendly travel, with a shift to using LNG gas that is more eco-friendly	Since 1971 the state has provided funding for a more extensive service than the market could otherwise sustain, especially during the off-peak winter season	In 2015, there was a total revenue of 1.2bn SEK, with an operating profit of 38.3m SEK, but a final 'net income' of -1.6m SEK	

	Operator	Provisions for investments, innovation	Prices/fares	Summary of minimum service level	Service flexibility	Profitability	Level of debt
Croatia	Jadrolinija	New vessels are in the pipeline (26, 23 of which will be newly built); 32 vessels will be retired. The three large vessels serving international routes to Italy are among those to be replaced. Some of the investment in vessels appears significant—for example, the construction of a ship for more remote islands such as Korčula, Vis and Lastovo is estimated to be worth €50m		Scheduled timetables published and adjusted by the operators	The state subsidises loss-making lines (for instance, night-time services), and also hires extra vessels if extra capacity is needed	In 2015, Jadrolinija experienced significant revenue growth: the company's net profit increased by 29.3% to HRK 8.3m	

Source: Oxera research based on a range of public domain sources.

A2 Details of economic impact assessment

A2.1 Methodology overview

The impact on the Isle of Man of different specifications of ferry services has been assessed using an approach that is consistent with the Department for Transport's Web Transportation Appraisal Guidelines (WebTAG) for transportation investment. The focus of our impact assessment is on ferry passengers (both inbound and outbound), and the Isle of Man economy as a whole.⁹⁴

Our analysis centres on productivity and value added, rather than welfare; however—consistent with WebTAG—we do consider the welfare differences for passengers travelling to/from the Isle of Man. Our assessment compares the current level, quality and capacity of services against the following scenarios (the 'counterfactual' scenarios):

- Scenario 1: service provided only by the existing ro-pax vessel (MS Ben-my-Chree). Services reduced to a 'commercially rational' level identified by IOMSPC, which involves 2x daily sailing and a focus on freight, with any spare capacity being used for passenger traffic. There are three versions of this scenario:
 - Scenario 1a: 2x daily sailings to Heysham only
 - Scenario 1b: 2x daily sailings to Birkenhead only
 - Scenario 1c: 1x daily sailing to Heysham and 1x daily sailing to Birkenhead
- Scenario 2: improvement of services based on IOMSPC's May 2016 offer, which includes a new ro-pax vessel with increased capacity and mechanisms for lower prices. Average prices are assumed to be lower by 10% as a result of IOMSPC's proposal, relative to current average prices. We also assume the same passenger utilisation of the new ro-pax vessel as of the current vessel.

We assess how these scenarios affect direct benefits (to service users) and wider economic benefits to the Isle of Man.

A2.2 Direct benefits

We consider direct benefits of the ferry service to be those that accrue to passengers travelling to and from the Isle of Man. Some passengers are crowded off the ferry due to decreased capacity if ferry services are cut, and passengers who remain on the ferry may face longer travel times due to the fast vessel not being available in Scenario 1.

Some passengers who are crowded-off the ferry will not travel at all to the island, while others will choose to fly instead. Travelling by air is more expensive than ferry travel, leading to detriment via higher costs for travellers switching to travel by air. Travellers who no longer travel to the island also face detriment in the form of the lost consumer surplus that they would otherwise have from travelling to the island.

In Scenario 1 we consider that average ferry prices would increase to the current maximum price per foot passenger. Passengers who currently take the Liverpool

⁹⁴ As such, our methodology is different to that used in the previous study on the impacts of Manx cultural heritage. Ecorys (2011), 'The Economic Impact of Manx National Heritage in the Isle of Man'.

ferry also divert to the Birkenhead ferry (where available) or the Heysham ferry otherwise, and passengers from the Heysham ferry divert to the Birkenhead ferry. Passengers who continue to travel will also face longer journey times due to sole use of the ro-pax vessel and additional travel time to a further port (i.e. Heysham or Birkenhead) where the ferry service to a previously used port is unavailable.

Business travellers are less productive when travelling than when not in transit.⁹⁵ Longer travel times therefore have an adverse productivity impact on business travellers: we value the productivity benefits that would accrue to the business traveller and the business traveller's employer.

We do not consider that there would be a material impact on freight transported under the scenarios we have considered, and we do not quantify an impact on freight volumes at this stage. This is because each scenario continues to offer at least a 2x daily service, and even if the main freight harbour in GB changes from Heysham, we assume that supply chains would adjust to any capacity constraints on freight due to the altered service, resulting in little to no impact on productivity.

A2.3 Wider impacts on the Isle of Man economy

We quantify the impacts of the current level of the ferry service on the Isle of Man economy, as described below. These are conservative estimates as we are able to robustly estimate only some of the mechanisms that would affect the Isle of Man economy.

- Lost productivity from business travellers—a number of business travellers are resident and employed on the Isle of Man, and the decreased productivity of these travellers due to longer travel times reflects lower output on the Isle of Man.
- Agglomeration in the tourist industry—there are positive externalities from similar businesses being located close to one another, which are known as agglomeration effects. We quantify the agglomeration effects in the tourism industry on the island, where output decreases due to losses in agglomeration in tourism in Scenario 1 and where output is enhanced due to increased agglomeration in the tourism industry in Scenario 2.

There are a number of other impacts that our methodology does not capture, and that need to be considered more qualitatively, such as migration, long-run dynamic economic adjustments (e.g. relocation of complete industries), and foreign direct investment. We have also not quantified the move to more/less productive jobs that is often considered in transportation appraisals, due to having limited data on the counterfactual employment of individuals who may move jobs (e.g. tourism industry employees) following a change in ferry services.

A2.4 Modelled results

Table A2.1 below summarises our results from the different scenarios.

⁹⁵ Department for Transport (2009), 'Value of Working Time and Travel Time Savings Long Run Implications Report', December.

Table A2.1 Modelled economic impacts (£m, per year)

	Scenario 1a	1b	1c	Scenario 2
Value of time	-1.9	-2.4	-1.9	-
Price	-6.6	-5.0	-5.1	1.7
Consumer surplus from non-travellers	-0.2	-0.4	-0.2	0.1
Total user impacts	-8.6	-7.8	-7.1	+1.8
Total wider impacts	-0.2	-0.6	-1	+0.1
Total overall	-8.8	-8.4	-8.1	+1.9

Note: All annualised impacts based on 2015 base year. If additional capacity to carry tourists lost in peak periods were found, the estimated impacts would have been approximately £2.5m per year lower.

Source: Oxera analysis, based on interviews and varied data sources from the Department of Infrastructure.

LIST OF CONTRIBUTORS TO ECONOMIC APPRAISAL CARRIED OUT BY OXERA CONSULTING

Interviews held on 23 September 2016

Director of Estates Shared Services, DOI	Mr Rodney Christopher
Director of Visitor Economy, DED	Mr Robin Bischert
Director of Ports, DOI	Mrs Anne Reynolds
Chief Executive, Chamber of Commerce and Industry	Ms Jane Dellar
Chief Executive, IOM Steam Packet Company	Mr Mark Woodward
Commercial Director, IOM Steam Packet Company	Mr John Watt
Chief Executive, Department of Infrastructure	Mr Nick Black
Representative of Travel Watch	Mr John Pennington
Representative of Travel Watch	Mr Steve Hamer
Representative of Travel Watch	Mr Mike Bathgate
Acting Executive Director, Policy & Strategy, Cabinet Office	Mr Carl Hawker

Interviews held on 3 October 2016

Member of House of Keys	Mr Ray Harmer
Member of House of Keys	Mr Geoff Boot
Member of House of Keys	Mr Chris Thomas
Member of House of Keys	Mr Bill Malarkey
Member of House of Keys	Mr Graham Cregeen
Member of House of Keys	Mr Alf Cannan
Minister of Infrastructure	Hon Phil Gawne
Chief Financial Officer, Treasury	Mrs Sheila Lowe
Member of House of Keys	Mr Chris Robertshaw

Those who were invited to contribute but were unavailable

Minister for Health	Hon Howard Quayle
Member of House of Keys	Mrs Kate Beecroft

www.oxera.com



Isle of Man Steam Packet
Review of Strategic Options
31st March 2016



Disclaimer

For Information and discussion purposes only

Park Partners Ltd is an appointed representative of Sturgeon Ventures LLP which is authorised and regulated by the FCA FRN # 452811. Park Partners Ltd is a limited liability company (Company number 8923987). Their trading address is 57 Grosvenor Street London, W1K 3JA. This presentation has been prepared and will be distributed by Park Partners Ltd. It is commercial in confidence and should not be made public without our express permission in writing.

This presentation was prepared at the direction of the Department of Infrastructure, Isle of Man Government (“the Client”) and exclusively for the Client’s sole benefit and use and therefore Park Partners owes no duty of care to any third party other than to the Client. Neither Park Partners, nor its respective directors, principals and personnel (collectively, the “Park Group”) involved in performing or preparing this presentation, assumes any duties, obligations, liabilities or responsibility to any third party arising out of their access to this presentation.

This presentation has been prepared based on information from various sources and all the sources will be clearly shown. This information is in line with COBS 4.2, in the FCA Handbook(www.fca.gov.uk). The information has not been independently verified and no representation is made nor warranty given as to the accuracy or completeness of any information or the reasonableness of any statements of opinion or belief.

Where this communication constitutes a financial promotion, it is issued and only made available to, and directed at, (a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the “Order”) or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”).

This presentation should not be acted or relied upon by persons who are not relevant persons. Any investment or investment activity to which this communication relates is only available to relevant persons and will be engaged with only relevant persons. This communication is being made to Professional Clients and Eligible Market Counterparties only, including Regulated Professional Advisors.

This presentation is for the Client’s private information and should not be used or viewed as guidance, recommendation or solicitation for any investments.

Past performance is not a guarantee for future returns. The value of investments and the income derived from them may fluctuate and you may not receive back the amount originally invested. Currency denominated investments are subject to fluctuations in exchange rates that could have an effect on the Investor’s return.

The distribution, reproduction or other use of all or any part of this presentation is prohibited. Neither this presentation nor any of the accompanying documents or information may be reproduced in whole or in part, nor may they be used for any purpose other than that for which they have been submitted, without prior written consent.

v.3 as of 10/11/2016



Contents

<u>Section</u>	<u>Page</u>
1. Park Partners	4
2. Background & Context	8
3. Review of Strategic Options	14
4. Company Limited By Guarantee	
– Overview	28
– Sources of Funding	34
– Valuation	38
– Process	43
5. Re-negotiation of User Agreement	49
6. Summary	58
Appendices	
I. Ferry Owner / Operator Profiles	62
II. IOMSP Financials	70



1. Park Partners



Park Partners Overview

1. Park Partners

Park Partners is an independent, privately-owned financial advisory firm

We bring value to clients through highest quality advice, ideas, and analysis

Our business is built around long-term trusted relationships with clients to help them achieve their strategic goals and financing objectives

Park Partners has an extensive network of relationships and access to specialist investors

1 Park Partners

- Park Partners provides corporate finance advice to companies, investment funds, and banks

2 Independence

- We are management owned, independent, and act only in the interest of our clients

3 Value to Clients

- We bring value through strategic review, new opportunities, access, and execution expertise

4 Highest Quality

- Park Partners prides itself on providing the highest quality thinking, analysis, and advice

5 Relationship Focused

- A long-term, trusted relationship with our clients is the foundation of everything we do

6 Network

- Park Partners has extensive network of relationships across industries and capital providers



Our Services

1. Park Partners

Park Partners provides its clients with financial advice in three principal areas:

- Corporate Finance and M&A
- Capital Raising
- Restructuring

We combine these services with in-depth knowledge of a number of market sectors to benefit our clients

Corporate Finance

- Corporate strategy
 - Portfolio review
 - Strategic development
 - Shareholder value
- Sellside Transactions
 - Preparation of business for sale
 - Identification of buyers
 - Process, tactics & negotiations
- Buyside Transactions
 - Acquisition sourcing
 - Approach, tactics & negotiations
 - Financing

Capital Raising

- Capital Structuring
 - Assessment of funding requirements
 - Review of financing capability
 - Optimal funding structure
- Equity Capital
 - Ordinary & preferred equity from institutions and family offices
 - Management of placement process
- Debt Capital
 - Private placement of senior & junior debt
 - Sourcing from banks and debt funds
- Sale & Leaseback
 - Sale & leaseback of shipping assets

Corporates

- Restructuring plans
- Creditor negotiations
- Refinancing

Lenders

- Review / monitoring of distressed borrowers
- Loan / assets sales

Restructuring



The Marine Services Team

1. Park Partners

Seasoned senior financial advisers with a long track record in investment banking, private equity, and industry

The team has a broad network of relationships and deep experience of executing complex transactions.

Our senior directors are fully involved day to day throughout the transaction providing highest quality advice based on rigorous analytics and creative solutions

Jon Howells

- Founded Park Partners in January 2014, Jon has over 20 years of investment banking experience
- Previously, he was Head of the European Transportation and Business Services team at Lazard where for 15 years he advised on M&A, IPO advisory, and restructuring transactions
- Particular sector experience in shipping, logistics, and subsea oil & gas services
- Prior to Lazard, he was a strategic consultant at Arkwright Consulting
- Jon graduated from Oxford University with a MA in Classics

Edward Matthews

- Edward has over 15 years of advisory and investment experience with a particular focus on the shipping and maritime services sectors
- Previously, he worked with a multi-family office, making and overseeing investments in the shipping, aviation and property sectors
- Before this, he worked in the Mergers & Acquisitions and Equity Capital Markets teams at Rothschild both in London and Hong Kong
- Edward graduated from Durham University with a BA in Combined Social Sciences

Peter Ahlås

- Peter has had a successful career in the maritime insurance and shipping services industries
- He served as Director & Chairman of HSBC Insurance Brokers, Cyprus and HSBC Shipping Services
- Currently Director of Maritime London, Trustee of Maritime London Officer Cadet Scholarship Trust, board member of Tide Forsikring, a Norwegian insurance distributor, and member of the advisory board of Svenska Bostadsfonden, a property investment company
- A Freeman of the City of London and Liveryman in The Worshipful Company of Shipwrights.



2. Background and Context



Background

2. Background & Context

Since 1995, the User Agreement has granted the IOMSP exclusive rights to use the IOMG harbour linkspan in Douglas

Beyond pricing, schedules, and periodic vessel investment, IOMG has no control over operations, profitability, or ownership

There is understood to be dissatisfaction in some parts of IOMG about the lack of control over ownership or ability to change terms of the User Agreement more frequently

Negotiations are underway to develop a new terminal in Liverpool

Background

- The IOM Steam Packet (“IOMSP”) is a vital national strategic asset for the Isle of Man.
- In 1995, the IOM Government (“IOMG”) entered into a User Agreement with the IOMSP which granted exclusive right to use the harbour linkspan but beyond pricing, schedules, and vessel investment, IOMG has no control over operations, profitability, or ownership.
- This has subsequently been renewed in 2002 and 2004 with the current User Agreement due to expire in 2026 if the extension option is exercised (the “UA”).
- The IOMSP was subsequently sold firstly to Sea Containers and then to a succession of private equity owners – Montagu, and two funds of Macquarie – each time for higher values supported by increasing debt.
- With a downturn in traffic volumes from the decline in Isle of Man economy in 2008-2012, IOMSP was unable to support its debt and ownership of the company passed over to the lenders, led by Banco Espirito Santo (“BES”).
- Over time, the other original lenders are understood to have sold down the debt at a discount to private equity distressed debt investors and BES has itself undergone a restructuring, with the ‘performing’ part of the bank, renamed Novo Banco, holding the IOMSP loans.
- Whilst the company appears, *prima facie*, to be operated efficiently, under the current financing and ownership structure there is neither the requirement nor, potentially, the financial ability to invest in new vessels to improve reliability and service standards.
- There is understood to be dissatisfaction in some parts of the IOMG that the Isle of Man has no control over change of ownership nor is it able to change the operating terms of the User Agreement on a more regular basis.
- IOMG is in the process of agreeing the purchase of quayside land in Liverpool to construct a new terminal facility for IOMSP. Before committing to the investment, there will need to be a long-term agreement with IOMSP to use the new facility



Scope of Strategic Review

2. Background & Context

This strategic review summarises the five principal options for the structure for provision of sea services to the IOM and consider their relative merits

Following presentation of these options to the SSSWG, this strategic review has examined in more detail

- Acquisition of IOMSP by a CLBG
- Negotiation of an extension of the User Agreement

This strategic review also considers the issue of vessel ownership and its implications for change of operator or protection of sea services

Scope & Objectives

- There is a window of opportunity to consider fundamental change in, *inter alia*, the structure, terms of the user agreement, and financing of strategic sea services for the Isle of Man as a result of:
 - IOMSP's request for an extension to the User Agreement
 - Need for new vessel investment in the next 5-10 years
 - Proposed new terminal in Liverpool
- Given this opportunity for change, Section 3 of this strategic review summarises the five principal options for IOMG to consider for the provision of strategic sea services and sets out the benefits and issues of each:
 - Change of ownership of IOMSP from the current shareholders via nationalisation or acquisition by a company without shareholders;
 - A franchise structure;
 - Negotiation of the proposed extension of the User Agreement; and
 - Allowing the current User Agreement to run its full term
- Following a presentation of the principal options above to the Strategic Sea Services Working Group ("SSSWG"), Park Partners was asked to examine in greater detail the options of acquisition by a company limited by guarantee and negotiation of an extension to the User Agreement, as set out in Sections 4 & 5 of this strategic review
- The strategic review also looks at the structure of comparable ferry service operators and the terms of similar user agreements
- Park has also considered the issue of vessel ownership and the implications this has for the ability of IOMG to change operator and protect sea services in the event of IOMSP insolvency or breach of the User Agreement
- The options must also be considered in light of the potential timing constraints of securing IOMSP commitment to the new Liverpool terminal prior to seeking Tynwald approval for the investment
- This strategic review has been prepared from an external perspective; Park Partners has not consulted with the DOI and has only had access to public information, with the exception of IOMSP's Strategic Sea Service Agreement document



