

**UNITED KINGDOM HYDROGRAPHIC OFFICE
STRUCTURAL AND OWNERSHIP OPTIONS STUDY**

EXECUTIVE SUMMARY

November 2007

Laid in the library of the House – 6th December 2007

**Ministry of Defence
Directorate of Business Delivery
Main Building
Whitehall
London
SW1A 2HB**

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INTRODUCTION

The UK Hydrographic Office (UKHO) Structural and Ownership Options Study, commissioned by Defence Ministers in February 2007, sought to identify whether different arrangements for the structure and ownership of UKHO offer the possibility of greater value (in the widest sense) to the taxpayer. This report sets out the background, findings and conclusions of the study.

BACKGROUND

UKHO is an Executive Agency of the Ministry of Defence and has operated as a Trading Fund since 1996. The Government Trading Act 1990 requires the Agency to: earn revenue from sales to cover all costs year on year; provide a return on capital to the owning department, and achieve HM Treasury financial targets. Trading Fund arrangements aim to create accountability and responsiveness to customers and impose commercial disciplines to encourage greater efficiency and effectiveness¹. UKHO also operates a Government Owned Company, Admiralty Holdings Ltd, which acts as an additional vehicle for commercial activities.

The Quinquennial Review (QQR) of UKHO in 2001 recommended that the organisation should continue as a Trading Fund, but noted that there were future risks associated with changes in regulation, technology and the competitive environment. It identified a need to reconsider the options for UKHO's ownership and structure as the impact of these changes became clearer. Consequently, Defence Ministers commissioned the Structural and Ownership Options Study in February 2007 to assess whether changes were necessary to allow UKHO to address these challenges whilst continuing to provide value for the taxpayer.

¹ The Government Trading Act 1990

UKHO'S BUSINESS ACTIVITIES

The study considered the impact of potential changes on each of UKHO's three principal areas of activity. These are:

- Defence. UKHO provides navigational and specialist hydrographic products that are critical to Defence planning and operations. In collecting and incorporating hydrographic data from around the world, the UKHO also helps sustain bilateral relationships of wider benefit to the MOD. Sales to UK Government account for only 14% of UKHO's total revenue. MOD, in particular, benefits significantly from the economies of scale that result from UKHO's commercial operations. However the MOD is the largest single customer of the UKHO and association with the Royal Navy is integral to the UKHO and 'Admiralty' brand
- Meeting UK Treaty Obligations. UKHO fulfils the UK's International Maritime Organisation treaty obligations for Safety of Life at Sea (SOLAS) by producing charts and other products for all UK waters. UKHO also fulfils an international role producing charts for waters of Primary Responsibility (PR) (typically, overseas territories, former colonies and dependent territories where UK has had a historic role in maritime navigation). Revenue from products for UK and PR waters alone would not cover the costs of fulfilling treaty obligations. However, through supplying the international mariner with global navigational products, UKHO is able to finance the full cost of its operations.
- Commercial Activities. UKHO is the leading provider of charts and publications to the international mariner. The current market is driven by the obligation for international mariners to use official charts for navigation. UKHO paper products are used by approximately 70% of international shipping. The total market is valued at approximately £115m/year. UKHO earned £64.8m revenue in this market in 2005/06. Whilst UKHO currently has a very strong position in the traditional

paper market, its share of the emerging market for digital products is small.

CHALLENGES TO UKHO

The UKHO faces three key challenges:

The International Maritime Organisation (IMO) are seeking to mandate digital navigation (an announcement is anticipated around 2010). The UKHO already produces a digital chart series for UK waters fulfilling immediate UK obligations. However, IMO mandation will ultimately cause significant reductions in revenue from its international paper chart series. Additionally the Royal Navy has started conversion to digital navigation, and seeks full coverage by 2011. To support the MOD requirement for international digital charts and ensure financial viability, UKHO must rapidly develop a capability to produce new digital products and services for the global market. The shift in technology presents an opportunity for greater competition from other chart and systems providers. Therefore, if UKHO is to succeed in the digital market and secure digital revenues to replace those lost from declining paper chart sales, it needs to develop and enhance technical and commercial capabilities.

The regulatory environment presents further challenge to operating efficiently and effectively. Understanding of regulations on the reuse of public sector information are continuing to evolve as the Government explores the potential for such information to be used to support wider economic growth. The outcome of work in this area could have a significant impact on the ability of public sector bodies such as UKHO to protect and exploit commercially the intellectual property created.

Trading Fund status presents both freedoms and constraints. This concerns issues identified by the UKHO 2007 Strategic Plan. The Plan identified a range of constraints, including pay, reward, culture and decision-making constraints related to Trading Fund status, likely to affect the organisation's ability to deliver new products in a changing market. The Plan also identified a strategy to address the challenges facing the organisation.

