

EXECUTIVE COUNCIL

RESTRICTED

Title of Report: Resource Rents and Economic Efficiency Test
Paper No: 156/09
Date: 23 July 2009
Report of: Director of Fisheries

1.0 Purpose

The two versions of the ExCo minutes for June '09 seek updates on the review of resource rents and the implementation of an economic efficiency test. This paper seeks to provide that update.

2.0 Recommendations

This paper is for information and does not set out any recommendations.

3.0 Summary of Financial Implications

<u>Operating Budget</u>	2009/10	2010/11	Full Year
	£	£	£
Consultancy	48300.00*		

* Sum to be funded from within existing budget.

4.0 Background

- 4.1** The ExCo minutes link resource rents and the economic efficiency test together. They are two separate issues and might be better dealt with separately, although this paper is perpetuating the link!
- 4.2** A review of resource rents is in the process of being commissioned. This is intended to evaluate the resource rents generated in the fishery and to review the mechanism by which access fees in the fishery are set, and whether there is a better model for setting access fees. ExCo considered this issue previously by way of ExCo papers 135/08 and 228/08. In considering this latter paper, ExCo agreed a process for setting the Terms of Reference and agreed that the project should proceed to tender. The project is a joint project between the industry (FIFCA) and FIG, and involves joint funding.

4.3 The Terms of Reference were finalised together with the Invitation to Tender (ITT) document. The ITT was released and advertised on 22 April with a deadline for return of tenders of 28 May 2009. This represents c. 3 months slippage on the original timetable, however it took some time to agree final terms of reference. A total of 6 bids were received by the deadline with a very international response.

4.4 A preferred consultant has been selected and contract negotiations are ongoing. Two significant issues arise in relation to timing and finance:

a) **Timing:** The preferred contractor indicates that they can undertake the work within 7 months compared to the project duration anticipated by FIG (6 months), but due to existing commitments wish to start the project on 1 November. It may be possible to pull that date forward a bit. Whilst this timing is later than ideal the impact is unlikely to be much different had any other contractor been chosen. ExCo paper 228/08 anticipated that the output of the project might be more relevant to 2011 than 2010, as the timetable was looking tight for implementing a new mechanism for setting fees for 2010, regardless of whether the original timetable had been held to. Whilst the preferred contractor should complete the project in May '10, any other contractor if available for an immediate start might deliver the final report around December. Assuming there are a number of implementation issues together with any element of consultation a 2010 start date would still be virtually impossible.

b) **Finance:** The project is to be jointly funded by FIG and FIFCA. The cost 'guestimate' was of the order of £50-60K. The preferred bid comes in at a total price of £96600, so £48300 for each of FIFCA and FIG. The cost includes an additional optional module which provides a computer programme/model to allow continuing assessment of fee structures and modification and updating of the fee scheme.

Both FIG and FIFCA have agreed the additional funding with FIG's share being funded from savings within the '08/09 fisheries budget.

4.5 Assuming the contract negotiations are successful, this project should proceed on this basis. If there are any insurmountable problems the bid ranked second in terms of preference would be activated.

Economic Efficiency Test:

4.6 The Economic Efficiency Test (EET) is one of a suite of 3 tests set out in the Fisheries Ordinance, the others being the tests of Effective Control and Active Involvement. The purpose of including these tests in the legislation was to give FIG some 'levers to pull' to influence fisheries development. However, in many respects they should be secondary drivers compared to the primary driver that is the transferable quota system. The transferability allows normal economic forces to drive efficiency and development. Initial trading in quota has started, so there is some evidence that this is working as anticipated.

4.7 The minutes of the June ExCo indicate that a report covering terms of reference are to be submitted to the July ExCo. The minute is headed “Fisheries Resource Rents – Economic Efficiency Test”. The draft ToR for the Resource Rents project were included with ExCo paper 228/08, and the final version of the ToR was circulated by email. In relation to the Economic Efficiency Test it was anticipated that what was required was for the test to be designed and implemented. It is not clear whether this satisfies the request for terms of reference set out in the ExCo minutes.

4.8 GMFIDC (Waugh), HoP (José) and DoF (Barton) met on 8 June to consider this issue. In general it was considered that there were likely to be 3 aspects to designing and implementing the EET:

- a) (i) Design: DoF may need to source some expertise either within FIG or externally to assist with the design of the EET. Some basic tests could be applied without much input but it depends on whether there are likely to be any elaborate financial tests which could be applied. In the first instance it might be as simple as turnover/gross profit/cost of sales/etc per unit of quota.
- (ii) There may well be arguments for keeping the test simple. Companies could adopt very different strategies:
 - Company A could retain and reinvest every penny it has in fishing/other assets, borrow to the hilt to fund its investment programme, and never declare a dividend.
 - Company B could charter vessels, have minimal investments in fixed assets and declare dividends at every opportunity.