Stakeholder Objectives

2. Background & Context

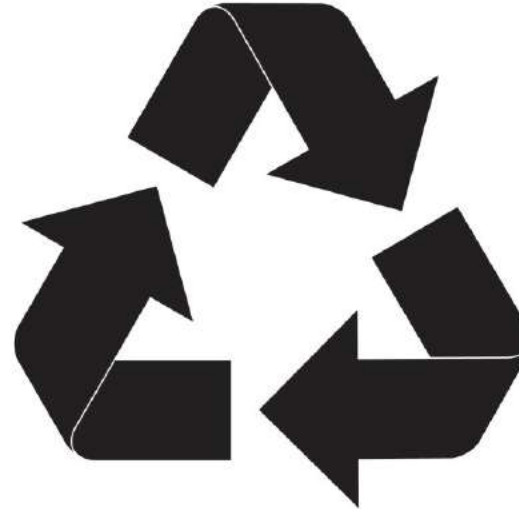
There are competing requirements between the principal stakeholders of any monopoly business

The aim of government in framing the industry structure is to ensure that there is a balance between all interests with sufficient benefit for each party to remain reasonably satisfied that their requirements are being met

Competing Requirements of Stakeholders in Monopoly Businesses

Government

- Safeguard of vital strategic asset
- Modern, cost effective, well run operations
- Minimal/no contribution from public purse



Public

- Regular, reliable operations
- Lowest possible prices
- Highest quality services

Operator

- Certainty of regulatory framework
- Maximisation of financial returns
- Independence from political interference



Key Aspects of Situation

2. Background & Context

There are currently a number of dynamics which create the opportunity to reconsider the way strategic sea services are provided for the Isle of Man, including:

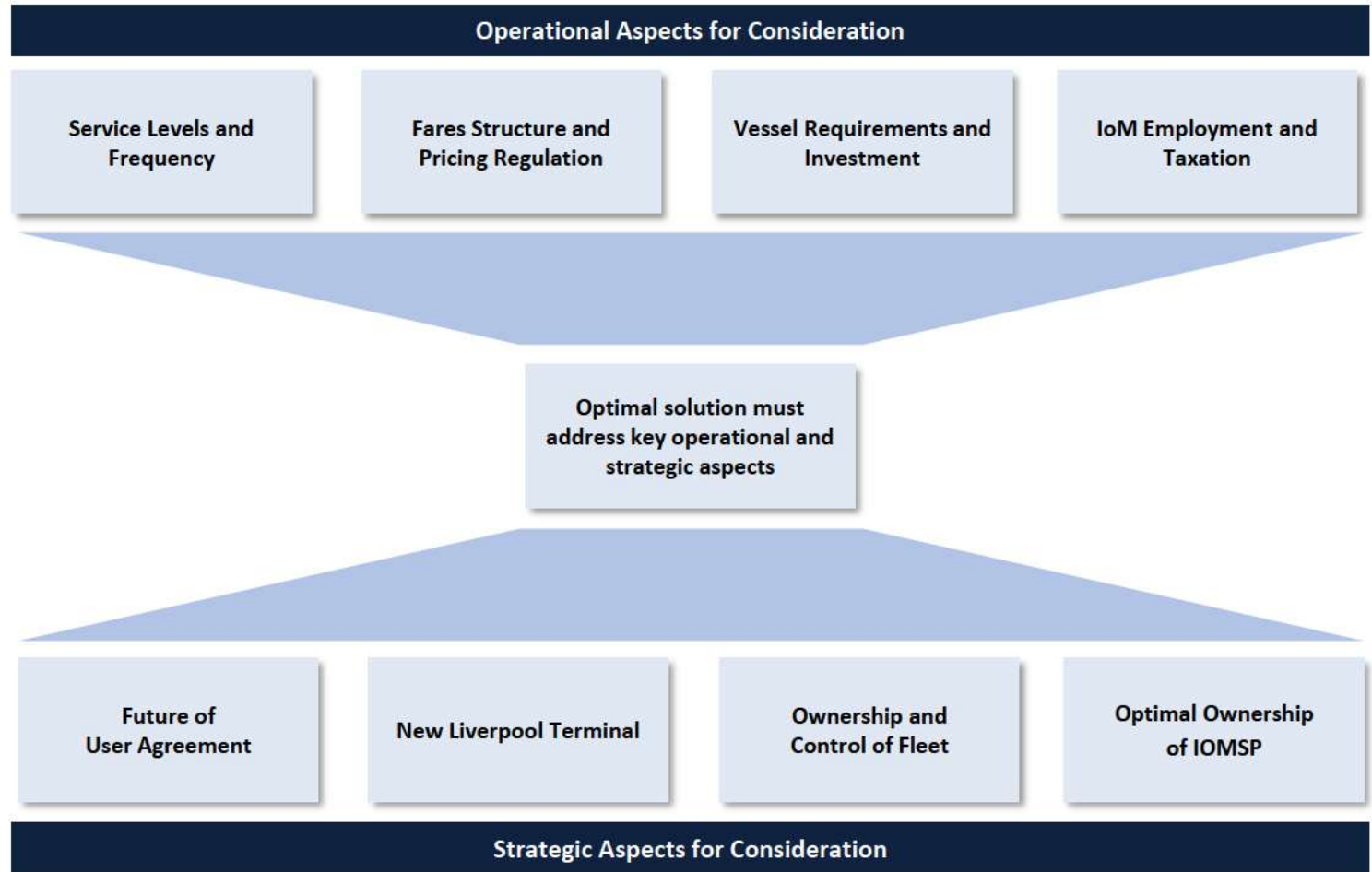
- IOMSP request for User Agreement extension
- New Liverpool terminal
- Need for new vessels

The optimal solution must address both operational and strategic considerations

The need to progress the new Liverpool Terminal brings potential timing constraints

- Urgency to move from existing landing stage
- Need to tie in IOMSP
- IOMSP linking consent to new user agreement

Operational and Strategic Considerations





Overview of Strategic Options

2. Background & Context

Strategic options can be grouped into two categories

New Structures

Changing from the existing User Agreement structure to one where IOMG has full or greater control over operations and operator

User Agreement

Continuing with or renegotiating the existing User Agreement

Implementation of any strategic option would almost certainly require the consent of the IOMSP and its shareholders

Current Position of IOMSP	
▪	IOMSP is a private company controlled by lenders / distressed debt investors post the 2011 debt default
▪	It has 10 (4 option 6) years remaining on the User Agreement with IOMG unable to force an early break
▪	IOMSP operates efficiently but is unlikely to invest in new vessels without an extended contract
▪	A meaningful proposal has been submitted by the company for a 15 year User Agreement extension

Strategic Options			
New Structures		User Agreement	
Nationalise IOMSP	<ul style="list-style-type: none"> Bring IOMSP and vessels back under public operation and ownership of the Isle of Man 	Status Quo	<ul style="list-style-type: none"> Continue with existing User Agreement and renegotiate / run competitive tender for operations starting in 2026
Company Limited by Guarantee	<ul style="list-style-type: none"> Ownership of IOMSP and vessels in 'not for profit' company without shareholders, independent from IOMG 	Extend User Agreement	<ul style="list-style-type: none"> Negotiate with IOMSP on terms for their proposed extension to the User Agreement
Franchising	<ul style="list-style-type: none"> Competitive tender for outsourced operator to run business for fixed term 		



3. Review of Strategic Options



Nationalisation

3. Review of Options

Whilst nationalising IOMSP would enable IOMG to gain full control over provision of sea-going freight, passenger and vehicle services, there are substantial issues to implementation and effective operations:

- Need to agree and fund purchase from existing owners
- Potential impact on commercial disciplines and innovation
- Risk of political interference going forward

Description

- Transfer the IOMSP from private to public ownership of the IOMG
- IOMG / DOI wholly responsible for operational oversight and management of the company as well as decision maker on pricing and service frequencies
- Full financial responsibility for the company and future investment
- Would require compensation to be paid to the existing shareholders and / or rolling over of manageable level of debt financing

Benefits

- Gain full control over national strategic asset, with monopoly on both Liverpool and Douglas Harbour linkspans and vessels
- Holistic approach to operational objectives, for example, company profitability, customer pricing, or wider benefit to IOM economy, e.g. tourism
- Ensures jobs and tax receipts remain on Isle of Man
- Public input on services through election of IOMG
- IOMG cost of capital cheaper than private sector operators

Precedent Examples

- **Caledonia MacBrayne** (Scotland)
 - Scottish owner/operator that connects the mainland with the islands on the west coast
 - The company is ultimately owned by the Scottish Government
- **Jadrolinija** (Croatia)
 - Croatian owner/operator that connects the coastal islands with the mainland and also runs routes to/from Italy

Issues

- Substantial funding requirement to purchase from current owners at an agreed price
 - Compulsory purchase may tarnish IOMG as counter-party with private sector
- Consolidation of any debts onto public balance sheet
- Commercial disciplines and innovation of private company may be diminished
- Risk of political interference into operations with detrimental impact on operational and cost efficiency



Nationalisation Structure

3. Review of Options

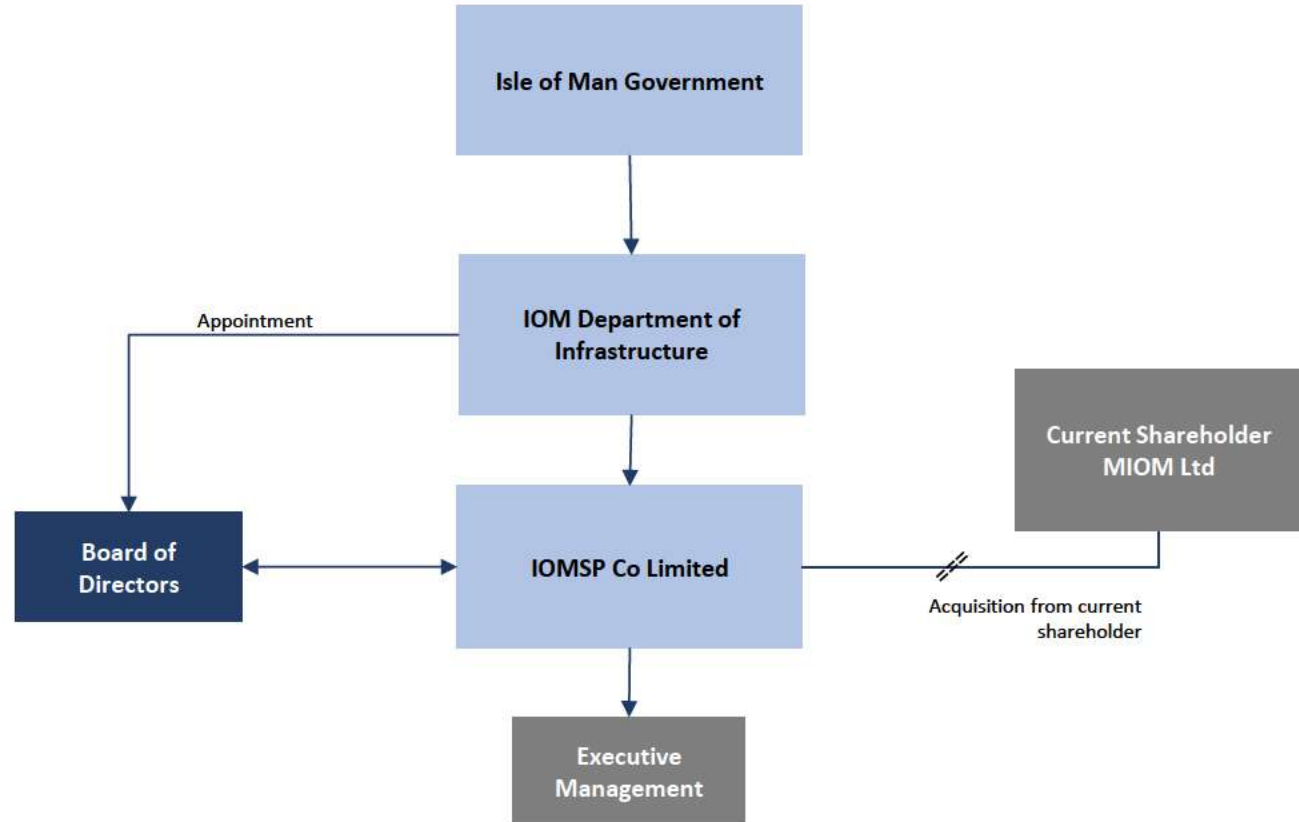
To nationalise the IOMSP, the IOMG would need to negotiate, agree, and fund its purchase from the existing owners

The IOMG would then be ultimately responsible for the operation, management and regulation of the Steam Packet

Financially, the IOMSP's cost of capital would fall but there may be some loss of private sector competitive discipline

There is also a risk that political interference may have an impact on operational and cost efficiency

Structure Chart





Company Limited by Guarantee

3. Review of Options

A Company Limited By Guarantee does not have shares or shareholders but it has the benefits of limited liability status, can enter into contracts, borrow, and purchase assets in its own name

The structure combines the benefits of private sector governance and discipline with no distribution of profit surplus to shareholders

- Ideal structure for a monopoly service for public benefit

Statutory corporation would deliver similar benefits

However, this option would still require acquisition of IOMSP at an acceptable price

Also does not introduce competition to drive efficiencies and innovation unless operations franchised to private sector

Description

- Private limited company without share capital or shareholders but with members who act as guarantors
- Typically no distribution to members with surpluses reinvested in business or returned to customers via price reductions
- Operates on normal commercial principles with executive management overseen by board appointed by the members
- Principles of the company established at incorporation by founder, in this case IOMG
- Company can finance itself through borrowings

Benefits

- Long-term, stable ownership brought on to Isle of Man
- Government can set policy objectives and regulation but company operates independently without interference
- Allows varied stakeholder representation via appointment as members
- Private sector entity subject to commercial disciplines and motivations
- Financially independent from IOMG with ability to raise debt

Precedent Examples

- **British Columbia Ferries (Canada)**
 - Canadian company providing access between various islands and parts of the mainland
 - Not for Profit organisation and can receive subsidies from the Government of British Columbia and Canada
- **Network Rail (UK)**
 - Set up by HMG to run UK's rail infrastructure when privatised Railtrack had financial difficulties
- **BUPA (UK)**
 - Commercial entity with large profits reinvested in growth

Issues

- Need to negotiate acquisition of IOMSP from the current owners at an acceptable price
- Initial funding may be required from IOMG to fund purchase
- Company / management not exposed to competition reducing potential for cost efficiency and innovation
- Implicit financial backstop by government may result in misalignment of interest without appropriate management oversight



CLBG Structure

3. Review of Options

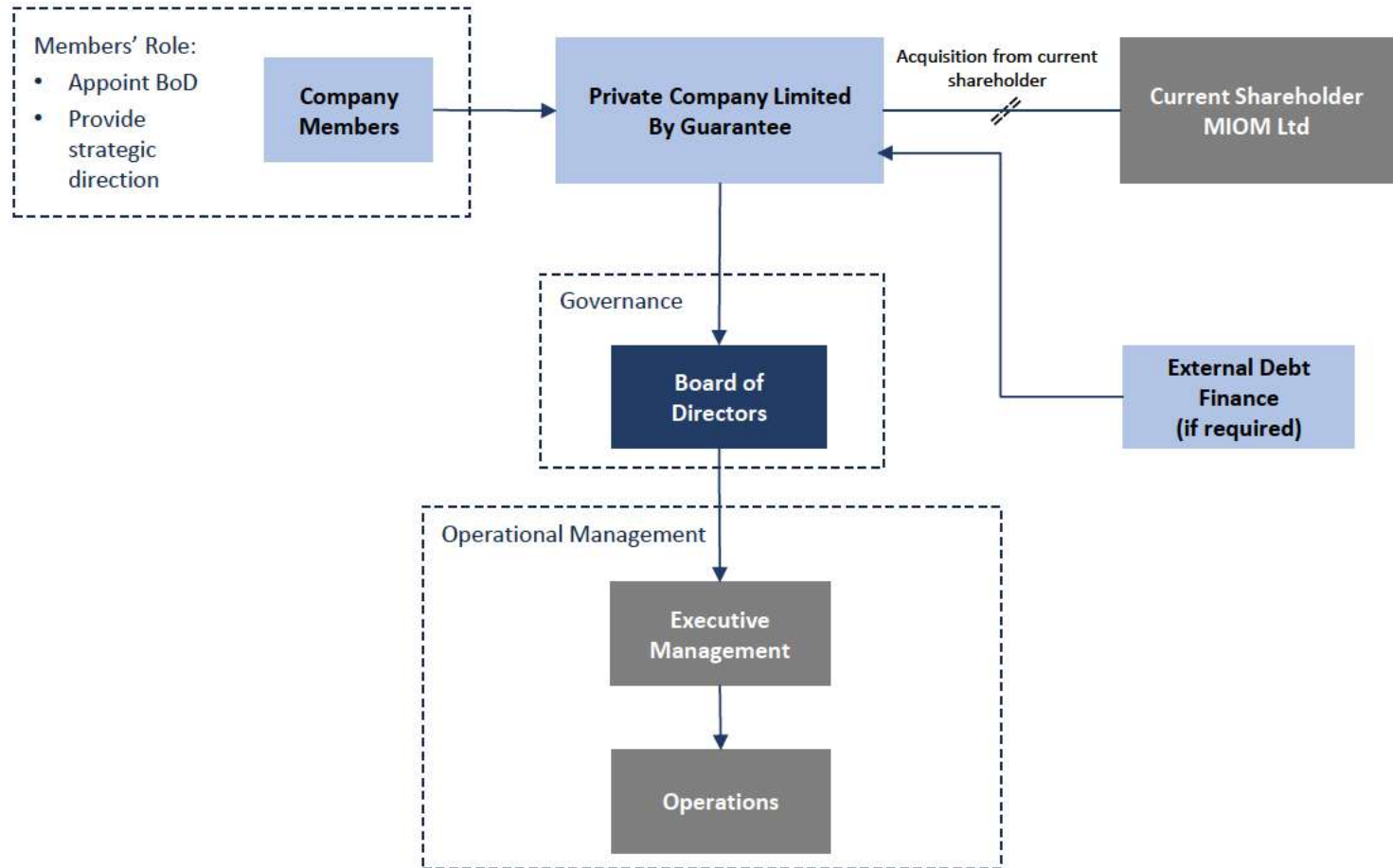
In a Company Limited By Guarantee the liability (for the company's debts) is limited to the amount of the guarantee set out in the company's articles, which is typically just £1

