PB2019-35

Shadow Board – Shetland Merger Project

Committee	Shadow Board
Subject	Company formation
Action requested	☒ For information only ☐ For discussion ☐ For recommendation
Brief summary of the paper	Final approval of the draft text of chapter 7: Financial Forecast of the MMBC
Resource implications [if yes, please provide detail]	Yes The financial forecast establishes the transition funding support required by the new college
Risk implications [if yes, please provide detail]	Yes The forecast is a critical reference document. However, it is a high-level forecast and does not represent a detailed budget and it is expected that detailed budget setting after vesting will lead to annual adjustments approved by the Audit Committee of the new Board of Directors.
Date paper prepared	22-Oct-19
Date of committee meeting	30-Oct-19
Author	Project Manager
Equality and diversity	No
Status	Non-confidential
Freedom of Information Can this paper be included in 'open' business?*	Yes

7.1 The base case merger scenario

The base position for the combined income and expenditure of NAFC Marine Centre, Train Shetland and Shetland College has been derived from analysis of the 2018/19 income and expenditure of these organisations.

The compilation of actual income and expenditure incorporated these factors:

Expenditure

- As Council departments, Train Shetland and Shetland College are subject to a range of re-charges for council services provided. These were calculated on a cost recovery basis that is likely to differ from the cost when the responsibility for providing these services is transferred to the new Institute. This has been addressed in the baseline model by retaining the cost of any services considered essential for the operation of the new Institute and removing costs regarded as surplus (e.g. Council senior management time).
- Employee costs include the National Pay Award for Shetland College lecturing staff (this award was not made to NAFC lecturing staff)
- (12) Property costs are allocated to Train Shetland and Shetland College even though the Council owns these buildings. The Council's Full Business Case agreed in 2018 reported the Gremista and Scalloway main buildings would be transferred or leased to the new Institute at "minimal cost" and the Train Shetland building retained by the Council. The baseline model therefore assumes 2018/19 property leasing costs will be removed (a saving of £494,234) a new benefit of rates relief can be applied (a saving of £117,392), and the remaining cost reported is running costs.
- (13) Operating costs in the baseline model represents the combined operating costs with the annual materials and equipment budgets of the three entities, including the vessels required by fisheries research and nautical curriculum. Analysis of expenditure showed that if delivery remains at 2018/19 levels, expenditure in this line cannot decrease.
- (16) Professional and Financial Fees includes costs such as insurance (previously SIC entities were self-insuring and this was allocated as a recharge to the college and Train Shetland).

Income

- All income is based on 2018/19 actuals, which had changed since the 2018 Full Business Case.
- (2) Tuition Fees, Contracts and Grants is derived from curricular activity;
- (3) Research Grants and Contracts is restricted income for specific research outputs;
- (7) Management and Services Fees represents the SDS contract for managing apprenticeships.
- (5) Sale of Meals represents Gremista canteen income. Canteen cost of sales is reported in Employee Costs and Operating Costs. The canteen breaks even at present.

Note

- In 2018/19 there was no income from residential accommodation (Port Arthur House was closed due to structural problems) and no surplus with which to support investment. These lines are represented in the baseline as £0.

	ANNUAL REVENUE BASELINE	
1	Scottish Funding Council	2,847,087
2	Tuition Fees, Contracts and Grants	1,744,801
3	Research Grants and Contracts	718,365
4	Residential Income	0
5	Sale of Meals	54,233
6	Sale of consultancy services	207,424
7	SDS Management and Services Fees	364,105
8	Other Income	373,104
9	Bank Interest	4,474
10	**Total Income**	6,313,593
	ANNUAL EXPENDITURE BASELINE	
11	Employee Costs	-5,438,009
12	Premises Costs	-456,997
13	Operating Costs	-1,059,778
14	Grants to Individuals/Organisations	-3,482
15	Marketing	-35,919
16	Professional and Financial Fees	-355,880
17	Travel/Vehicle Expenses	-162,791
18	Investment funded from Current Revenue	0
19	**Total Expenditure**	-7,612,855
20	**Surplus** / **Deficit**	-1,299,261

Further comments on the baseline

Shetland College and Train Shetland have been heavily subsidised by the Council prior to the merger. NAFC Marine Centre has struggled with a reducing Council grant for core costs which it could not replace with other forms of income. It therefore approaches the merger with diminished cash reserves. The baseline deficit is therefore expected to increase over time.

The baseline assumes that key assets (all buildings except Train Shetland, vessels and vehicles) remain in the operating costs to support current delivery and growth. Reviews of assets (Broodstock Building and Hatchery, vessels) were undertaken in 2018 and again in 2019 and concluded they continue to contribute to the income generating potential of the college and nevertheless would be unlikely to realise their book value if there was an attempt to sell them and with limited prospect of ready buyers.