The annual accounts for these two companies would look different. Which is better or more economically efficient? The question as to which is better is difficult to answer. In terms of economic efficiency and of the EET as conceived during the original policy discussion, it would be the company which has the greatest positive difference (or least negative difference) per unit of quota between ‘Turnover’ and ‘Cost of Sales’; so gross profit. If the test is limited to this aspect there may not be any need for an elaborate design phase. There may be arguments for extending the EET to other areas, equally there will be arguments for confining it to turnover/cost of sales/gross profit.

- b) Data: At present the Director of Fisheries receives annual accounts for all quota owning companies as part of the annual process of renewing names on ITQ eligibility registers. Whilst this provides a lot of information and probably more than most sectors it is likely to be insufficient to allow for the application of the EET. Application of the EET will have to be standardised on the basis of the quantity of quota held in each fishery (or catch entitlement or similar). Most companies hold quota in more than one fishery. In order for the EET to be applied it is likely to be essential that companies report basic financial data by fishery. At its most basic this will require

turnover or sales to be reported by fishery together with some apportionment of cost of sales across each fishery. Whilst the industry has yet to be consulted on this it should not be as onerous as it might seem. The production on any given day in any fishery should be known. The prices used for each species may be the average sales price for all fisheries unless companies have well developed tracking and recording systems. However, the main issue here is that regulations are likely to have to be introduced to ensure the information is reported by all companies in the required format.

- c) Application: In the discussion on 8 June, it was anticipated that if a moderately complex set of tests were developed and if annual accounting information was used, then there was likely to be a requirement to have someone with accounting experience and qualifications spend 2-3 months to apply the EET. This might be done every 2-3 years but would require some dedicated resource to achieve it.

If, however, the test is limited to the relatively simple aspects set out in a), and if data is forthcoming in a standard format as anticipated in b), then the application of the test could most likely be handled using existing resources (it might require some input from the Policy Unit or Treasury auditors etc).

4.9 The ExCo minute picks up on the issue of whether GMFIDC should be involved. The fishing industry has at least two concerns in this regard. Firstly, they are concerned that the GM of the development and business promotion function of FIG should become involved in what is primarily a regulatory issue. Secondly, they are concerned, and question the legality of GMFIDC being involved with a key section of the Fisheries Ordinance. Some of this is a bit cosmetic, the ExCo minute indicates that the Director of Fisheries should be able to co-opt or procure advice as necessary, which the industry accepts, although they still have the reservation about mixing development and regulation.

4.10 The point has been made previously about the timing issue in applying the EET. At present a full set of accounts are available for all companies for the year ending 31 December 2007. Some companies whose financial year ends in March or June, have submitted accounts for 2008. Most companies should be in a position to submit 2008 accounts shortly, although in some cases it is almost a year after the event that signed audited accounts are available. A couple of fisheries (Toothfish, *Loligo*) entered the quota system pre-2008. The majority of fisheries entered the quota system during 2008, so 2009 will reflect the first full year of operation for most quota fisheries for which accounts will be available in mid-late 2010. Most of the money is, of course, in the two fisheries which entered the quota system in 2006.

5.0 Conclusion and Action

5.1 The following action is proposed:

- a) Resource Rents project:
 - i) Negotiate contract with preferred contractor

- ii) Implement project; 1 November '09 commencement date
- iii) May 2010 contract conclusion and report delivery
- iv) Implement new procedures for 2011

b) Economic Efficiency test:

- i) Address any further requirements from ExCo arising as a result of this paper
- ii) Discuss implementation of regulations with AG to provide collection of data in a standard format
- iii) Inform/consult with FIFCA
- iv) Implement basic test at earliest opportunity (earlier for *Loligo* than other fisheries)
- v) Review process

6.0 Financial Implications

6.1 Resource Rents: As described in section 4.4b), costs are higher than anticipated but should be met within existing budgets.

7.0 Legal Implications

7.1 Economic Efficiency Test: Regulations on submission of data in the required format needs to be made in due course once the requirement is clearly defined. This may require consultation with the industry.

7.2 Resource Rents: Contract to be finalised, signed and monitored.

8.0 Human Resources Implications

8.1 None immediately. In the event that a more elaborate EET is required then some dedicated accountancy resource may be necessary.