There are no shareholders but the company must have one or more members (total number at the discretion of the IOMG)

Members' role is to select the Board of Directors and provide them with strategic direction and oversight

A CLBG must have at least one director, total number again subject to discretion of IOMG

Company Structure





Franchising

3. Review of Options

The operation of IOMSP services would be franchised to a private sector operator for fixed term via a competitive process

- Common structure for transportation services, including ferries

Private sector management and competitive tendering process should drive value and service for customers

IOMG would set requirements for operator which could be revised at end of each franchise period

In existing ferry franchises, there are example of vessels owned by franchisor and by franchisee

- Level of competition may be limited if there is requirement to provide vessels

Description

- Competitive tender process to run IOMSP franchise
- IOMG defines service levels and other requirements e.g. Manx employees, for franchisee
- Interested parties bid on level of payments to IOMG based on expectations for cash flow, growth and cost savings
 - Benefits of outperformance accrue to franchisee
- Can require operator to provide own vessels, e.g. Destination Gotland or lease IOMG vessels, e.g. Northlink
- Typical term of 4-10 years depending on investment needs

Benefits

- IOMG defines service level requirements and pricing model
- Service provided by private sector companies and awarded under a competitive process to drive value
- Franchise term significantly shorter than User Agreement, allowing IOMG regularly to:
 - Replace underperforming / unsatisfactory operator
 - Revise terms of franchise
- Separation of asset ownership / control and operations facilitates changing of operator
 - New vessels provides opportunity to implement this

Precedent Examples

- **NorthLink (Orkney & Shetland Isles)**
 - Serco operates service with leased vessels
- **Destination Gotland (Sweden)**
 - Ferry operator to Gotland with own vessels
- **UK Train Operating Companies (TOCs)**
 - Bid to run train services on Network Rail infrastructure
 - Leases trains and carriages from rolling stock companies ("ROSCOs")

Issues

- Motivation for IOMSP to give up User Agreement?
 - Likely to have to grant IOMSP first franchise until 2026
- Feasibility of competitive tendering without separation of vessel ownership and operations
 - Funding considerations for separate IOMG ownership
- Level of interest in franchise, cf. recent market sounding
 - Different without need to provide vessels?
- Acquisition of Steam Packet brand to licence to franchisee
- Need for employees to be transferred across to new franchisee



Franchising Structure

3. Review of Options

To set up a franchise structure the IOMG would need to either

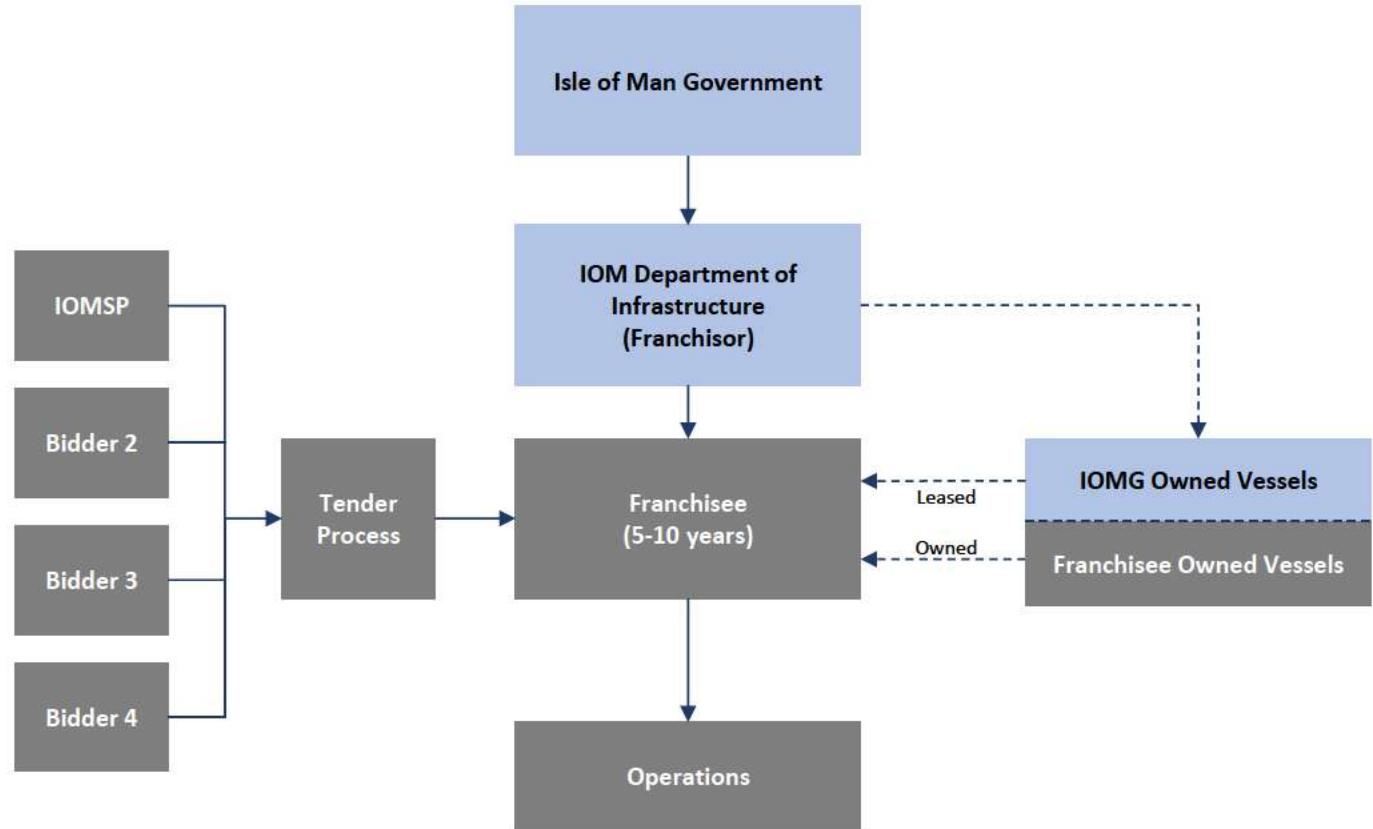
- Negotiate immediate end to UA and run a tender process
- Hold a tender process near to the expiration of the UA in 2026
- Award the first franchise to the IOMSP expiring in 2026, with a second competitive franchise commencing thereafter

Private sector management and competitive tendering process should drive value and service for customers

IOMG would set requirements for operator which could be revised at end of each franchise period

In existing ferry franchises, there are examples of vessels owned by franchisor and by franchisee

Franchise Structure





Status Quo

3. Review of Options

The current User Agreement continues for 10 years to 2026 if not extended as requested by IOMSP

- Still potential to introduce new vessels, funded by IOMG

Upon expiry, IOMG could put in place preferred structure for future provision of strategic sea services

However, risks exist to service levels and investment if IOMSP shareholders do not expect to renew agreement

Tactical window of opportunity currently exists to restructure IOM sea services

Overview

- The current User Agreement with IOMSP runs until 2020 with an option to extend until 2026, exercisable by either side
- The IOMG does not agree to the Strategic Sea Services Agreement proposed by IOMSP and allows the current UA to run until expiry
 - IOMSP almost certain to extend option
- Near to expiry of the UA, IOMG decides new structure and terms for provision of strategic sea services
- IOMG would be free to introduce any of the strategic options in this paper

Benefits

- Current IOMSP performance could improve but is acceptable
- IOMG could invest in new vessels to lease to IOMSP for remaining period of the UA
 - Scope for improved UA terms in return?
- Free to implement preferred structure after UA expires
- On renewal, IOMSP has no leverage via vessel ownership as current fleet will need replacing



Issues

- Changes to UA / introduction of new benefits postponed for 10 years
- Willingness to commit to use Liverpool terminal?
- No new vessels unless funded by IOMG and IOMSP agrees to lease
- Risk of being run as cash cow if no expectation of UA renewal at end of term
- Misses tactical window of opportunity to re-structure strategic sea services



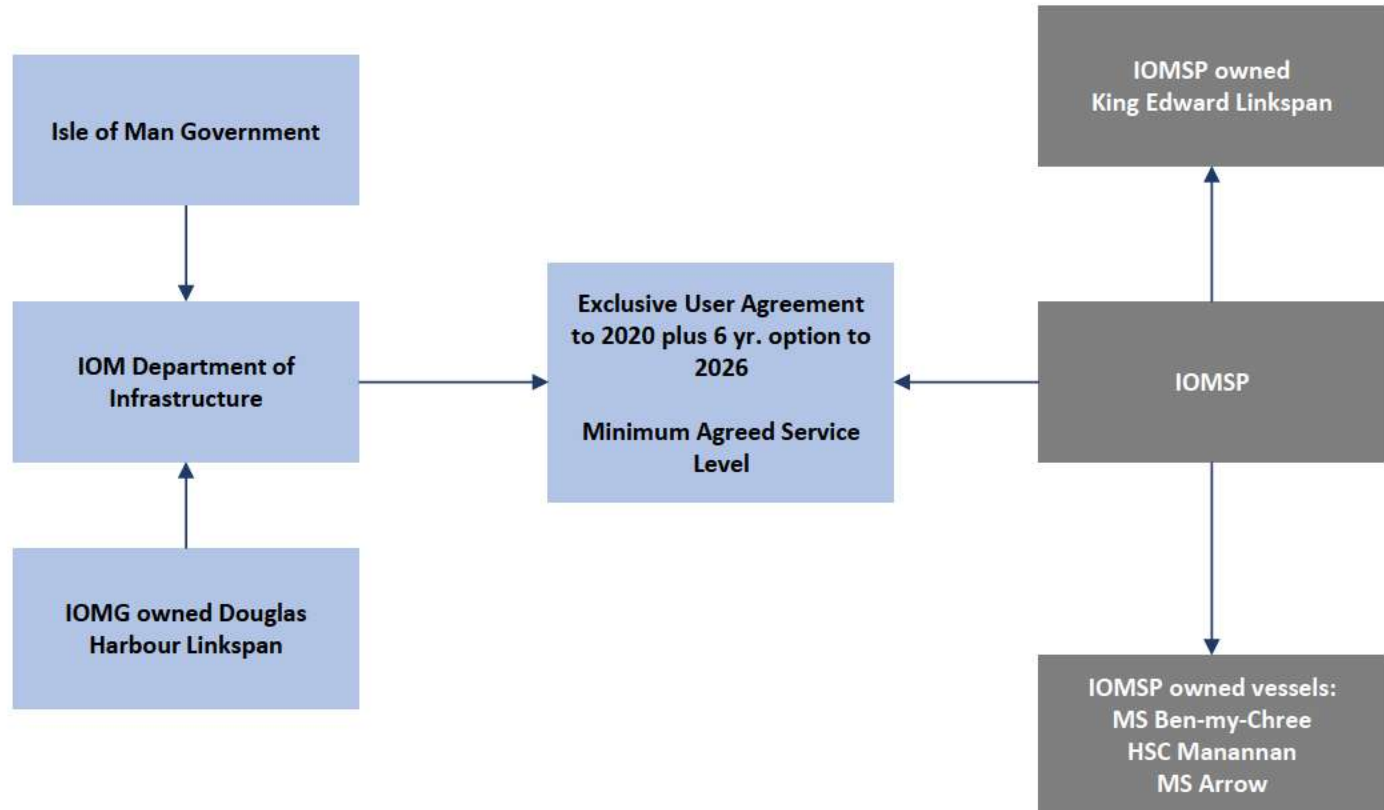
Status Quo Structure

3. Review of Options

The current UA gives the IOMSP a monopoly on use of the two Douglas Harbour linkspans until 2026

IOMSP owns the two principal vessel used for strategic sea services and charters in a reserve vessel

User Agreement Structure





Extend User Agreement

3. Review of Options

The IOMSP have recently submitted a proposal to extend the User Agreement for 15 years in return for service benefits, including:

- Vessel investment
- Pricing / fare schemes
- Use of Liverpool terminal

Whilst many of the proposed benefits are attractive, IOMSP would be granted a very long exclusivity with no opportunity to revise key terms of the UA

IOMSP would continue to own the vessels, providing significant leverage over IOMG in the event of financial difficulties or breach of financial stability requirement

Description

- IOMSP has submitted a proposal to extend the UA for an additional 15 (10 option 5) years
- In return, the IOMSP is offering to bring forward service benefits to the Isle of Man which are not contractually required during current UA, including
 - Vessel investment
 - Pricing commitments and discounted fare schemes
 - Use of new Liverpool ferry terminal
- The extended UA would commit IOMG to the provision of sea service by IOMSP for the next 25 years

Benefits⁽¹⁾

- Brings forward investment in new vessels with larger capacity without funding from IOMG
- Improved fare initiatives, e.g. frequent traveller, special offers, freight discount, and revenue growth sharing
- Commitment to new Liverpool ferry terminal
- Continued RPI cap and guarantee on Manx employment
- Financial stability requirement else UA is breached
- IOMG consultation and formal triennial review

Negotiation Considerations

- IOMSP shareholders keen to extend UA to increase value in business via recouping more of outstanding debt and / or increasing value of company for sale
 - Current shareholders not long-term owners
- Failure to reach an agreement on new framework for sea services results in status quo for 10 more years
- Willingness of IOMSP to commit to Liverpool terminal without agreement on extended UA?
 - Timing constraints to start terminal project

Issues

- IOMSP granted very long exclusivity with no opportunity to revise key terms of UA
- Does not introduce competition
 - what would another operator offer for 25 year UA?
- Vessel ownership remains with IOMSP
- Financial stability breach terminates UA but does not give control of vessels
 - IOMG implicit underwriter of vessels at any cost?
- No control over change of ownership of IOMSP

(1) Park has not been able to compare certain claimed benefits, e.g. fare schemes, against present situation



Extend User Agreement Structure

3. Review of Options

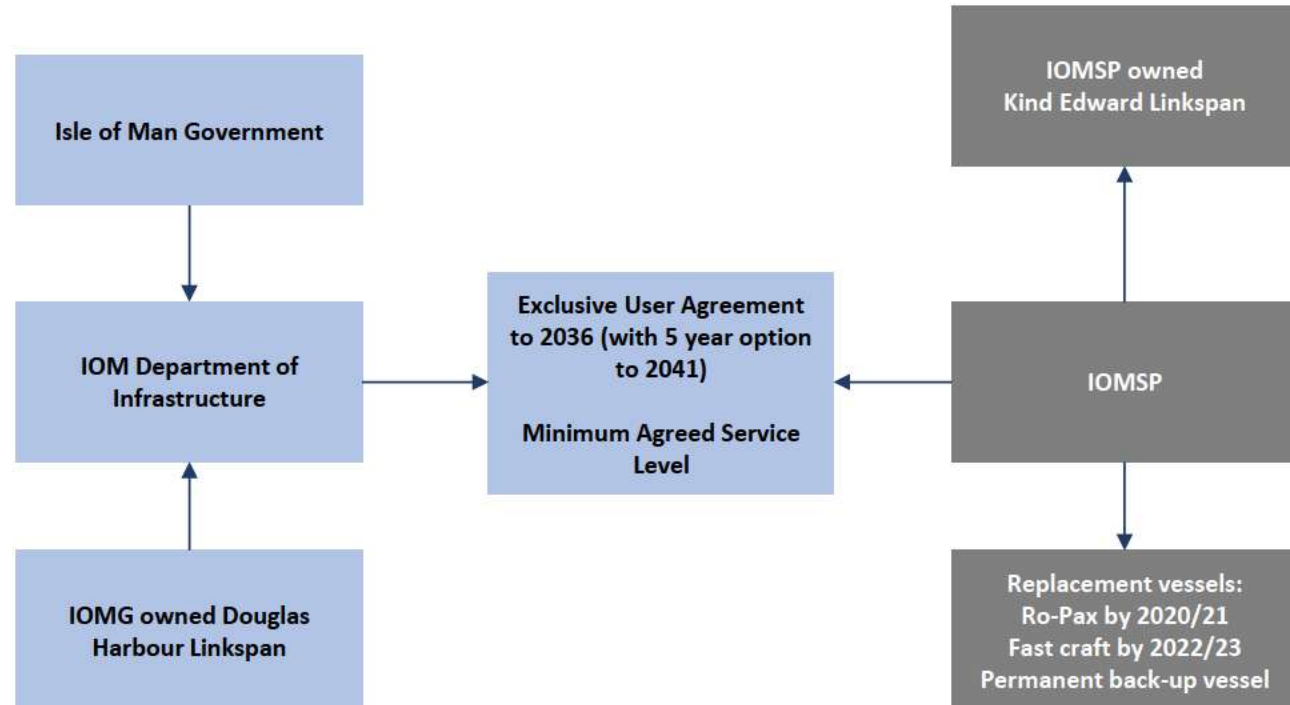
The IOMSP have recently submitted a proposal to extend the User Agreement for 15 years in return for service benefits, including:

- Vessel investment
- Pricing / fare schemes
- Use of Liverpool terminal

IOMSP would continue to own the vessels, undertaking to:

- replace the Ben-My-Chree and Manannan in 2020/21 and 2022/23 respectively
- provide a permanent back-up vessel

User Agreement Structure





IOMSP UA Extension Proposal

3. Review of Options

The IOMSPC has put forward an offer to the IOMG outlining its proposals for a new strategic sea services agreement (“SSSA”)

In return for the services outlined in the offer, the IOMSPC have asked for the new SSSA to run from the expiry of the existing UA in 2026 for a further 10 years with a 5 year option (declarable by either party)