7.2 Financial base case for the merged Institute: A 5-year budget forecast was developed building from the baseline in 7.1

5 YEAR FORECAST					
	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Annual cumulative price (revenue) increase	0.00%	0.00%	0.00%	3.00%	3.00%
Annual cumulative inflation (expense) increase	0.00%	-2.00%	-1.00%	1.00%	1.00%
INCOME					
Subject to cumulative price (revenue) increase					
Scottish Funding Council	2,847,087	2,847,087	2,847,087	2,932,500	3,020,475
Tutition Fees, Contracts and Grants	1,744,801	1,744,801	1,903,098	1,960,191	2,018,997
Research Grants and Contracts	718,365	868,365	878,365	904,716	931,857
Residential Income	0	0	70,448	72,561	74,738
Sale of Meals	54,233	54,233	54,233	55,860	57,536
Consultancy	207,424	207,424	207,424	213,647	220,056
(SDS) Management and Services Fees	364,105	364,105	364,105	375,028	386,279
Other Income	373,104	423,104	423,104	435,797	448,871
Total Income	6,309,119	6,509,119	6,747,865	6,950,301	7,158,810
EXPENDITURE					
Subject to inflationary increase					
Employee Costs	-5,535,723	-4,851,723	-4,851,723	-4,900,240	-4,949,243
Premises Costs *(see note 3)*	-556,997	-545,857	-597,818	-603,797	-609,835
Operating Costs	-1,079,321	-1,057,734	-1,047,157	-1,057,629	-1,068,205
Grants to Individuals (Bursaries)	-3,482	-3,412	-3,378	-3,412	-3,446
Marketing	-35,919	-35,201	-34,849	-35,197	-35,549
Professional and Financial Fees	-355,880	-324,752	-321,505	-324,720	-327,967
Travel/Vehicle Expenses	-162,791	-159,535	-157,939	-159,519	-161,114
Non-recurring Expenditure					
Capital Investment - Student Accommodation	-150,000	-200,000			
Equipment Replacement & Investment	-227,900	-118,960	-200,344		
Total Expenditure	-8,108,012	-7,297,174	-7,214,713	-7,084,513	-7,155,358
NET SURPLUS / (DEFICIT)	-1,798,892	-788,055	-466,849	-134,212	3,452
Total Funding Requirement					**3,184,556**

Employment costs %-age of Expenditure	71.61%	69.53%	69.17%	69.17%	69.17%
Employment costs %-age of Turnover	87.74%	74.54%	71.90%	70.50%	69.13%
Sensitivity Analysis - Impact on Outcome					
	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
5% increase in costs (exc Employee, Premises & non-recurring costs)	-1,880,762	-867,086	-545,090	-213,236	-76,362
5% decrease in income (exc SFC)	-1,971,994	-971,156	-661,887	-335,102	-203,465
2.5% increase in costs (exc Employee, Premises & non-recurring costs)	-1,839,827	-827,570	-505,969	-173,724	-36,455
2.5% decrease in income (exc SFC)	-1,885,443	-879,605	-564,368	-234,657	-100,007

Notes

1. Scottish Funding Council income will be maintained at current levels in years 1 and 2 whilst reviewing the activity for which FE credits are claimed and awaiting the outcome of the UHI review of how HE RAM and Micro-RAM is awarded. During the 5 year period we will be seeking to request increased allocation of FE credits for Shetland and an increased share for Shetland of UHI's HE module leadership and lecturing.
2. Gradual increases in Tuition Fees and curriculum-related grants and contracts are not expected until year 3. This is because of (1) the impact of restructuring on development in years 1 and 2; (2) the fact that new HE courses (e.g. MSc Marine Spatial Planning) will take time to go through UHI approval processes; (3) efforts to attract international students are dependent on resolving student accommodation challenges and improved marketing.
3. Research grants and contracts will take minimum of one year to improve even with energetic fundraising and tendering. Levels of income are anticipated to improve by £200k by year 3 and to be sustained at that level. This income is sensitive: loss of one grant can lead to significant loss of income and to date most grants and contracts have been short term. Our strategy will be to attract longer term grants to reduce pressure on cash flow.
4. Following reinstatement of Port Arthur House (conservatively estimated to be Yr 3 due to current unknowns on refurbishment project) income from student accommodation is forecast (including summer lets). Note that running costs associated with accommodation means this is likely only to achieve a break-even position.
5. Sale of meals is not anticipated to change significantly since the Gremista location has limited footfall other than students.
6. Consultancy income is anticipated to remain at similar levels as the baseline which was based on improved performance in 18/19 from previous years.
7. Management and Services Fees will be maintained at baseline levels in the first three years since current contracts would need to be renegotiated with increased allocations for Shetland for this to increase.