The Plan highlighted the requirement for UKHO to adapt its business model, become more efficient and gain a number of new capabilities in digital production and services.

ASSESSMENT

This study conducted a detailed assessment of a number of options for UKHO's future structure. The study process included workshops and consultations with customers, suppliers and Government bodies. These identified the totality of UKHO's numerous relationships and transactions. Market assessment and legal advice assisted evaluation of the viability and risks of alternative ownership models, including non-financial benefits.

The process identified two potentially viable options for UKHO's future structure and ownership. These being:

- continuing as a Trading Fund operating with efficiencies identified in the strategic plan;
- transfer of a substantial element of UKHO into a wholly owned Service Company (ServiceCo) which would provide all data processing, production and support capabilities under contract to a smaller UKHO Trading Fund, which would itself retain essential Government functions.

Furthermore, Government Owned Company (GovCo) status for the whole of UKHO was considered but ruled out following consultation with stakeholders. Under current regulations, it would not sustain the range of relationships necessary to source data globally. Some would refuse to supply data, while many IMO signatories would not regard charts produced by a company as having official status.

Both viable options were modelled under two different sets of market and regulatory conditions:

- current conditions, with mandation of digital navigation creating a fall in demand for paper charts and

- changed market and regulatory conditions with greater competition, reduced market share and margins.

Modelling of these options and sensitivity analysis provided insights into the viability of options and informed the study conclusions.

STUDY CONCLUSIONS

The study concluded that a major benefit of the current Trading Fund model is its proven ability to sustain key Government to Government relationships for the exchange of data, and its provision of a clear Government identity for Admiralty brand charts, enabling them to be widely accepted by nations for use by their fleets as official charts.

Testing of potential market changes and freedoms under different ownership arrangements, including GovCo and ServiceCo, indicated that Trading Fund status provides the most appropriate ownership arrangement for the UKHO in the current regulatory environment.

While the creation of a Government Owned Service Company (ServiceCo) providing production and support services back to the UKHO might accelerate the process of change and offer greater pay freedom for specific skills, it would lack sufficient benefit to offset the cost, complexity and risks of creating, managing and operating the model.

If the regulatory environment changes, removing the requirement for mariners to use charts produced only by or on the authority of National Hydrographic Offices, it will be necessary to revisit these conclusions. Regulatory change could open up alternative sources of supply to satisfy some UK Government requirements and change the analysis of the feasibility of UKHO to operate as a private company. It would, however, introduce new competitive threats to UKHO and the value it generates for the MoD as Owner. Nevertheless, based on the feedback from IMO members and relevant stakeholders, we judge it unlikely that the regulatory environment will undergo sufficient change to allow UKHO to operate successfully and independently as a Government Owned Company in the medium to long term.

To remain viable in the longer term, to fulfil future Defence and SOLAS responsibilities and to remain an economic asset to MOD, UKHO must continue to improve efficiency in its processes, develop a competitive digital offering and use available skilled staff and commercial opportunities effectively.

If the margins and volumes available to the Trading Fund from the evolving digital market proved unsustainable, MOD would have to consider the options for central funding to discharge treaty obligations or in the extreme, transfer critical functions to Government departments. This could lead to UKHO becoming a drain on, rather than a contributor to, the UK Defence budget. Delivery of UKHO's new digital products is critical to its future success.

RECOMMENDATIONS

1. MOD should continue to own and operate UKHO as a Trading Fund, including the operation of Admiralty Holdings Ltd.
2. UKHO should seek to maintain its position as the leading hydrographic office internationally, and continue to focus on delivering future SOLAS and Defence requirements by developing appropriate digital products, services and processes.
3. UKHO management should continue to evaluate options to secure and develop the capabilities necessary to succeed in the digital market and preserve value for MOD as a matter of priority. Opportunities within the freedoms provided by Trading Fund status, including outsourcing, partnering and exploiting Admiralty Holdings Ltd, should be considered in conjunction with the Owner.
4. MOD should review the Governance and delegations for UKHO with a view to improving the efficiency and speed of decision-making.
5. UKHO should identify specific evidence on the need for pay and reward flexibilities to support the delivery of digital products and processes.
6. MOD and UKHO should jointly assess the merit of clarifying the Public Task for UKHO, as a means of reducing uncertainty in data licensing and pricing policy.

As a general point, MOD should consider reviewing the effectiveness of delegation in pay and reward below Senior Civil Service, drawing on evidence from all Trading Funds, and engage the Cabinet Office on a case by case basis in recruiting and retaining senior executives.