Proposal & Key Considerations

	Proposal Detail	Considerations
Investment in Fleet	<ul style="list-style-type: none"> Bring forward replacement Ro-Pax Bring forward replacement fast craft Permanent back-up vessel Vessel consultation 	<ul style="list-style-type: none"> Significant wait for vessel replacement - explore earlier replacement of Ben-my-Chree / Manannan (4/5 and 6/7 years respectively) and at a lower cost? Ask to review financial projections that underpin 20 year payback requirement
Increased Capacity	<ul style="list-style-type: none"> Passenger capacity Freight capacity 	<ul style="list-style-type: none"> Employment of consultants to verify increased passenger and freight capacity is suitable for the next generation of vessels given growth of IOM economy Increased capacity also delivers a significant benefit for IOMSP returns
Fare Initiatives	<ul style="list-style-type: none"> Frequent traveller scheme Increased special offers Special group discounted fares Freight discounts 	<ul style="list-style-type: none"> Comparison of fare initiatives vs. existing fare schemes – are proposals a material difference? Ability of IOMG to police initiatives Are financial disclosure obligations adequate?
Revenue Sharing	<ul style="list-style-type: none"> Revenue growth sharing mechanism 	<ul style="list-style-type: none"> Merits of revenue growth vs. profitability as basis for sharing mechanism Appropriate IOMG share of growth and right growth benchmark Financial disclosure obligation to provide management accounts & forecasts Potential for regular adjustment reviews, e.g. every five years



IOMSP UA Extension Proposal

3. Review of Options

The IOMSPC has put forward an offer to the IOMG outlining its proposals for a new strategic sea services agreement (“SSSA”)

In return for the services outlined in the offer, the IOMSPC have asked for the new SSSA to run from the expiry of the existing UA in 2026 for a further 10 years with a 5 year option (declarable by either party)

Proposal & Considerations

	Proposal Detail	Considerations
Manx Resident Employment	<ul style="list-style-type: none"> Manx resident employment guarantees 	<ul style="list-style-type: none"> Does this have a significant impact on company costs which is passed onto customers in fares? Requirement that all employees pay NICs in Isle of Man
Additional Benefits	<ul style="list-style-type: none"> Capped fare increases Enhanced consultation Value for money transparency Manx community assistance Financial stability Marketing spend 	<ul style="list-style-type: none"> Are current Liverpool landing stage terms appropriate for new facility? Obligation for annual not triennial Formal Service Reviews Are fare comparisons against rates on comparable routes meaningful? Amend financial stability requirements to include compliance with bank lending covenants; allow period to remedy any covenant breaches Penalties for breach of financial covenants to include measures to ensure ongoing service, e.g. ability to continue use of vessels
Requirements of the SSSA	<ul style="list-style-type: none"> Length of extension Incorporate the Fuel Surcharge Agreement Stability on IOMG charges Consultation of minimum service frequency variations Government support for the SSSA 	<ul style="list-style-type: none"> Reduction of term of extension, e.g. five years; need for extension option? Change of control clause – right to terminate UA if IOMSP is sold Government can withdraw support/cancel SSSA in full if terms are breached and not rectified within a certain time period



Vessel Ownership Considerations

3. Review of Options

IOMSP vessels are specific to the port requirements of Douglas and the secondary charter market for suitable replacement vessels is thin

Owning and controlling the vessels is therefore a key strategic element for provision of strategic sea services

- Facilitates changing operator
- Protects IOMG in event of IOMSP insolvency or breach of User Agreement
- Prevents IOMG being forced buyer to ensure continuity of service

Options for financing and owning new vessels include:

- SPV owned and funded by IOMG
- SPV controlled by IOMG with third party leasing finance
- IOMSP owned and financed

IOMSP

Pros

- Investment from private sector avoids funding from IoM DoI
- Aligns interests in design, construction, operations, financing

Cons

- Specific vessel requirements give IOMSP significant strategic position
- Disadvantages other operators if tendering for sea services
- IOMG does not control vital strategic asset with risks if IOMSP breach user agreement or becomes insolvent
 - IOMG could be forced buyer in such circumstances

IOMG

Pros

- Full control over nationally important strategic assets
- Guarantees services to the island will always be maintained
- Gives IOMG significant leverage in negotiations with IOMSP
- Allows shorter User Agreement term as operator does not need to recover investment
- Facilitates tendering for new operator
- Commercial return can be earned by IOMG on investment

Cons

- Substantial capital investment potentially required from IOMG

Ownership Structures

Government Ownership

- Take advantage of IOMG low cost of capital
- IOM SPV set up by IOMG to purchase and own vessels
- SPV funded by IOMG alone or with external bank debt
 - Scope to raise public bond for both Liverpool terminal & vessels?
- Bareboat charter (finance lease) of vessel(s) to IOMSP
 - No operational or maintenance responsibilities
 - Periodic inspection rights to protect asset value

Third Party Lease Financing

- New IoM SPV wholly owned by IOMG to control vessels
- Vessels purchased by financing company and leased to SPV
 - IOMG provides guarantee to lessor
- SPV bareboat charters vessels to IOMSP (as above)
- Higher cost of capital than IOMG ownership but lower than IOMSP's as benefits from IOMG credit rating

IOMSP Ownership

- IOMSP funds acquisition or construction of new build vessels through own equity and external debt
- IOMSP has highest cost of capital of all three structures
- Amount of leverage provided by banks and cost of debt will depend on duration and terms of the User Agreement



4. Company Limited By Guarantee

- Overview



CLBG Structure

4. CLBG - Overview

A company limited by guarantee is an established structure for a company without shareholders

- Companies with a state function also formed as statutory company⁽¹⁾

The aim of acquiring IOMSP via a CLBG is to remove ownership from the private sector with distribution of profits but keep company out of IOMG control

The company would be governed by IOMG appointed members, who in turn appoint the Board of Directors

Executive management, operations, and employees would not need to change

IOMG would be required to provide initial equity funding with debt coming from IOMG or external sources

Overview

CLBG Principles

- A private sector, 'not-for-profit' company without shareholders
- No shareholder distributions but re-invests surplus profits or returns them to customers
- Legal limited liability status e.g. can agree commercial contracts, borrow and acquire assets/vessels
- Aims to achieve benefits/disciplines of private sector without distributions to shareholders

Purpose

- An IOMSP CLBG would be set up to acquire the IOMSP from the current shareholders, including:
 - Vessels, brand name, rights under the User Agreement, staff, and liabilities
- Company would be governed by company members and board of directors
- IOMG would have no involvement beyond stipulating and enforcing service and fare requirements
- IOMSP CLBG could directly operate services or tender operations to private sector via franchise

Component Parts

- IOMSP CLBG: a newly incorporated company with Memorandum & Articles of Association
- Members: appointed by IOMG to direct and govern CLBG; can include interest group representatives
- Board of Directors: appointed by Members to set strategic / financial targets and oversee management
- Executive Management: day to day operations and implementation of Board objectives
- Operations & Employees: operating companies, vessels and employees required for ferry service
- Funding: Initial equity from IOMG ; debt from IOMG or external sources

Independent Regulatory Body (Optional)

- In light of the lack of competition, option to establish regulator independent from IOMG to oversee fares and service levels
- Body and individuals would be appointed by the IOMG

(1) Statutory company not examined as an option but besides legal formation and structure is broadly similar to CLBG



Governance

4. CLBG - Overview

CLBG would be incorporated by Department of Infrastructure with approval from IOMG

Memorandum of Association will be signed by first subscribers who will be first members

Articles of Association required which regulate internal affairs and management of company

No requirement for members or directors to be residents of the Isle of Man

Company secretary required, either an individual or corporate

Annual AGM required and annual accounts (BS, P&L, directors' report)

Key Governing Bodies & Roles

Company Members

- CLBG has no shareholders but must have 1 or more members
- Possible to have different classes of members (e.g. voting, non-voting if desired)
- Subject to articles, members entitled to attend company meetings and vote, power to appoint and remove directors, have ultimate control over the company
- Members could include IOMG representatives, independent experts / businessmen, and stakeholder representatives

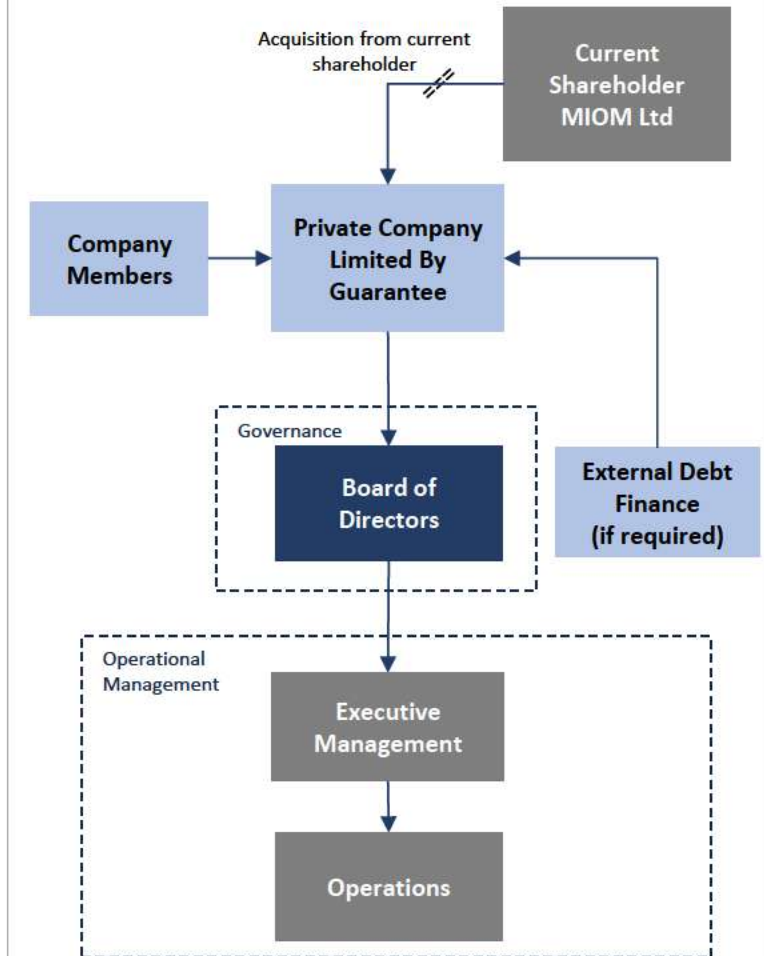
Board of Directors

- CLBG must have at least one director
- Board of directors sometimes referred to as a committee, managers, trustees or governors
- Power conferred on directors collectively when sitting on board and passing resolutions for management of company
- Directors can be executive and non-executive including independent directors from IOM or elsewhere

Executive Management

- Day to day management resides with executive directors reporting to the board as with normal limited company
- Likely IOMSP roles include CEO, CFO, Chief Commercial Officer and Chief Technical Officer (in charge of vessels)
- No need to change existing management team

Illustrative Structure for IOMSP CLBG










Illustrative Companies

4. CLBG - Overview

There are a number of illustrative CLBG or statutory companies

Common uses of such companies include commercial enterprises, non-governmental organisations, charities, clubs and sports associations

IOM & UK Existing CLBG

Company	Description	Governance	Use of Surplus	Initial Capitalisation
Network Rail 	<ul style="list-style-type: none"> State-owned CLBG Formed in 2002 to own/manage rail network in England, Scotland & Wales 	<ul style="list-style-type: none"> BoD reports to members Were c.100 members until July 2015 All members removed leaving the special member, UK Transport Secretary, as sole member 	<ul style="list-style-type: none"> Re-invests all income / surplus in the railway 	<ul style="list-style-type: none"> No equity Principally finance through bonds with HMG guarantee Currently consolidated on HMG balance sheet
BUPA 	<ul style="list-style-type: none"> Private CLBG Originally formed in 1947 Private international healthcare company 	<ul style="list-style-type: none"> Managed in line with UK listed company BoD with majority of independent non-executives, including Chairman c.100 Association Members serving terms of 10 years New members nominated by separate Nomination & Governance Committee 	<ul style="list-style-type: none"> Run as a profit-generating company along PLC lines but re-invests all surplus in the business 	<ul style="list-style-type: none"> n/a
British Standards Institute 	<ul style="list-style-type: none"> Founded in 1901 by act of UK Parliament Production of standards & supply of standard related services 	<ul style="list-style-type: none"> Non-profit distributing body operating under Royal Charter No shareholders, no stock exchange listing BoD, both executive and non-executive 	<ul style="list-style-type: none"> Re-invests all profits in business 	<ul style="list-style-type: none"> n/a
The Tote 	<ul style="list-style-type: none"> Created by the Racecourse Betting Act 1928 as a statutory corporation Sold to Betfred in 2011 for £265m 	<ul style="list-style-type: none"> Bookmaker owned by the UK Government until sale Set up to provide alternative to illegal off-course betting and ensure money put back into racing BoD and Executive Management 	<ul style="list-style-type: none"> Levy Board collected a charge on horserace bets Revenues directed back into the sport of horseracing 	<ul style="list-style-type: none"> n/a
British Horseracing Authority 	<ul style="list-style-type: none"> CLBG formed in 2007 Regulatory authority for horse racing in Great Britain 	<ul style="list-style-type: none"> Governed by a Board of Directors (9) with a CEO and Chairman 	<ul style="list-style-type: none"> Concentrates on activities which are to the benefit of British Racing 	<ul style="list-style-type: none"> n/a



Capitalisation

4. CLBG - Overview

Initial capital to fund a new CLBG could come from both debt and equity sources

Equity

Equity invested from the IOMG in the form of preference equity debenture loans which could be repaid over time. Sources are:

- Reserve Funds; or
- Issuance of public bonds

Debt

Debt funding could be provided as either loans or bonds from:

- IOMG
- Commercial lenders
- Existing IOMSP loans rolled over into the new structure

Considerations for funding an acquisition of IOMSP are examined further in the next section

Equity

	Pros / Benefits	Cons / Issues
Reserve Funds	<ul style="list-style-type: none"> Investing state funds in core infrastructure Politically attractive decision with public Economic gain likely outweighs capital cost 	<ul style="list-style-type: none"> Requires liquidation of other investments Significant funding concentration in single asset IOMG internal approval process?
New Issue of Public Bonds	<ul style="list-style-type: none"> New IOM Treasury bond attractive to market Low IOMG interest cost with AA+/AAA rating Low cost of capital for new IOMSP structure 	<ul style="list-style-type: none"> Willingness of IOMG to take on public borrowing? Requires time to prepare and execute

Debt

	Pros / Benefits	Cons / Issues
IOMG Debt	<ul style="list-style-type: none"> Cheapest form of capital Flexibility over term, cost, etc. Can earn spread margin from CLBG 	<ul style="list-style-type: none"> Negative impact upon IOMG balance sheet Potentially sets unwelcome precedent
Bank Debt / Public Bonds	<ul style="list-style-type: none"> Deep liquidity from bank and bond markets Commercial disciplines for management Keeps separation of IOMG from CLBG 	<ul style="list-style-type: none"> More expensive than IOMG debt Likely to require greater proportion of equity Implicit IOMG guarantee in event of default?
Existing Loans	<ul style="list-style-type: none"> May lend higher total to maximise debt recovery Flexibility on terms and pricing as part of overall deal 	<ul style="list-style-type: none"> Some debtholders focused on recouping investment Deal concessions required to get attractive terms?



Key Considerations

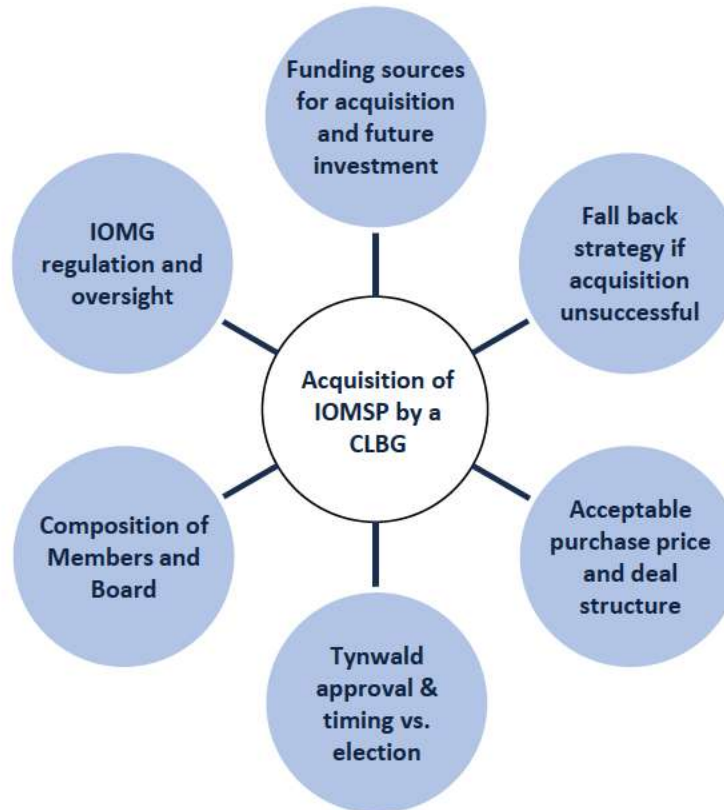
4. CLBG - Overview

It is important to address all the key considerations before starting to implement the strategy of acquiring the IOMSP by CLBG

In particular, this applies to:

- Tactics for approaching the IOMSP shareholders
- Valuation thresholds
- Clarity on funding structure and sources
- Backup strategy if approach is unsuccessful

Considerations regarding implementation of a CLBG Structure





4. Company Limited By Guarantee - Sources of Funding



Funding Considerations

4. CLBG – Sources of Funding

There are a number of key funding considerations which should be addressed as part of the analysis of an acquisition of the company and before engagement with IOMSP shareholders