8. Increases in Other Income reflect a 1-year period for positioning the Institute to attract more grants (most funders have an average 9-month application-to-decision window) and anticipating an increase of £50k per year. This could increase or reduce depending on whether support can be secured, or capacity developed in-house, for a dedicated fundraiser / business development manager.
9. Employee costs are based on the 100% transfer of all staff into the new Institute by the merging employers (baseline) followed by (1) Yr 1 increase in costs due to restructuring taking place during the year, and the harmonisation costs for NAFC staff in line with NRPA pay and T&Cs (additional pay in lieu of holiday for lecturing staff who do not want NRPA holidays); (2) a reduction in Yr 2 to reflect the impact of restructuring and streamlining of sections, in which a target of £684k savings has been set, broadly in line with the savings anticipated in the SIC Full Business Case. Until restructuring has been concluded this is a target for cash-saving and there is not a head-count target at present.

10 – 13 and 15: Premises, operating costs, marketing and travel/vehicle costs are assumed to remain similar and rise with inflation.

14. Professional and financial fees are assumed to be higher in Yr1 due to restructuring (e.g. additional HR support) and to assume a steady pattern Yrs 2-5.
16. Capital investment will be required to bring Port Arthur House into operational use for student accommodation. Note this activity may be completed in Yr 1 but has been spread across two years to account for project delays that may occur since plans and estimates have not yet been commissioned.
17. Equipment replacement and investment is required to ensure continued curriculum delivery in key income-generating courses and to ensure Shetland remains feasible – at present several sections are operating with equipment that is not fit for purpose, for example, knitting machines for textiles courses. We must ensure we remain competitive using equipment that keeps pace with the technological advances in the real world of work our students will enter, particularly on sponsored courses such as Marine Cadetships. All investment will be assessed for its impact on the curriculum, and may include:
    - A simulator upgrade (or conversion to virtual reality assisted learning) for the nautical simulator facility – an upgrade could enable additional course development and maintain competitiveness;
    - Lathes and welders to support existing curriculum and new short courses;
    - 3D printers and carvers in construction and engineering;
    - Knitting machines, design computer, ribbers and linkers to support existing curriculum and increased short courses in creative textiles.

    Investment in further upgrades will be sought within grant applications. It should be noted that due to the financial challenges all the organisations have faced in recent years, there is no comprehensive current inventory of planned maintenance and renewals on essential equipment. It is important that during the first two years of the Institute a Asset Renewal and Replacement Plan is developed to ensure capital replacements are strategic and budgeted for over as long term as possible.
18. The total funding requirement shows the need for a tapering transition support package to enable a break-even position by year 5, with transition support in the first two years absolutely critical to the long term sustainability and success of the new Institute.

7.3 Merger related savings

The purpose of the merger is to improve the financial position of tertiary provision in Shetland from deficit to a positive financial position. The merging organisations are small and growth depends on sufficient delivery staff to make the step change in curriculum and research activity to become sustainable.

Savings that have been considered:

- Rationalising the estate: as explored in section 5, current demand and forecast growth of the Institute estate requires existing space. The saving that has been identified is to relinquish the Train Shetland building (saving £68k per annum)
- The greatest saving that could be made to premises costs in the future is by replacing existing energy and heating systems (including reducing carbon emissions). The capital investment required for such a project is prohibitive and loan finance would be a risk for the new organisation if savings do not cover repayments immediately. The decision at present is to seek grant funding when opportunities become available for non-repayable investment that can lead to immediate savings.
- Investments proposed in Port Arthur House and equipment replacement are considered necessary to attract more students, leading to the increased fee income identified in Yrs 3-5 which repays this investment by year 5.
- Employee costs are the most significant element of the Institute’s proposed budget. Every effort has been made to streamline costs whilst ensuring sufficient staff are available to deliver the curriculum and attract funding to grow activity. Strategic investments will be required by allocating more staff time to core functions of marketing and business development in order to secure the projected increase in grant income and student numbers.