Areas for Consideration

Area	Considerations
▪ Availability of IOMG Funding	<ul style="list-style-type: none">▪ Availability of funding from IOMG and attractiveness of financing the acquisition of IOMSP▪ If IOMG funding is to be used, what is the best source?<ul style="list-style-type: none">➢ Treasury bond, Reserve Fund, Consolidated Loan Fund
▪ IOMG Guarantee	<ul style="list-style-type: none">▪ IOMG guarantee on borrowing would lower costs and increase available leverage, formalising government's de facto role as underwriter of strategic sea services▪ However, there are potential concerns, including setting unwanted precedent, disincentive for CLBG management, and potentially state aid implications
▪ IOMSP Funding Capacity	<ul style="list-style-type: none">▪ IOMSP forecasts need to be understood to define the optimal capital structure, which can be serviced from operating cash flows with adequate headroom for trading variations, capital expenditure, and investment
▪ Investment in New Vessels	<ul style="list-style-type: none">▪ The funding structure needs to take into account the requirement for investment in two new vessels over the next 5-10 years as well as servicing this new financing
▪ Liverpool Terminal	<ul style="list-style-type: none">▪ If the IOMG is providing funding, it may make sense to combine financing for the Liverpool terminal with financing for the acquisition of IOMSP
▪ Timing for Funding Strategy	<ul style="list-style-type: none">▪ A preliminary strategy for funding is required before making an approach to IOMSP▪ This will enable proper analysis of the appropriate price and value for money for IOMG as well as demonstrating serious intent and financing certainty to the shareholders
▪ Bridge Financing	<ul style="list-style-type: none">▪ The IOMG may wish to provide bridge financing in order to complete the acquisition and subsequently put in place a longer term structure



Sources of Funding

4. CLBG – Sources of Funding

The acquisition of IOMSP by the CLBG could be financed by the IOMG, existing debtholders, or new third party providers

The CLBG could be entirely financed by IOMG, funded by a treasury bond or from the Reserve Fund

The Reserve Fund targeted return likely to make this suitable for only equity

In this case, the CLBG will be required to raise external debt via a bond, from banks, or from the existing lenders

Existing lenders may increase lending in order to reduce amount of junior loans created during debt restructuring

An IOMG guarantee would increase debt capacity and reduce borrowing cost

However, there may be political / treasury considerations

Debt and Equity Providers

	Description	Preferred Equity	Debt Financing
IOM Gov.			
Treasury Bond	<ul style="list-style-type: none"> Treasury raises 100% of capital in bond market Provided to company in preferred mixture of equity and debt 	←————→	
Reserve Fund	<ul style="list-style-type: none"> Capital from IOM Reserve Fund used as equity Cost of capital too high to be provided as debt External debt funding sourced for remainder 	←————→	
CLBG			
Existing Debtholders	<ul style="list-style-type: none"> Existing performing debt is rolled over Increasing debt amount may be attractive to debtholders and reduces IOMG equity Pref. equity funded by IOM government 	←	←————→
CLBG Bond	<ul style="list-style-type: none"> Existing debt repaid CLBG issues unsecured bond in public market Pref. equity funded by IOM government 		←————→
New Lender	<ul style="list-style-type: none"> Existing debt repaid New debt financing raised on commercial markets Pref. equity funded by IOM government 		←————→



Indicative Cost of Funding

4. CLBG – Sources of Funding

IOMG debt is the cheapest form of capital and could be used for equity or equity and debt

Use of the Reserve Fund is probably only feasible for equity due to the targeted returns on the fund's assets / opportunity cost of funding the CLBG

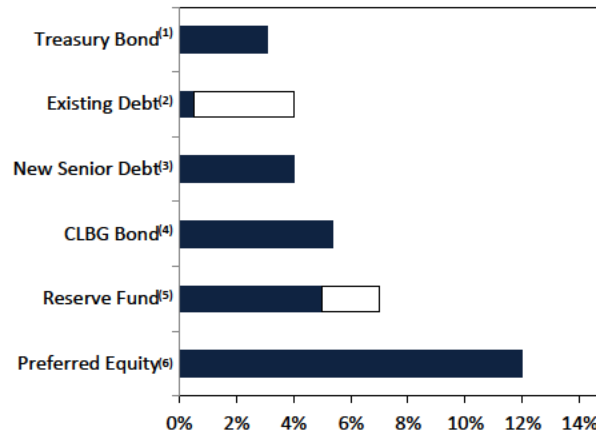
CLBG debt finance would be at market rates for an independent company

- An IOMG guarantee would reduce this cost substantially

Government funding should also be provided to the CLBG at market rates in order to:

- Deliver a spread return for IOMG
- Ensure market disciplines on the CLBG management

Indicative Cost of Types of Funding



Indicative Weighted Cost of Capital

- Weighted cost of capital assumes 60% debt financing

		<u>Cost of Debt</u>			
		Existing Debt	Treasury Bond	Senior Debt	CLBG Bond
<u>Cost of Equity</u>		2.5%	3.1%	4.0%	5.4%
Treasury Bond	3.1%	2.7%	3.1%	3.6%	4.5%
Reserve Fund	6.0%	3.9%	4.2%	4.8%	5.6%
Preferred Equity	12%	6.3%	6.6%	7.2%	8.0%

Cost of Funding Considerations

- The overall cost to the IOMG of funding acquisition of the IOMSP will depend on the mix of equity and debt and the cost of each component
- The cheapest form of new funding is to take advantage of IOMG's credit rating to raise a bond for either the equity or all the funding requirements
 - A bond issued by CLBG without an IOMG guarantee would be more expensive
- New senior debt raised by the CLBG would be cheaper than a bond but lower leverage is likely
- Rolling over the existing debt could have advantages:
 - Understood to have low cost currently:
 - Lenders may be more flexible on leverage and terms given that they are seeking to maximise overall value from a sale
- A IOMG guarantee would reduce the cost of third party debt to near the level of its own borrowing
- The cost of capital to the CLBG of IOMG capital is likely to be different than IOMG's funding cost, i.e. it would be charged at the same rates which the company could achieve in the financial markets
- This would allow IOMG to make a return on its investment, ensure that the CLBG management is subject to normal commercial disciplines, and avoid any state aid issues

(1) Current yield to maturity of Isle of Man 2030 Treasury bond
 (2) Lenders may require higher rate up to market
 (3) Assumes Libor plus 350 bps

(4) Bloomberg European High Yield Index yield to maturity
 (5) Assumes total targeted return on investments of 5%-7%
 (6) Assumes targeted required return on equity for mgmt. of 12%



4. Company Limited By Guarantee - Valuation



Historical Financials – P&L

4. CLBG - Valuation

IOMSP Co Ltd financials filed with the UK Company Register

Financials for MIOM and Sealion not available as private companies do not have to file accounts in the IOM

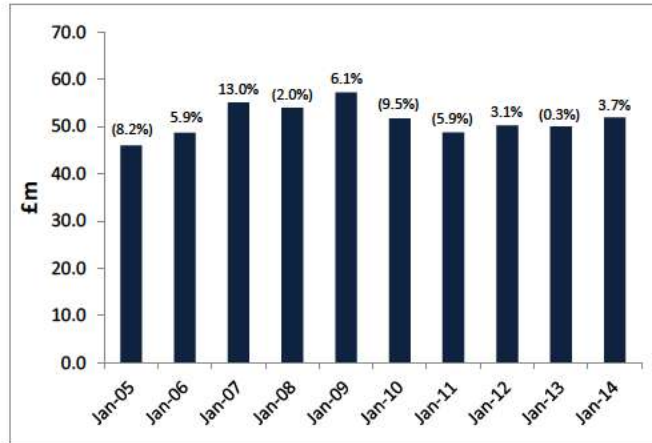
Revenues have been growing broadly in line with inflation since the downturn of 2010-11

Costs have been stable, with efficiency savings offsetting inflationary increases

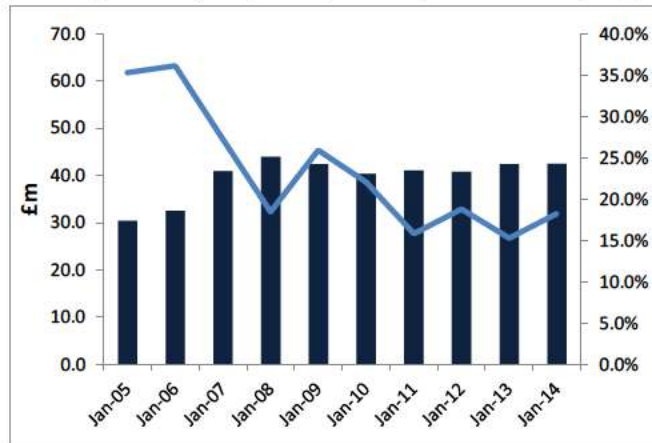
Profitability is driven principally by changes in revenue, reflecting the fixed nature of the cost base

Shareholders have withdrawn an estimated £100m from the company over 10 years

Revenues & Growth



Operating Costs (LHS) & Operating Profit Margin (RHS)



Comments

- Revenue grew strongly during the second half of 2000s on the back of economic growth
- Since the downturn in 2010-11, revenues have seen increases around inflation only
- Operating costs have remained broadly constant reflecting no change in service requirements and cost savings offsetting cost inflation
- Changes in margin have been driven principally by revenues, reflecting the fixed nature of the cost base
 - Going forward, profitability is leveraged to both positive and negative growth of the IOM economy and passenger / freight volumes
- Total dividends of £65.7m drawn by shareholders between 2005-09 with surplus distributed by means of loans to parent company thereafter
 - Increase in short-term debtors of £27.3m between 2011 and 2014
- Debt serviced by IOMSP cash flows is held in parent companies resulting in no interest payable



Indicative Valuation Metrics

4. CLBG - Valuation

Using comparable metrics values assumes IOMSP is a company with long-term viability

- Value to IOMSP shareholders is less if they do not renew the UA after 2026

Listed comparable companies are Irish Continental Group, Finnlines and the DFDS Group

Using ICG and DFDS as the most comparable companies, with a discount for size and being a private company, implies an indicative EV range of c.£99m - £109m

Most comparable transactions are those involving IOMSP itself and Wightlink

Comparable transactions imply indicative EV range c.£101m-£131m

Values are purely illustrative and require confirmation of financials by the IOMSP

Listed Comparable Companies

- IOMSP operates in the European passenger/freight ferry sector where there are only a limited number of listed comparable companies:
- **Irish Continental Group** – owner of Irish Ferries and operator of container vessels in UK, Ireland and Europe. Owner of Dublin & Belfast terminals
- **Finnlines Group** – Listed company but 90% owned by Grimaldi. Operator of ro-ro and ro-pax services in Baltic and North Sea
- **DFDS Group** – one of Europe's largest integrated shipping and logistics companies operating ro-pax, ro-ro, cruise and freight shipping services plus logistics solutions

Comparable Transactions

- Precedent IOMSP transactions:
 - Montagu, July 2003, for £142m
 - Macquarie, October 2005, for £225m
- Other relevant acquisitions comparable to IOMSP include:
 - Infracapital's acquisition of Red Funnel, June 2007 (price not disclosed)
 - Macquarie's acquisition of Wightlink, June 2005
 - Balfour Beatty's acquisition of Wightlink, Feb 2015 (price not disclosed)

Comparable Company Multiples/Valuation

Company	Mkt Cap (€m)	EV (€m)	2015a EV/EBIT (x)	2016e EV/EBIT (x)
Irish Continental Group	954.7	999.0	17.5	14.4
Finnlines Group	906.9	1,456.9	20.7	n.m.
DFDS Group	2,028.3	2,266.3	14.1	12.6

IOMSP Valuation Range	Low (€m)	High (€m)
Multiple ⁽¹⁾	10.0	11.0
EBIT (2016e)	9.9	9.9
EV	98.8	108.7
Net Debt ⁽²⁾	88.7	88.7
Implied Equity Value	10.2	20.1

Comparable Transaction Multiples/Valuation

Date	Buyer	Target	Curr.	EV (m)	EV/EBIT (x)
Jul-03	Montagu PE	IOMSP	GBP	142	10.2
Jan-01	RBS VC Fund	Wightlink	GBP	180	12.9
Oct-05	Macquarie IF	IOMSP	GBP	225	16.2
Jun-05	Macquarie IF	Wightlink	GBP	230	13.3

IOMSP Valuation Range	Low (€m)	High (€m)		(x)
Multiple	10.2	13.3	Average	13.2
EBIT (2016e)	9.9	9.9	Median	13.1
EV	101.2	131.4	Min	10.2
Net Debt ⁽²⁾	88.7	88.7	Max	16.2
Implied Eq. Value	12.6	42.8		

(1) Discounted multiple for a private company
 (2) IOMSP 2016E EBIT and outstanding debt levels are assumptions and purely indicative; no reliance should be placed on the implied values
 (3) Net debt of £116m in 2011 less increase in short term debtors 2010-14 of £27m (loans to parent company)



Indicative Cash Flow Valuation

4. CLBG - Valuation

Indicative DCF gives an enterprise value to the shareholders of the IOMSP of £104m - £137m

Assumptions

- 10 years of cash flows
- Turnover & operating costs growing at 2.1% per annum
- Operating profit margin constant at 18.2%
- Depreciation net of capex based on historic financials and depreciation of vessels over useful life of 30 years
- Working capital based on 10% of sales, in line with historical figures

Book value of vessels depreciated to scrap value, c.£1m, over remaining useful life (18 years) assuming 30 year life span

Assume change of control premium sought by shareholders, market practice for a private company is c. 20% - 30%

Forecast DCF Cash Flows y/e December	Dec-14 Actual	Dec-15 Forecast	Dec-16 Forecast	Dec-17 Forecast	Dec-18 Forecast	Dec-19 Forecast	Dec-20 Forecast	Dec-21 Forecast	Dec-22 Forecast	Dec-23 Forecast	Dec-24 Forecast	Dec-25 Forecast	Dec-26 Forecast
Turnover	51.9	53.0	54.2	55.3	56.5	57.7	59.0	60.2	61.5	62.8	64.2	65.6	67.0
Operating costs	(42.4)	(43.3)	(44.3)	(45.2)	(46.2)	(47.2)	(48.2)	(49.2)	(50.3)	(51.4)	(52.5)	(53.6)	(54.8)
Operating profit	9.5	9.7	9.9	10.1	10.3	10.5	10.8	11.0	11.2	11.5	11.7	12.0	12.2
Depreciation (Net of Capex)	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
EBITDA	12.9	13.1	13.3	13.5	13.7	13.9	14.1	14.4	14.6	14.9	15.1	15.4	15.6
Working capital	5.2	5.3	5.4	5.5	5.7	5.8	5.9	6.0	6.2	6.3	6.4	6.6	6.7
Change in WC	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Operating cash flow	12.7	12.9	13.2	13.4	13.6	13.8	14.0	14.2	14.5	14.7	15.0	15.2	15.5

WACC Calculation

- Cost of debt based on likely borrowing cost for IOMSP in commercial markets
- Cost of equity based on illustrative public market equity return
- Shareholders cost of capital may be based on debt financing only

WACC Calculation

Cost of Debt	4.5%	
Cost of Equity	12.0%	
Debt portion	100.0%	80.0%
Equity portion	0.0%	20.0%
WACC	4.5%	6.0%

Sensitivity – WACC vs. Control Premium

Enterprise Value		Control Premium				
		0%	10%	20%	30%	40%
WACC	4.5%	114	126	137	149	160
	5.0%	111	123	134	145	156
	5.5%	109	120	130	141	152
	6.0%	106	117	127	138	149
	6.5%	104	114	124	135	145
	7.0%	101	111	121	131	141
	7.5%	99	109	118	128	138

(1) Indicative only. Assumptions require verification and no reliance should be placed on implied value



Valuation Drivers

4. CLBG - Valuation

The value to IOMSP shareholders reflects what it can earn over the remaining 10 years of the User Agreement less outstanding liabilities:

- Cash flows
- Sale of vessels at end of UA
- IOM brand
- Pension fund deficit

There may be option value in the potential for extending or renewing the User Agreement

- This value is currently low

Key value drivers are:

- Revenue growth
- Cost management
- Vessel maintenance
- Pension deficit
- Vessel replacement

Value to IOMSP Shareholders

User Agreement Term

- Value can only be attributed during the remaining 10 years of the User Agreement if there is no certainty of renewal

Cash Flows

- Sum of free cash flow, post operating costs and vessel maintenance payments
- Cash flows will be greater than operating profit which includes significant depreciation
- Cash flows need to be discounted back to today's value
 - Appropriate rate for a bank?

Value of vessels in 2026

- At end of User Agreement, vessels can be sold
- By 2026 vessels will be 28 years old and near end of economic life
- Vessel values will be close to scrap and need to be discounted to today's value

Value of the IOMSP brand

- As one of the oldest ferry operators, the IOMSP brand has value to the operator of services to IOM
- Value of brand included as part of acquisition premium?

User Agreement Extension Option

- Option value that UA can be extended

Liabilities to Be Deducted From Value

- Current defined benefit pension deficit of c.£10m
- Potential other actual / contingent liabilities?

Key Value Drivers

Length of User Agreement

- The User Agreement provides certainty over business viability
- Hard to attribute value to IOMSP after User Agreement term

Revenue Growth

- With pricing capped at RPI, revenue driven by increased passenger and freight volumes
- Given high fixed cost base, increased volumes at marginal pricing impacts profitability directly
 - e.g. frequent traveller scheme, discounted fares

Cost Management

- Keeping cost increases below RPI through efficiency savings will increase margin

Vessel Maintenance

- Vessel maintenance likely to increase as they get older
- Fourth 'special survey' due in 2018 could be expensive

Pension Deficit

- Changes to DB pension scheme valuation may result in increased liabilities and need for additional payments

Investment in Replacement Vessels

- New vessels will entail significant financial investment which needs extended period to be recouped
- However, new vessels will have increased capacity and lower operating costs



4. Company Limited By Guarantee

- Process



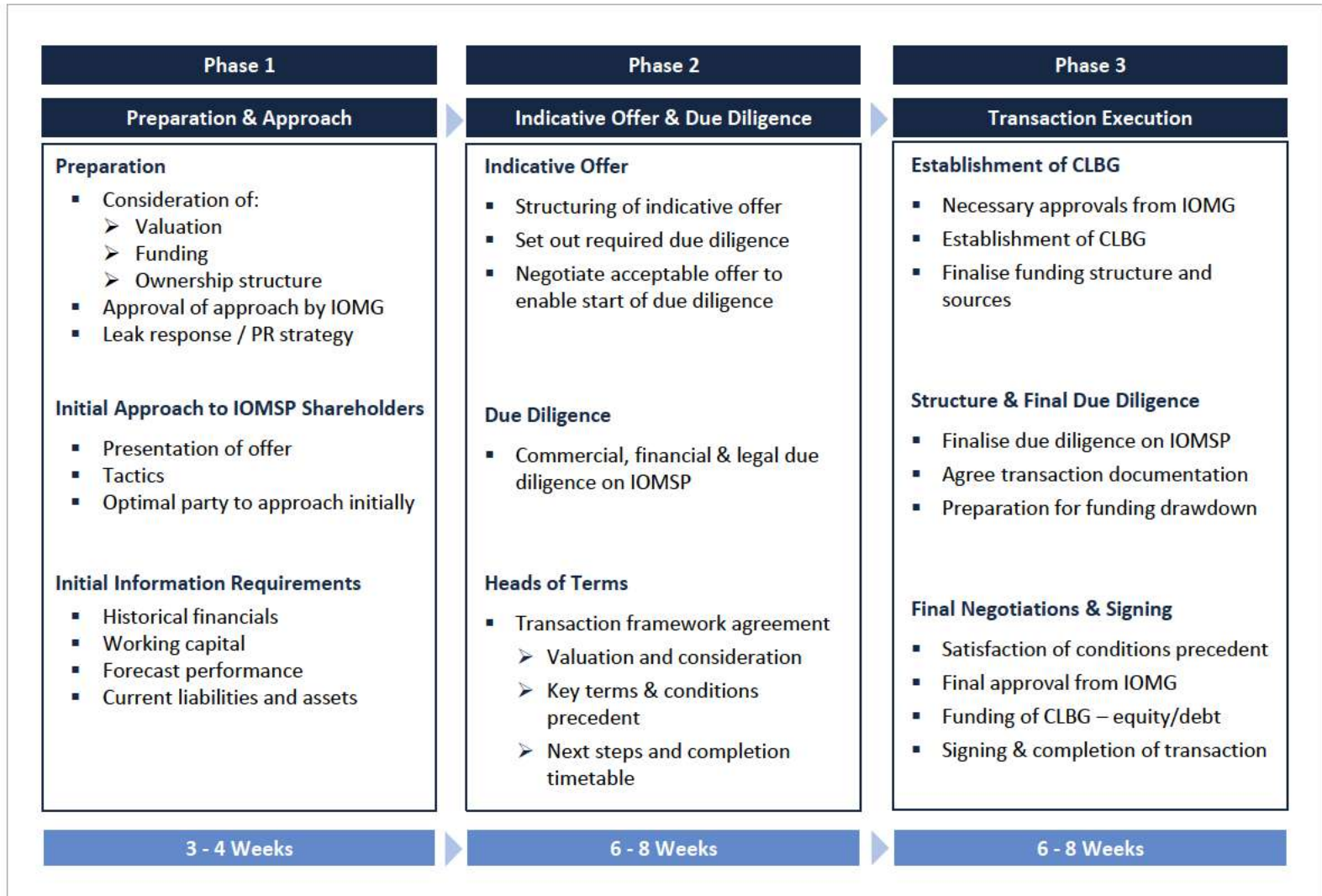
Process Overview

4. CLBG - Process

The process to evaluate, structure, negotiate, and complete an acquisition of the IOMSP would have three principal phases

- Preparation & approach
- Agreement of indicative offer and due diligence
- Structuring, funding, and completion of transaction

The process could be completed in 4-5 months with co-operation from the other side





Preparation & Approach

4. CLBG - Process

Full preparation will be key to:

- Positioning the proposal to IOMSP shareholders correctly;
- Minimising risks during transaction process; and
- Maximising value for money for IOMG

Each shareholder may have different motivation for a sale; need to decide which party is best to approach initially to gain support for a process

Access to information will be required in order to submit a meaningful indicative offer

Preparation

- Detailed analysis of options available to the IOMG; review of CLBG vs. extension of User Agreement/SSSA
- Valuation metrics and assessment of likely value required
- Evaluation of funding options and agreement on optimal structure and sources for IOMG
- Review of available ownership structures and decision on the preferred option
- Approval of chosen approach from required IOM bodies, including Minister of Infrastructure, Council of Ministers and National Strategy Sub-Group
- Leak response preparation

Initial Approach to IOMSP Shareholders

- Presentation of IOMG vision for strategic sea services, rationale for acquisition, consequences if shareholders do not sell, and benefits for shareholders
- Formulation of response regarding User Agreement if shareholders unwilling to enter into discussions
- Agree tactics using leverage against shareholders and mitigating actions for IOMG points of weakness
- Consideration of best party to approach initially, most likely Novo Banco (“NB”)
- Aim to explore opportunity with NBES initially, before involving other shareholders
- Agree process steps and transaction framework and timing

Initial Information Requirements to Submit Indicative Offer

- Last three years management accounts for IOMSPC Ltd and, possibly, holding company Sealion (IoM) Ltd, including P&L, cash flow, and balance sheet
- IOMSP forecast financials, ideally for remainder of UA, including passenger volumes, pricing, and capex
- Other actual or contingent liabilities or assets which may have an impact on valuation e.g. pension deficits / MNOPS, significant capex, vessel lease obligations



Indicative Offer & Due Diligence

4. CLBG - Process

IOMG will need to negotiate a non-binding offer acceptable to the shareholders of the IOMSP in order to be allowed access to full due diligence

Due diligence will allow IOMG to submit a binding offer with limited conditionality

The target of Phase 2 is to agree and sign a Head of Terms which will guide the final stages of the transaction

Indicative Offer

- Submission of an indicative non-binding offer for 100% of the equity share capital of IOMSP
- Based upon preliminary information provided and subject to due diligence and IOMG approval
- Main terms will include price, assumptions, basis for valuation, form of consideration, offer conditions
- Offer likely to be negotiated by IOMSP shareholders and may require revising
- Aim to agree provisional terms to enable diligence to commence and binding offer to be submitted

Due Diligence

- Financial: Review of historical accounts and assessment of financial forecasts
- Commercial: Review of IOMSP assumptions for passenger growth, operations, processes and contracts
- Legal: Review of legal structure, material contracts, litigation, compliance, insurance, change of control
- Taxation: Review of IOMSP tax assets and liabilities and impact of proposed transaction
- Pensions: Review of pensions schemes, most recent valuations and liabilities and assets
- Vessels: Review of condition of IOMSP vessels, forecast maintenance & capex requirements, and valuation

Heads of Terms

- Agreement on offer price and form of consideration
- Set out final commercial and legal framework for transaction and steps to completion
- Conditions precedent to signing and completion
- Terms of IOMSP's shareholders role in transaction financing, if applicable
- Agreement of Heads of Terms and timetable to completion



Transaction Execution

4. CLBG - Process

Once Head of Terms are agreed the IOMG can proceed with execution of the transactions:

- Incorporation and establishment of CLBG
- Finalisation of funding
- Completion of remaining due diligence
- Agreement of transaction documentation
- Transaction signing and completion

Establishment of CLBG

- Seek and secure necessary approvals from IOMG and Tynwald to execute transaction based on Heads of Terms, legal structure, funding requirements and valuation
- Incorporation of CLBG and set up of necessary operating requirements, e.g. bank account
- Appointment of appropriate CLBG members and a Board of Directors
 - Interim appointees pending selection of full membership and Board?
- Finalise optimal interim / long-term funding structure and sources and agreement with funding providers

Structure & Final Due Diligence

- Finalise outstanding due diligence items
- Agreement on remaining valuation and/or transaction structure issues
- Drafting, negotiation, and agreement of transaction documentation
- Shareholder and management disclosures, representations and warranties
- Preparation for funding drawdown

Final Negotiations & Signing

- Satisfaction of all conditions precedent
- Final approval from IOMG and / or Tynwald to execute transaction in the agreed form
- Drawdown / funding of CLBG capital structure
- Signing & closing of transaction
- Transaction announcement and public relations management



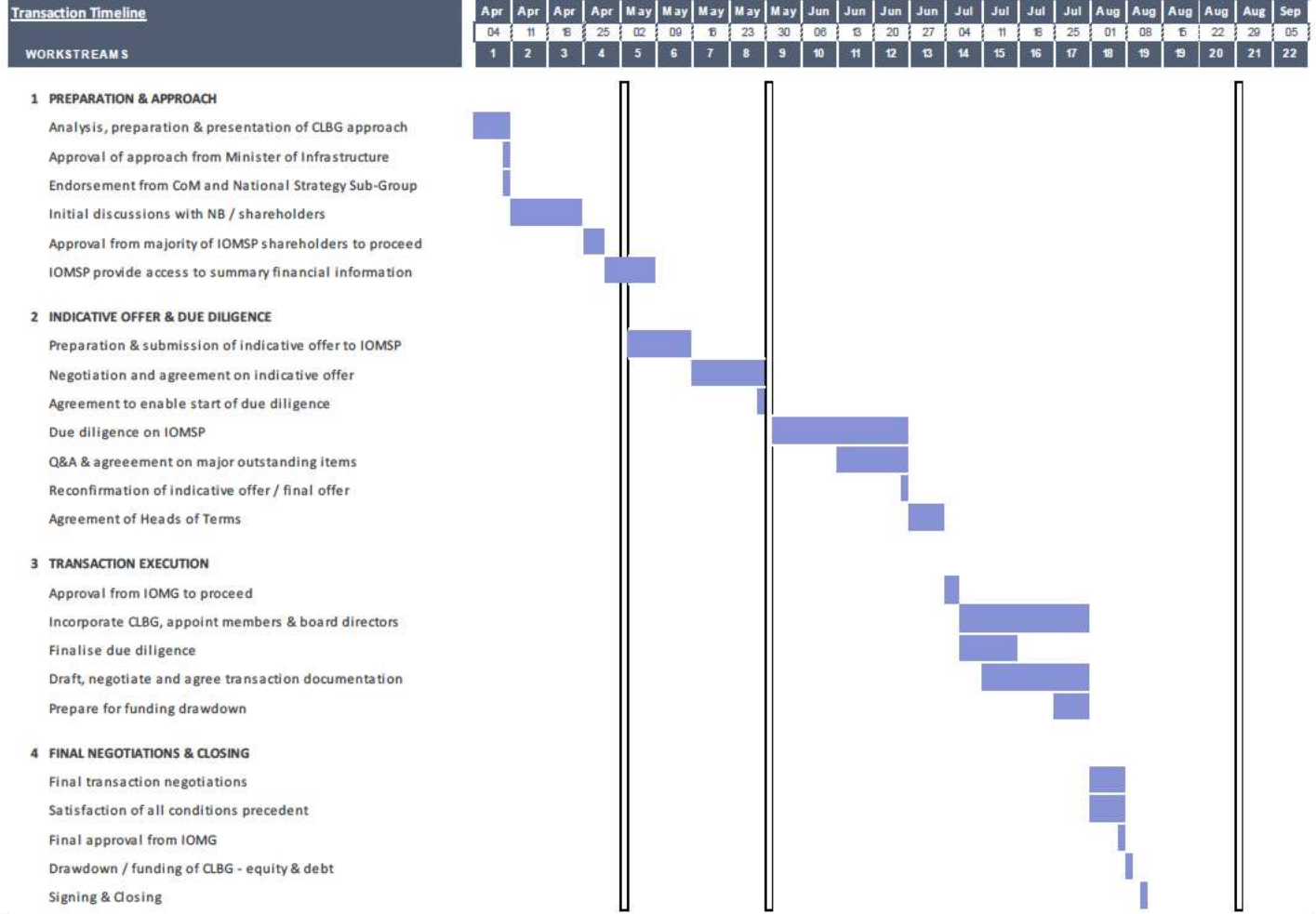
Illustrative Timetable

4. CLBG - Process

We envisage a four stage transaction timetable consisting of:

- Preparation & Approach
- Indicative Offer and Due Diligence
- Transaction Execution
- Final Negotiations & Signing

With co-operation from the other side and no political or IOMG delays, the transaction could be completed in 4-5 months



(1) Timetable duration and dates are illustrative assuming starting on 1st April and full co-operation of IOMSP shareholders and no political delays



5. Renegotiate User Agreement / SSSA



Evaluation Approach

5. UA Re-Negotiation

We have evaluated the IOMSP's offer for an extension of the User Agreement using two approaches:

- Comparison of the current User Agreement terms with those of two other island ferry operators, NorthLink (Orkney & Shetland) and Condor (Channel Islands)
- Outside perspective on attractiveness and considerations of the terms presented in the Strategic Sea Services Agreement

Comparison With Other Ferry Service Agreements

- We have compared how different ferry service contracts currently treat a variety of terms
- The companies and contracts which we have considered are:



- Original User Agreement signed in 1995 for 10 years between 1995-2005 (with 5 year option)
- Supplemental agreement to extend for five years between 2005-10 signed in 2002
- Agreement to extend UA signed in 2004 for 10 years between 2010-20 (with further 6 year option)



- Serco is the incumbent operator for ferries between mainland Scotland and the Northern Isles of Orkney & Shetland
- Contract agreed & signed with Scottish Ministers in 2012



- Condor is the incumbent operator for services between the Channel Islands, UK and France
- Contract agreed & signed with the Harbour Master of Jersey in 2014

Analysis of IOMSP SSSA Proposal

- The IOMSP submitted an offer for a new Strategic Sea Services Agreement ("SSSA") between the IOMG and IOMSP in January 2016
- We have analysed from an outside perspective the detail of the offer and identified the benefits and considerations under six main headings:
 - Investment in fleet
 - Increased capacity
 - Fare initiatives
 - Revenue sharing
 - Manx resident employment; and
 - Other additional benefits / considerations







Guidance From Similar Contracts

5. UA Re-Negotiation

The NorthLink and Condor contracts could help instruct the IOMG's negotiating position if it decided to re-negotiate the User Agreement / SSSA with the IOMSP

Comparison of Proposed SSSA with Existing User Agreement and Other Ferry Operators

	 Existing UA	 IOMG Considerations for Proposed SSSA		
Term	<ul style="list-style-type: none"> Fixed 10 year term from 2010-2020 with option for six year extension, exercisable by either party 	<ul style="list-style-type: none"> IOMG could consider reducing contract extension to 5 years (15 years from present) 	<ul style="list-style-type: none"> Contract period is 6 years (2012-18) No extension option available Contract will be re-tendered 	<ul style="list-style-type: none"> Contract period of 7 years (2015-22) Parties will meet to discuss possible 3 year extension at least 1 year prior to 2022
Options	<ul style="list-style-type: none"> Both sides, IOMSP and IOMG, have the option to extend by 6 years from 2020 to 2026 	<ul style="list-style-type: none"> IOMSP propose 5 year option Consider no option or option for 3-5 year period only exercisable by IOMG 	<ul style="list-style-type: none"> No options provided to either side 	<ul style="list-style-type: none"> No options provided to either side
Vessels	<ul style="list-style-type: none"> Commitment to invest £26m by Dec 2015 (£18m by 2012) Provision of fast craft Max age of replacement vessels, 25 years 	<ul style="list-style-type: none"> IOMSP propose new ropax, fast craft vessel in 4-6 years + permanent back up vessel Consider bringing forward delivery dates 	<ul style="list-style-type: none"> Vessel fleet chartered to Serco by Royal Bank Leasing Ltd Additionally Serco may employ/charter in other vessels 	<ul style="list-style-type: none"> New HSC¹ must be deployed 18 months after signing agreement Average fleet age must be a minimum of 25% of economic life

1. HSC = High Speed Craft







Guidance From Similar Contracts

5. UA Re-Negotiation

The Northlink and Condor contracts could help instruct the IOMG's negotiating position if it decides to re-negotiate the User Agreement / SSSA with the IOMSP

Comparison of Proposed SSSA with Existing User Agreement and Other Ferry Operators

	 Existing UA	 IOMG Considerations for Proposed SSSA		
Service Requirement	<ul style="list-style-type: none"> 936 return journeys per annum to north west UK ports 7,800 lane metres freight capacity per week 	<ul style="list-style-type: none"> IOMSP proposals maintains 936 return journeys per annum? Increases to 10,000 lane metres freight capacity per week 	<ul style="list-style-type: none"> Serco must comply with a detailed timetable set down by the Scottish Ministers 	<ul style="list-style-type: none"> As stipulated in the tender contract by the Harbour Master of Jersey and States of Guernsey
Fare Control	<ul style="list-style-type: none"> Applies to standard fares & charges Increases no more than Manx RPI Guarantee of special offers 	<ul style="list-style-type: none"> Keeps RPI fare cap Introduces rev. sharing, increased special fares, & other benefits Consider RPI-X fare cap and periodic fare control reviews 	<ul style="list-style-type: none"> Index linked tariff Yearly approval for published rates from Scottish Ministers Preferential tariffs or discounts require approval 	<ul style="list-style-type: none"> Maximum prices in place for passengers Adjustments in line with weighted Jersey, Guernsey & UK RPI Freight prices published & adjusted in same way
Marketing / Brand	<ul style="list-style-type: none"> Marketing spend of £550k per annum No mention of IOMSP brand 	<ul style="list-style-type: none"> Maintain existing marketing spend of £550k per annum IOMG should consider including option to acquire IOMSP brand 	<ul style="list-style-type: none"> Implement marketing plan to satisfaction of Scottish Ministers Retain Northlink ferry brand 	<ul style="list-style-type: none"> No specific or identified commitments







Guidance From Similar Contracts

5. UA Re-Negotiation

The Northlink and Condor contracts could help instruct the IOMG's negotiating position if it decides to re-negotiate the User Agreement / SSSA with the IOMSP

Comparison of Proposed SSSA with Existing User Agreement and Other Ferry Operators