7.4 Major risks related to the achievement of the base case

Risk	Likely	Impact	Possible cause	Mitigation	Review
Delayed restructuring	Low	Medium	Process of ER/VS slow; inadequate HR input; windows of opportunity for consultation and action provided by term times is limited.	Advance planning to ensure activity takes place as expected; Manage HR input closely and procure additional support if necessary.	SMT
Target savings from restructuring not achieved	Low	High	Retention of essential posts for delivery costs more than expected	Advance planning to ensure staff time is strategically allocated to support delivery and growth in the most cost-effective way.	SMT External HR advice
Further pay rises through NRPA without government uplift impacts on affordability	Low	High	Further national bargaining.	Collaborate with Regional Strategic Body, Colleges Scotland and Scottish Funding Council on managing impact	Audit Committee SMT
Loss of key skills impacts on new course development	Medium	High	Key personnel leave for new opportunities elsewhere.	Ensure all staff are aware of growth priorities and effort to secure investment; Effective and vigorous fundraising and business development activity to secure investment. Strategic collaboration with UHI network to secure new course approvals etc. Ensure Shetland Institute is a positive place to work and develop a career with a programme of culture change and seeking professional development opportunities via the UHI network.	SMT
Significant price rises impact on operational costs	High	Low to High	Wide range of variables and wide range of costs could be affected.	Ensure management of cash flow allows for strategic purchasing of e.g. reserve fuel; Ensure all sections manage operational costs efficiently and have planned responses to price rises or subsequent resource shortages.	Audit committee All section leaders
Drop in student numbers impacts on SFC income	Low	High	Demographic changes Loss of institution reputation e.g. in response to course closure Industry sponsorship reduces	Re-boot marketing and engagement to promote Institute opportunities; Make managed changes to the curriculum to ensure least impact on students; Ensure proactive industry engagement.	SMT
Failure to improve student accommodation options reduces potential for student fee increases	Medium	Medium	Capital works on Port Arthur House delayed or it remains unfit; Alternative solutions not found.	Make student accommodation solutions a high priority project; Collaborate with local public sector partners on shared solutions.	Business Development

Failure to attract grant income reduces potential for growth	Medium	High	Fundraising and business development not competitive; Increased competition for funds across all sectors; Track record and potential of Institute not sufficiently promoted.	Ensure dedicated staff time for fundraising and business development and invest in the skills development to ensure high quality submissions; Maintain a robust fundraising strategy with identified prospects, understanding of trends, positive engagement with funding bodies; Ensure the profile and positioning of the Institute reaches a wide UK audience.	Business Development
Continuing restrictions in EU funding (or lack of replacement) impacts on grant funding					
Change in government in 2021 adversely affects FE/HE funding	Low	Low	Even with a change in government, sudden changes to funding and ring-fencing unlikely without consultation.	Collaborate with Regional Strategic Body, Colleges Scotland and Scottish Funding Council on managing impact.	Audit committee SMT

7.5 Alternative scenarios that may arise and key economic and financial sensitivities

1. **Scottish Fisheries Training Centre Trust forced to wind up before vesting**
   If this occurred, redundancies of all NAFC staff would be made before they could be transferred to the new college; the assets (buildings owned by SFCT, all building contents, vehicles and vessels) would be managed by bankruptcy administrators; or if winding up occurs to avoid bankruptcy, assets would have to be transferred to another charity with similar aims approved by OSCR. The selected charity could be the new Institute if charitable status has been achieved before this eventuality. This eventuality would be catastrophic in terms of huge loss of course delivery capacity, research capacity, impact on students, staff and the community; these losses would be irrecoverable by the new Institute even if assets were transferred to it. There would be major impact on Shetland's reputation and the reputation of the new Institute. Without NAFC course delivery capacity, the new Institute would not be able to quickly replace the credit income, and the new Institute would not be viable.

2. **The new Institute is formed independently of Shetland Islands Council, SFCT remains a separate entity**
   Due to loss of credit-earning capacity and research capacity, it is unlikely an independent college could achieve sustainability within five years, unless credits were withdrawn from NAFC over time and delivered directly by the new college, although achieving this would be very challenging due to the more limited staff capacity of the new college, and lack of key resources to deliver engineering, nautical and aquaculture courses which currently have high student intakes.

3. **The National Islands Plan and the Islands Deal brings significant new opportunity for Shetland**
   The government and Scottish Government has committed to these programmes but as yet it is not clear about the scale of financial support for Shetland, the timescale for the support, and the potential for the new Institute in particular to be a beneficiary. All that can be advised in relation to this scenario is that the Shetland Institute will be a willing and able partner to any island incentives, and already has proposals drafted within the Islands Deal planning process.

4. **Significant industry changes in Shetland**
   Shetland has very few large employers. Loss of a major employer would have a significant impact on employment, apprenticeships and course demand. In such circumstances, Shetland is potentially more likely to see sudden depopulation of working age people, rather than an increase in unemployed people seeking to retrain for work. In response to this scenario, the new Institute will become an active partner with Skills Development Scotland PACE programmes and any other local responses.

7.6 The Transition Support Request

MMBC Chapter 7 – Outline of the Financial Business Case

To be drafted based on Shadow Board position.