	 Existing UA	 IOMG Considerations for Proposed SSSA		
Financial Stability	<ul style="list-style-type: none"> No specific clause binding company and shareholders of IOMSP 	<ul style="list-style-type: none"> Adequate financial & management resources to meet financial obligations Consider including as default breaching bank covenants 	<ul style="list-style-type: none"> Number of events of default including inability to pay debts as fall due, wind up or liquidation 	<ul style="list-style-type: none"> A Financial Distress Event is basis for Termination, including liquidation, bankruptcy, insolvency or breaching banking covenants
Financial Reporting	<ul style="list-style-type: none"> No specific commitments from IOMSP to deliver financial reports/accounts to the IOMG 	<ul style="list-style-type: none"> Include obligations to provide full accounts to IOMG 	<ul style="list-style-type: none"> Operator must provide copy of audited financial statements to Scottish Ministers within 6 months and any enlarged Group which it is part of 	<ul style="list-style-type: none"> Must provide ROACE¹ calculations for review Profitability to remain within ROACE tramlines If upper range exceeded for 2 years, agreement can be terminate
Insolvency / Default	<ul style="list-style-type: none"> IOMG can terminate agreement if IOMSP is in liquidation, receivership or makes an assignment to its creditors 	<ul style="list-style-type: none"> Consider IOMG first right of refusal on vessels/brand if sold from liquidation, receivership, or assigned to creditors 	<ul style="list-style-type: none"> Scottish Ministers have the right to claim costs/expenses incurred to re-tender the service 	<ul style="list-style-type: none"> Harbour Master of Jersey has rights to declare default and terminate agreement given a Financial Distress Event

1. ROACE = Return on Average Capital Employed







Guidance From Similar Contracts

5. UA Re-Negotiation

The Northlink and Condor contracts could help instruct the IOMG's negotiating position if it decides to re-negotiate the User Agreement / SSSA with the IOMSP

Comparison of Proposed SSSA with Existing User Agreement and Other Ferry Operators

	 Existing UA	 IOMG Considerations for Proposed SSSA		
Change of Control	<ul style="list-style-type: none"> No specific clauses 	<ul style="list-style-type: none"> Consider inclusion of right to terminate agreement in event of change of control 	<ul style="list-style-type: none"> Change of control is a contract event of default unless Scottish Ministers give prior consent (not to be unreasonably withheld) 	<ul style="list-style-type: none"> Agreement continues so long as operator is controlled by a fit and proper person e.g. professional investor or sponsor
Dispute Resolution	<ul style="list-style-type: none"> Disputes referred to tribunal of three independent arbitrators – one nominated by each side and one mutual agreement 	<ul style="list-style-type: none"> Efficient commercial mechanism e.g. negotiation between individual reps, then representative board, before appointing arbiter 	<ul style="list-style-type: none"> Initial negotiation between operator and Scottish Ministers Then referred to representative Board, then appoint arbiter 	<ul style="list-style-type: none"> Referred to a ferry services steering group, consisting of Jersey, Guernsey and operator officials
Termination & Handover Process	<ul style="list-style-type: none"> By mutual agreement If IOMSP incurs a loss equal to 2% or more of turnover or £600k (inflation adjusted for 1995 prices) 	<ul style="list-style-type: none"> Existing termination rights continue Include Run Off plan to ensure orderly handover, e.g. right to lease vessels 	<ul style="list-style-type: none"> Number of Events of Default e.g. failing to pay debts as they fall due 	<ul style="list-style-type: none"> States of Jersey can determine an Exit and Run Off plan of 1-3 years in case of Termination and Exit



IOMSP UA Extension Proposal

5. UA Re-Negotiation

The IOMSPC has put forward an offer to the IOMG outlining its proposals for a new strategic sea services agreement (“SSSA”)

In return for the services outlined in the offer, the IOMSPC have asked for the new SSSA to run from the expiry of the existing UA in 2026 for a further 10 years with a 5 year option (declarable by either party)

Proposal & Key Considerations

	Proposal Detail	Considerations
Investment in Fleet	<ul style="list-style-type: none"> Bring forward replacement Ro-Pax Bring forward replacement fast craft Permanent back-up vessel Vessel consultation 	<ul style="list-style-type: none"> Significant wait for vessel replacement - explore earlier replacement of Ben-my-Chree / Manannan (4/5 and 6/7 years respectively) and at a lower cost? Ask to review financial projections that underpin 20 year payback requirement
Increased Capacity	<ul style="list-style-type: none"> Passenger capacity Freight capacity 	<ul style="list-style-type: none"> Employment of consultants to verify increased passenger and freight capacity is suitable for the next generation of vessels given growth of IOM economy Increased capacity also delivers a significant benefit for IOMSP returns
Fare Initiatives	<ul style="list-style-type: none"> Frequent traveller scheme Increased special offers Special group discounted fares Freight discounts 	<ul style="list-style-type: none"> Comparison of fare initiatives vs. existing fare schemes – are proposals a material difference? Ability of IOMG to police initiatives Are financial disclosure obligations adequate?
Revenue Sharing	<ul style="list-style-type: none"> Revenue growth sharing mechanism 	<ul style="list-style-type: none"> Merits of revenue growth vs. profitability as basis for sharing mechanism Appropriate IOMG share of growth and right growth benchmark Financial disclosure obligation to provide management accounts & forecasts Potential for regular adjustment reviews, e.g. every five years



IOMSP UA Extension Proposal

5. UA Re-Negotiation

The IOMSPC has put forward an offer to the IOMG outlining its proposals for a new strategic sea services agreement (“SSSA”)

In return for the services outlined in the offer, the IOMSPC have asked for the new SSSA to run from the expiry of the existing UA in 2026 for a further 10 years with a 5 year option (declarable by either party)

Proposal & Considerations

	Proposal Detail	Considerations
Manx Resident Employment	<ul style="list-style-type: none"> Manx resident employment guarantees 	<ul style="list-style-type: none"> Does this have a significant impact on company costs which is passed onto customers in fares? Requirement that all employees pay NICs in Isle of Man
Additional Benefits	<ul style="list-style-type: none"> Capped fare increases Enhanced consultation Value for money transparency Manx community assistance Financial stability Marketing spend 	<ul style="list-style-type: none"> Are current Liverpool landing stage terms appropriate for new facility? Obligation for annual not triennial Formal Service Reviews Are fare comparisons against rates on comparable routes meaningful? Amend financial stability requirements to include compliance with bank lending covenants; allow period to remedy any covenant breaches Penalties for breach of financial covenants to include measures to ensure ongoing service, e.g. ability to continue use of vessels
Requirements of the SSSA	<ul style="list-style-type: none"> Length of extension Incorporate the Fuel Surcharge Agreement Stability on IOMG charges Consultation of minimum service frequency variations Government support for the SSSA 	<ul style="list-style-type: none"> Reduction of term of extension, e.g. five years; need for extension option? Change of control clause – right to terminate UA if IOMSP is sold Government can withdraw support/cancel SSSA in full if terms are breached and not rectified within a certain time period

Pages repeated from Section 3



IOMSP Proposal – January 2016

5. UA Re-Negotiation

The benefits of agreeing the SSSA for the IOMSP shareholders will be considerable in terms of ownership, funding and debt access

- Certainty for the stakeholders of the IOMSP over a 25 year period
- Increased attractiveness of business to a new owner due to attractiveness of 25 year monopoly
- Ability to support more performing debt / write back of non-performing loans

Proposal & Considerations

Ownership

- In 2011 ownership of the IOMSP passed from the shareholders (Macquarie) to the debt providers (led by Novo Banco) in a debt for equity swap
- Signing of the new SSSA would provide the IOMSP and its stakeholders with renewed certainty for a period of 25 years
- This has significant value and may lead to a restructuring of the capital structure or sale of the business to new owners

Funding

- Increased business certainty likely to lead to stable and growing profits
- Surplus cash can be used to pay off performing and non-performing debts
- With its 25 year monopoly, infrastructure focus, government backing and steady cash flows, IOMSP would be of significant interest to maritime/shipping trade buyers and infrastructure funds

Debt

- During the debt restructuring in 2011, the banks split the debt into performing and non-performing loans
- Under banking rules non-performing loans require banks to set aside considerable equity capital to cover the perceived risk (e.g. up to 100% of face value)
- Extending the UA will allow NBES (and others?) to reclassify some or all of non-performing loans as performing with significant benefits for their balance sheet and profitability



6. Summary



Summary

6. Summary

The IOMG should have appropriate strategic control of strategic sea services for the Isle of Man

From five potential structural options, the DOI and SSSWG prioritised two for further evaluation

- **Company Limited by Guarantee**
- **Renegotiation of the user agreement**

Decision on the best option to pursue will require political and treasury considerations as well as financial and strategic evaluation

Background

- Strategic sea services are of vital national importance to the Isle of Man over which the IOMG should have appropriate strategic control to ensure efficient operations, reasonable fares, and continuity of service.
- Five structural options for how strategic sea services can be provided were initially set out. Following an interim presentation, the DOI and SSSWG have prioritised for further evaluation two of the options for providing greater strategic control:
 - Acquisition of the IOMSP by a CLBG or similar structure; or
 - Renegotiating the User Agreement.

Company Limited by Guarantee

- Acquiring the IOMSP via a CLBG has many significant advantages over the current User Agreement structure:
 - Provides long-term, stable ownership on the Isle of Man;
 - Not for profit entity with no distributions of profit but legally separate from IOMG;
 - IOMG sets policy objectives and regulates but the company should operate independently without political interference;
 - Private company with typical board / corporate governance and subject to commercial disciplines and motivations; and
 - Financially independent from IOMG with ability to raise debt (need to clarify if liabilities consolidated on IOMG balance sheet).
- However, CLBG structure needs careful consideration of the following:
 - Ability to negotiate acquisition of IOMSP from current shareholders at a price which delivers value for money;
 - Availability of IOMG funding for at least equity component and political / public perception of use of funds for this purpose;
 - Whether CLBG would in practice be free from political interference despite legal independence; and
 - Lack of competition may reduce potential for cost efficiency / innovation without appropriate management oversight.



Summary (Cont'd)

6. Summary

The IOMG should have appropriate strategic control of strategic sea services for the Isle of Man

From five potential structural options, the DOI and SSSWG prioritised two for further evaluation

- Company Limited by Guarantee
- Renegotiation of the user agreement

Decision on the best option to pursue will require political and treasury considerations as well as financial and strategic evaluation

Company Limited by Guarantee (Cont'd)

- Further discussions need to take place with DOI, Treasury and ministers to review these considerations. If comfort can be reached on these points, acquisition of IOMSP by CLBG could be explored further including approaching the current shareholders to test their willingness to sell and price requirements
 - Achieving appropriate value for money must be a key determinant in whether to proceed

Renegotiation of User Agreement

- The IOMSP has submitted a new Strategic Sea Services Agreement which proposes a 15 (10 option 5) year extension to the current term running to 2041.
- The proposal has some attractive features when compared to the existing User Agreement
 - Brings forward investment in new vessels with larger capacity without funding from IOMG;
 - Introduces new fare initiatives for the public, such as more discounted fares and a frequent traveller scheme;
 - Puts in place a revenue growth sharing scheme to share business outperformance; and
 - Offers a financial stability requirement to provide comfort on IOMSP remaining a 'going concern'.
- Despite the above attractive features, there are some significant issues relating to the IOMG's desire to achieve greater strategic control over strategic sea services:
 - IOMSP would be granted a very long (25 year) exclusivity with no opportunity for IOMG to revise key terms of the UA;
 - Vessel ownership would remain with IOMSP, restricting the strategic flexibility of IOMG, e.g. in event of default or insolvency;
 - The 15 year extension significantly increases the value of IOMSP to current shareholders; and
 - With a long exclusivity in place, it is highly likely that the current shareholders will sell IOMSP and IOMG has no control over this.



Summary (Cont'd)

6. Summary

The IOMG should have appropriate strategic control of strategic sea services for the Isle of Man

From five potential structural options, the DOI and SSSWG prioritised two for further evaluation

- **Company Limited by Guarantee**
- **Renegotiation of the user agreement**

Decision on the best option to pursue will require political and treasury considerations as well as financial and strategic evaluation

Renegotiation of User Agreement (Cont'd)

- If IOMG wishes to continue with the current structure for provision of strategic sea services, the IOMSP proposal should be renegotiated, using the comparable contracts for Northlink and Condor as a guide to market practice, covering *inter alia* the following areas:
 - Length of term (comparable companies have 5-7 year contracts);
 - Timing of introducing new vessels and whether these should be purchased and owned by IOMG instead;
 - Stronger protection in event of contract default or insolvency;
 - Change of control provisions; and
 - Financial disclosure provisions.
- The IOMG should also consider the timing of when the User Agreement should be re-negotiated, for example, now, in five years time or closer to expiry in December 2026
- The IOMG wishes to seek Tynwald approval in June for funding for the new Liverpool ferry terminal and requires IOMSP commitment for using the terminal for the duration of the existing User Agreement.
- IOMSP has linked providing this commitment to submitting their proposal to Tynwald for approval and IOMG needs to consider the best approach to ensuring Tynwald approval can be sought in June whilst putting in place the best long-term solution for strategic sea services which gives appropriate strategic control.



Appendix – Other Ferry Operator Profiles



BC Ferries (Canada)

BC Ferries



British Columbia ("BC") Ferries operates ferry services around Vancouver and the West Coast of Canada

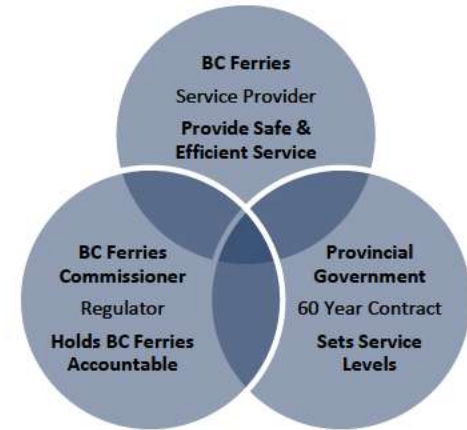
Founded in 1960 BC Ferries is one of the largest ferry operators in the world providing vehicle and passenger service on 24 routes to 47 terminals with a fleet of 35 vessels

The business forecasts revenues of C\$845m and an EBITDA of C\$240m (28% margin) in 2016

Description

- In 2003 BC Ferries was transformed from a Crown corporation into an independent, commercial organisation under the Company Act
- BC Ferries is governed by an independent Board of Directors appointed by the B.C. Ferry Authority.
- The purpose of the new structure was to separate the operation of the company from the establishment of ferry policy, to ensure government has the full ability to establish policy but not to affect the day-to-day operation of the company
- An independent no-share-capital corporation called B.C. Ferry Authority owns the single issued voting share of BC Ferries. The Crown is the sole shareholder
- BC Ferries' routes and service levels are defined in a Coastal Ferry Services Contract between the Province of British Columbia and BC Ferries
- The contract, originally signed in 2003, is a binding 60-year agreement that is reviewed and updated at regular intervals (4 year performance terms).
- BC Ferries' fares and core service levels are overseen by an Independent Regulator (British Columbia Ferries Commissioner) who is appointed by the Province of British Columbia

Organisation Structure / Governance



Vessel & Terminal Ownership

- BC Ferries has a fleet of 34 vessels and 47 terminals, four maintenance yards, one refit complex and a head office
- The company provides capital investment to replace or upgrade aged assets, meet regulatory requirements and improve service to customers (2016e):
 - Vessel projects - C\$141.4m
 - Terminal projects - C\$36.3m
 - Information systems and other projects - C\$47.4m
 - Net Capital Expenditure - C\$225.2m



Caledonian MacBrayne (Scotland)

CalMac



Caledonia MacBrayne (CalMac[™]) operates the Scottish Hebridean and Clyde Ferries

In order to comply with European guidelines on State Aids in Maritime Transport, an open public tender was held in 2006

To ensure a level playing field for all bidders CalMac was split into two companies:

- An asset owning company – CMAL; and
- A new operating company – CFL

CFL has operated the service since 2007 having won the first six year contract to 2013 which was then extended until 2016

The next contract will be awarded in Spring 2016

Description

- CalMac Ferries Ltd (CFL) is a wholly-owned operating subsidiary of David MacBrayne Ltd, which in turn is wholly owned by the Scottish Government, and is the current operator of the Clyde & Hebrides Ferry services
- A separate entity, Caledonian Maritime Assets Ltd (CMAL), retains ownership of the vessels and piers which it leases to the incumbent operator CFL
- CMAL is also owned by the Scottish Government but each entity has its own Board and their relationship is solely contractual
- In return for subsidies from the Scottish Government, CalMac returns any profit it receives to the Government over and above £1.5m
- CFL has one wholly owned subsidiary; Caledonian MacBrayne Crewing (Guernsey) Ltd, which employs and supplies all sea going staff (approximately 770) to CFL
- CalMac employs 1,342 people including 200 at its Gourock headquarters in the Firth of Clyde
- There are currently 27 routes within the CalMac network served by 32 vessels
- In 2014, the company carried over 4.6m passengers and over 1.2m of cars, coaches and commercial vehicles

Organisation Structure / Governance

- Effectively Caledonian MacBrayne is split into a Opco / Propco structure, both of which are currently owned and subsidised by the Scottish state
- The Propco is CMAL which owns the vessels and piers which it leases to CFL
- CFL is the incumbent operator, through a competitive tender process which operates the assets/services
- Any excess profits over and above £1.5m are returned to the state

Vessel & Terminal Ownership

- CMAL owns 31 ferries and leases one further ferry
- The vessels are leased to the current operator, CalMac Ferries Ltd on routes to the islands and peninsulas of the west of Scotland
- CMAL also owns and leases other piers, harbours and properties around Scotland



Destination Gotland (Sweden)

Destination Gotland



Destination Gotland is a private company which operates the Gotland service with the support of the Swedish state through an agreement with the Swedish Transport Administration

Since 1971, the service between the Swedish mainland and Gotland has received state support

Description

- Destination Gotland AB is a Swedish ferry line linking Gotland with the mainland Sweden
 - Gotland similar in location, population size and nature to Isle of Man
- The company is fully owned by Rederei AB Gotland, a Gotland company
- The company is 60% owned by the Nilsson family. Of the remaining 2,400 shareholders, two-thirds are from the island
- Rederei AB Gotland has investments in ferry, ro-ro and product tanker shipping
- On behalf of the Swedish Government, Destination Gotland operates the ferry service between Gotland and the Swedish mainland, with harbours in Visby, Nynashamn and Oskarshamn
- The present agreement with the Swedish Transport Administration (STA) runs until 31 January 2017
- In 2014, Destination Gotland signed an agreement with the STA which comes into effect on 1 February 2017 and runs for a further 10 years
 - It was reported that Scotland's CalMac also bid for the business but were unsuccessful

Organisation Structure / Governance

- Private company structure which operates the service with the support of the Swedish state
- The company was founded in 1998 and was originally 75% owned by Rederei AB Gotland and 25% by Silja Line, a Finnish cruise/ferry brand operated by Estonian ferry company Tallink
- In 1999 Silja Line sold its share in the company to Rederei AB Gotland

Vessel & Terminal Ownership

- The Destination Gotland fleet consists of:
 - Four fast Ro-Pax ferries – two larger vessels operate all year round with two smaller vessels boosting services in summer
 - One freight vessel employed as a reserve vessel (with a small number of passenger capability)
- The transport volumes to the island of Gotland are approximately 1.4m passengers and 640,000 lane metres of freight per year



Isles of Scilly Steamship (UK)

Isles of Scilly Steamship



Private company operating both sea and air routes between Cornwall and Isles of Scilly

Around 1,000 shareholders, many of whom live on the Scilly Isles

Description

- Formed in 1920 the Isles of Scilly Steamship Company (ISSC) operates the principal shipping service from Penzance, Cornwall to the Isles of Scilly, a journey of 28 miles
- The company was formed by selling shares, mostly in the Isles of Scilly, and it currently has 1,000 shareholders, around half of whom still live on the Isles of Scilly
- In the 1980s the company founded the Isles of Scilly Skybus which provides fixed wing services and sight seeing flights. The company also owns Land's End Airport
- In 2009 ISSC took over the lease to operate and manage Penzance Dry Dock
- The ISSC accounts for around 61% of the total passenger market (sea & air)
- In 2015 the ISSC acquired Island Carriers which provides haulage and courier services on the islands

Organisation Structure / Governance

- Privately company but over 1,00 shareholders, many of whom live on the Isles of Scilly, who therefore have an interest in its commercial success
- Private/public company structure with senior management team and 7 strong board made up of Chairman, CEO and other non-executive directors

Vessel & Terminal Ownership

- Owns 4 vessels
 - 1 RoPax
 - 1 long range geared freight vessel
 - 1 short range freight vessel
 - 1 fast craft post boat
- Owns 2 aircraft
 - 19 pax and freight Twin Otter
 - 8 pax and freight Islander



NorthLink Ferries (Scotland)

NorthLink Ferries



A previously state subsidised ferry service which is now operated on six year terms by private sector operators

Transport Scotland began tenders for the operating contract in 2002

The original incumbent fell into financial difficulties due to competition from a rival operator and higher than expected operating costs

A state subsidised interim arrangement was reached before the contract was re-tendered

The current incumbent is the Serco Group, 2012-18

Description

- Northlink Ferries operates passenger and vehicle ferries between mainland Scotland and the Northern Isles of Orkney & Shetland
- They are currently operated by the Serco Group under a six year contract worth a reported £243m
- The previously subsidised ferry services (operated by P&O Scottish Ferries) were put out to tender by Transport Scotland in 1999 and have been operated by various contractors since:
 - 2002 – 2003: NorthLink Orkney & Shetland Ferries (a Caledonian MacBrayne & RBS joint venture)
 - 2003 – 2006: Interim arrangements subsidised to some extent by Transport Scotland after previous operators hit financial difficulties
 - 2006 - 2012: Northlink Ferries Ltd (owned by Caledonian MacBrayne)
 - 2012 – 2018: Serco Group
- During the most recent tender process the contract's two services (Aberdeen-Lerwick and Scrabster-Stromness) were to be de-bundled
- However, Transport Scotland was forced to re-bundle the routes when insufficient interest was shown in the separate routes
- Serco Group won the contract and, using the vessels and branding of its predecessor, began operations in July 2012

Organisation Structure / Governance

- The Northlink ferries are owned by Northern Isles Ferries Ltd, a subsidiary of RBS
- The ferries are operated by a franchisee, currently Serco 2012-18

Vessel & Terminal Ownership

- The current NorthLink fleet consists of five vessels:
 - Three passenger vessels ; and
 - Two further freight vessels are on charter from Seatruck Ferries



Sydney/Harbour City Ferries (Aus)

Sydney / Harbour City Ferries



Sydney Ferries



Harbour Ferries is a joint venture company which currently operates a seven year franchise contract for Sydney Ferries, the New South Wales state owner of ferries and other required maritime assets

Description

- Sydney Ferries is the public transport ferry service on Sydney Harbour and the Parramatta River in Sydney, Australia
- In 2011, following a change in the New South Wales State Government, it was decided to contract out the operation of Sydney Ferries to the private sector, with the government retaining ownership of the maintenance facilities and ferry fleet, and control over the structure, routes and timetables through its service contract
- In July 2012, Harbour City Ferries, a 50/50 joint venture between Veolia Transdev and Transfield Services, began operating the services of Sydney Ferries under a seven year contract

Organisation Structure / Governance

- Structure where assets and operations are split and owned/controlled by different entities
- The state, Sydney Ferries, owns the vessels and piers
- A private company, Harbour Ferries, holds the franchise/contract to operate the service for an extended period – 7 years

Vessel & Terminal Ownership

- Sydney Ferries fleet consists of 28 vessels:
 - Freshwater Class (4 vessels)
 - Lady Class (2 vessels)
 - First Fleet Class (9 vessels)
 - RiverCats (7 vessels)
 - HarbourCats (2 vessels)
 - SuperCats (4 vessels)
- NSW Government also retains ownership of the Balmain Shipyard maintenance facility



Condor Ferries (Channel Islands)

Condor Ferries



Condor Ferries operates passenger and freight ferry services between the UK, Guernsey, Jersey and France

The company was acquired by the Macquarie European Infrastructure Fund II in 2008 with the approval of the Jersey Competition Regulatory Authority

Description

- Condor Ferries is a privately owned operator of passenger and freight ferry services between the UK, Channel Islands and France
- The company was founded in 1964 and established the first high-speed car ferry service to the Channel Islands from Weymouth in 1993
- Condor Ferries then acquired British Channel Island Ferries, which operated conventional ferry services in 1994
- Technical difficulties with fast craft vessels hat led to late-running services forced the Channel Island governments to put the licence to operate ferry services to the UK out to tender in 1997
- P&O European Ferries and Hoverspeed both submitted bids to run the services but Condor retained the licence, although it was forced to purchase the Havelet to act as an all weather back-up
- In 2002, the company was sold in an MBO for £150m backed by ABN Amro. The group was sold again to the venture capital arm of RBS in 2004 for £240m before being sold once again to Macquarie in 2008
- In 2015 Condor introduced a new vessel, the Condor Liberation, to the fleet which reportedly marked a £50m investment in the Channel islands

Organisation Structure / Governance

- Condor is a private company ultimately owned by investment funds of Macquarie
- In August 2014 Condor Ferries, Jersey and Guernsey signed a 10 year non-exclusive operating agreement until 2024 which enabled Condor to make further investments in the company by acquiring the Condor Liberation
- Jersey/Guernsey have a get out clause after seven years if the operation does not perform as required
- Other operators are able to compete on the maritime service as well but have to provide the same level of service as Condor

Vessel & Terminal Ownership

- Condor Liberation – a high speed fast car ferry built in Australia in 2010. Space for 800 pax and 245 cars
- Condor Rapide - a high speed fast car ferry built in Australia in 1997. Space for 741 guests and 175 cars
- Commodore Clipper – a purpose built all weather traditional ferry/Ro-Pax built in the Netherlands in 1999. space for 300 pax and 100 cars



Appendix – IOMSP Financials



Historical Financials – P&L

IOMSP Financials

IOMSP Co Ltd financials filed with the UK Company Register

Financials for MIOM and Sealion are not available as private companies do not have to file accounts in the IOM

Profit & Loss Account

Profit & Loss (£m) y/e December	Dec-04 Actual	Dec-05 Actual	Dec-06 Actual	Dec-07 Actual	Dec-08 Actual	Dec-09 Actual	Dec-10 Actual	Dec-11 Actual	Dec-12 Actual	Dec-13 Actual	Dec-14 Actual
Turnover	50.1	46.0	48.7	55.0	53.9	57.2	51.8	48.7	50.2	50.1	51.9
Growth (%)		(8.2%)	5.9%	13.0%	(2.0%)	6.1%	(9.5%)	(5.9%)	3.1%	(0.3%)	3.7%
Operating costs	(38.4)	(30.4)	(32.5)	(40.9)	(44.0)	(42.4)	(40.3)	(41.0)	(40.8)	(42.4)	(42.4)
Exceptional operating income/(expense)	(0.6)	0.6	1.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating profit	11.1	16.2	17.6	15.0	10.0	14.8	11.4	7.7	9.4	7.7	9.5
Margin (%)	22.1%	35.3%	36.1%	27.2%	18.5%	25.9%	22.1%	15.8%	18.8%	15.3%	18.2%
Growth (%)		60.0%	2.3%	(24.7%)	(32.2%)	40.4%	(14.8%)	(28.3%)	18.7%	(18.6%)	19.4%
(Loss)/profit on sale of assets	0.0	(0.8)	0.0	(0.0)	(0.0)	0.2	0.0	(0.1)	0.0	0.0	0.0
Exceptional items	0.0	0.0	0.0	0.0	0.0	0.0	2.9	(1.8)	(0.1)	0.2	(0.1)
Interest receivable	0.3	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Interest payable	(0.4)	(0.4)	(0.3)	(0.3)	(0.2)	(0.2)	(0.1)	(0.0)	(0.0)	(0.0)	0.0
Profit before tax	10.9	15.3	17.5	14.8	9.8	14.8	14.3	5.7	9.4	7.8	9.4
Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit after tax	10.9	15.3	17.5	14.8	9.8	14.8	14.3	5.7	9.4	7.8	9.4
Dividends	0.0	(6.1)	(19.6)	(22.0)	(17.9)	0.0	0.0	0.0	0.0	0.0	0.0
Retained profit	10.9	9.2	(2.1)	(7.2)	(8.1)	14.8	14.3	5.7	9.4	7.8	9.4

Montagu ownership – acquired in July 2013
 Acquired by Macquarie in October 2005
 Beginning of loss of UK VAT subsidies to IOM
 Debt default – IOMSP repossessed by lenders, led by BES

Total dividends of £65.7m drawn by shareholders between 2005-09
 Operating profit CAGR 2011-14 of 7.1% per annum



Historical Financials - BS

IOMSP Financials

IOMSP Co Ltd financials filed with the UK Company Register

Debt position not reflected in balance sheet as loans are now held higher up at the MIOM and Sealion levels

Balance Sheet

Balance Sheet (£m) y/e December	Dec-04 Actual	Dec-05 Actual	Dec-06 Actual	Dec-07 Actual	Dec-08 Actual	Dec-09 Actual	Dec-10 Actual	Dec-11 Actual	Dec-12 Actual	Dec-13 Actual	Dec-14 Actual
Fixed Assets											
Investments	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Tangible fixed assets	28.2	20.5	20.5	21.3	39.3	35.3	33.9	29.6	29.7	26.7	25.7
	28.4	20.7	20.6	21.4	39.4	35.5	34.0	29.7	29.9	26.8	25.9
Current assets											
Stocks	1.5	1.3	1.5	1.5	1.5	1.6	2.4	2.1	1.7	1.9	1.8
Debtors	53.0	67.0	64.9	67.5	66.6	65.2	71.2	83.8	92.5	103.2	98.6
Cash at bank and in hand	4.9	3.2	2.8	1.1	2.0	6.9	0.5	2.4	3.6	3.6	4.4
	59.4	71.4	69.1	70.1	70.1	73.7	74.0	88.4	97.8	108.7	104.8
Creditors < 1 year	(8.5)	(10.0)	(9.1)	(19.4)	(48.2)	(33.9)	(19.5)	(24.9)	(25.7)	(27.9)	(15.1)
Net current assets	50.9	61.4	60.0	50.8	21.9	39.8	54.5	63.4	72.1	80.8	89.7
Creditors > 1 year	(3.9)	(3.2)	(4.0)	(3.1)	(0.8)	(0.1)	(0.1)	(0.0)	0.0	0.0	0.0
Net assets excluding pension funds	75.4	78.9	76.7	69.1	60.5	75.1	88.5	93.1	101.9	107.6	115.5
Pension fund surplus	0.0	0.0	0.6	1.2	0.5	0.0	0.3	0.0	0.0	0.0	0.0
Pension fund liability	(8.3)	(4.2)	(1.6)	(0.9)	(1.6)	(3.2)	(2.5)	(5.1)	(9.7)	(6.3)	(10.2)
Net assets	67.2	74.6	75.6	69.5	59.4	72.0	86.2	88.1	92.2	101.3	105.3
Capital and reserves											
Called up share capital	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Share premium account	44.2	44.2	44.2	44.2	44.2	44.2	44.2	44.2	44.2	44.2	44.2
Profit & loss account	15.4	22.9	23.9	17.7	7.7	20.3	34.5	36.3	40.5	49.5	53.6
Equity shareholders' funds	67.2	74.6	75.6	69.5	59.5	72.0	86.2	88.1	92.2	101.3	105.3

Annotations:

- Montagu ownership – acquired in July 2003 (points to Dec-04)
- Acquired by Macquarie in October 2005 (points to Dec-05)
- Acquisition of M/V Manannan for c.£22m in 2008 (points to Dec-08)
- Debt default – IOMSP repossessed by lenders, led by BES (points to Dec-11)
- Surplus distributed by means of loans to parent company thereafter. Increase in short-term debtors of £33.4m between 2011 and 2014 (points to Dec-11 and Dec-14)
- Deteriorating pension fund liability position (points to Dec-11 and Dec-14)



Forecast Financials

IOMSP Financials

We do not have access to the IOMSP latest annual report to Dec 2015 nor the company's financial forecasts

We have made some broad assumptions of the company's financials over the remaining period of the UA to Dec 2026

- Analysis is only illustrative and requires verification

Sales assumed to grow constantly at 2.1% (CAGR 2011-14)

Operating cost growth at 2.1% per annum in line with sales growth

Depreciation net of capex based on historical financials and depreciation of vessels over useful life of 30 years

Working capital based on 10% of sales, in line with historical figures

Forecast Cash Flow

Forecast Cash Flow	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23	Dec-24	Dec-25	Dec-26
y/e December	Actual	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast
Turnover	51.9	53.0	54.2	55.3	56.5	57.7	59.0	60.2	61.5	62.8	64.2	65.6	67.0
<i>Growth (%)</i>	3.7%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
Operating costs	(42.4)	(43.3)	(44.3)	(45.2)	(46.2)	(47.2)	(48.2)	(49.2)	(50.3)	(51.4)	(52.5)	(53.6)	(54.8)
<i>Growth (%)</i>	0.0%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
Operating profit	9.5	9.7	9.9	10.1	10.3	10.5	10.8	11.0	11.2	11.5	11.7	12.0	12.2
<i>Margin (%)</i>	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%	18.2%
<i>Growth (%)</i>	23.7%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
Depreciation (Net of Capex)	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
EBITDA	12.9	13.1	13.3	13.5	13.7	13.9	14.1	14.4	14.6	14.9	15.1	15.4	15.6
<i>Margin (%)</i>	24.8%	24.6%	24.5%	24.4%	24.2%	24.1%	24.0%	23.9%	23.7%	23.6%	23.5%	23.4%	23.3%
Working capital	5.2	5.3	5.4	5.5	5.7	5.8	5.9	6.0	6.2	6.3	6.4	6.6	6.7
<i>As % of Sales</i>	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Change in WC	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Operating cash flow	12.7	12.9	13.2	13.4	13.6	13.8	14.0	14.2	14.5	14.7	15.0	15.2	15.5

Source: Park Partners assumptions and analysis



Contact & Location

Park Partners is located in Mayfair, London

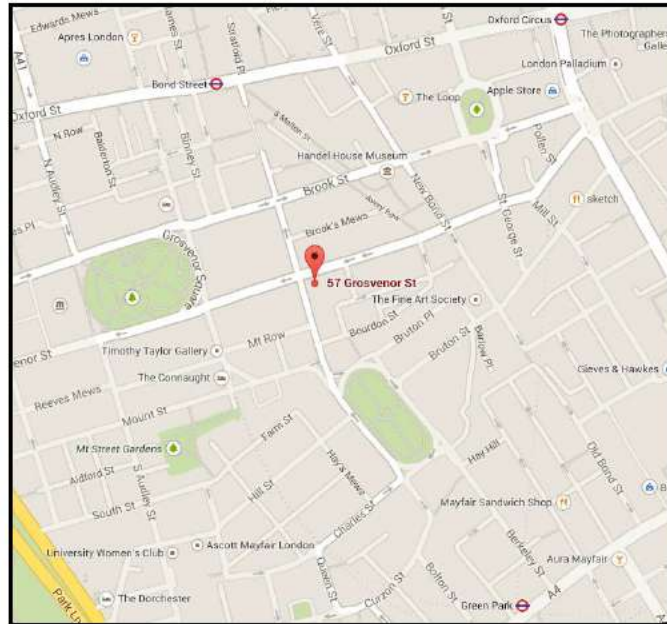
The closest tube stations are:

- Bond Street Station
- Green Park Station

Park Partners Ltd

57 Grosvenor Street
Mayfair
London W1K 3JA
United Kingdom

Phone: +44 (0)20 3405 1035



Contact:

Jon Howells

Tel: +44 20 3405 1035
Mob: [REDACTED]
E-mail: jhowells@parkpartnersltd.com

Simon Dunn

Tel: +44 20 3405 3312
Mob: [REDACTED]
E-mail: sdunn@parkpartnersltd.com

Ed Matthews

Tel: +44 20 3405 3294
Mob: [REDACTED]
E-mail: ematthews@parkpartnersltd.com

Alex Shivananda

Tel: +44 20 3405 3313
Mob: [REDACTED]
E-mail: ashivananda@parkpartnersltd.com



Cabinet Office
Government Office
Bucks Road
Douglas
IM1 3PN