

## ADDENDUM TO SUBSIDY CONTROL PRINCIPLES ASSESSMENT: ZEBRA 2



### Executive Summary

Following receipt of the Report of the Subsidy Advice Unit dated 23 October 2024, the Council has reviewed its Assessment of its proposed subsidy to Plymouth Citybus Ltd. For the reasons detailed below, it is considered that the proposed subsidy is compatible with the Subsidy Control Act 2022, satisfying the subsidy control and energy and environmental principles; and as such it is appropriate for the Council to award the proposed grant, subject to compliance with relevant transparency and expiration of the relevant challenge period<sup>i</sup>.

### 1. Introduction

- 1.1 This document refers to the Council's detailed assessment of its proposed subsidy to Plymouth Citybus Ltd ("**PCL**"), against the subsidy control and energy and environmental principles which was submitted to the Competition and Markets Authority (Subsidy Advice Unit) on 6 September 2024 ("**the Assessment**"). The Subsidy Advice Unit issued its report ("**the SAU Report**") on 23 October 2024 (available at [Referral of the proposed subsidy to Plymouth Citybus Limited by Plymouth City Council - GOV.UK](#)). The Report was required under the Subsidy Control Act 2022 as the proposed subsidy exceeds £10 million, making it a Subsidy of Particular Interest and therefore subject to mandatory referral to the SAU.
- 1.2 Overall, the Report is positive; in particular it notes that 'the discussion of the expected emissions abatement [the principal policy objective of the Subsidy] and the calculation methodology are clear and well-articulated' and highlights part of the Assessment provides an example of 'good practice' nationally, noting 'the well-structured and detailed approach taken when conducting the balancing exercise in principle G is to be commended'. However, as one would expect, there are some suggestions for how the Assessment could possibly be improved but more importantly two areas which the Council should consider further.
- 1.3 All parts of the Report have been considered before reaching the conclusion in Section 5. Nevertheless, this Addendum focuses on the Council's response to the two key points for improvement raised in the Report, namely
  - (a) The Assessment should better evidence why the size of the Subsidy is the minimum necessary (Section 2 below); and
  - (b) The Assessment should more systematically consider how the design of the Subsidy will limit potential negative effects on competition and investment including discussion of aspects of subsidy design which are set out in the Statutory Guidance (e.g. monitoring, ringfencing, and clawback mechanisms), but which are not currently addressed (section 3 below).

### 2. Size of the Subsidy

- 2.1 Stage 3 of the Council's assessment considers the distortive impacts that the subsidy may have and how these have been kept as low as possible. In doing so the Assessment has considered how the subsidy is proportionate to the specific policy objective and limited to what is necessary to achieve it.
- 2.2 Fundamentally the Assessment demonstrates that without the Subsidy the policy objectives would not be met as there would be no investment in ZEBs by PCL in the absence of the Subsidy. This is evidenced by not only the PCL and parent company statement to that effect but also national policy (as set out in the National Bus Strategy (Chapter 5)) and the existence of the DfT ZEBRA 2 Fund itself.
- 2.3 No evidence is available to the Council which would indicate that the total subsidy is greater than the viability gap (i.e. the difference between costs and the level of borrowing that future operating profits would suggest the investment is capable of repaying whilst still offering a reasonable rate of return), including a contingency which will only be payable should the Project risks, as quantified in the quantified risk register for the Project, demonstrably materialise.
- 2.4 The Council's finance team have scrutinised and interrogated all the available information relating to the viability gap for the project, and are reasonably satisfied that the subsidy (with a requirement for evidence to support any need for the contingency) is limited to the identified base viability gap.
- 2.5 This assessment is based on the business case produced by the parent company of Plymouth Citybus to assess the commercial viability of investment in electric buses for PCL with and without subsidy, with the assumption being continued investment in diesel buses as the baseline scenario. With the Subsidy there is a positive investment case. In contrast when the subsidy is removed from the calculation, the payback period increases significantly, the net present value is negative, based on the latest discount factor, and the internal rate of return is below Go Ahead's weighted average cost of capital. In short, these non-subsidy figures do not represent an investable business case. Therefore, the subsidy is required in order to enable Plymouth Citybus to take a positive investment decision to proceed, notwithstanding the uncertainties of future income and costs to which the contingency is geared, as set out below.
- 2.6 To ensure that the Subsidy is the minimum necessary, it is built within both the DfT's ZEBRA 2 Fund, and the local Collaboration and Grant Agreement between the project partners, as a contingency sum. This means that the Subsidy to PCL is set at a maximum of £11,453,718 (excluding contingency only payable in additional specified circumstances). The additional £827,306 of potential Subsidy is contingent on certain, quantifiable, risks being met and is then only payable on a 50/50 proportional basis as and when quantified risks materialise<sup>ii</sup>, ensuring that, at all times, PCL only receives the minimum Subsidy necessary to allow the Project to be delivered and the policy objectives to be achieved.
- 2.7 All bus operators providing bus services within the Plymouth Enhanced Bus Partnership Area were afforded the opportunity to partner the Council's ZEBRA bid. However, only PCL chose to be involved in the bid, and hence it was neither necessary nor possible to undertake a competitive allocation process for the subsidy,

which would have allowed the identification of recipients who required the smallest subsidy to achieve the policy objective, thus enhancing this section of the Assessment. However, the Council are satisfied that the costs of the ZEBs and infrastructure, from which the value of the Subsidy has been derived, are reflective of the market costs of delivering the project, having been taken from quotes from external companies. This, alongside the Council's assessment of the Project's viability gap which demonstrates that the level of subsidy is necessary to secure the private sector investment<sup>iii</sup> is why the Council remain satisfied that the project costs are sound and subsequently so is the level of subsidy.

- 2.8 Furthermore, to ensure that the level of subsidy is no more than needed, the Council has previously ascertained that PCL has not received (nor is expected to receive) any other subsidy for a similar purpose to that of the Project. Moreover, there is a specific requirement in the Collaboration and Grant Agreement that both PCL and its parent company notify the Council in the event that they propose to apply for any third-party funding for the Project and that they both obtain the Council's approval prior to any such application (see clause 4.9.3 – 4.9.5).
- 2.6 Finally, regarding the SAUs comment that '*...nor is it explained how and to what extent DfT scrutinised the value for money of the ZEBRA 2 bid, and whether this could ensure that the Subsidy is set at the minimum level*' the Council are not privy to the DfT's ZEBRA 2 Fund bid evaluation processes. However, as set out in the Assessment, the Plymouth ZEBRA 2 project is one of only 25 nationally to secure funding, although it is reasonably assumed that substantially more than 25 bids were submitted given the number of expressions of interest to the Fund (58 in total), and is one of the few principally urban based programmes, noting the intended bias of the Fund to rural areas '£25 million will be initially reserved for proposals to introduce ZEBs in rural areas, recognising the additional challenges this may bring' ([Apply for zero emission bus funding \(ZEBRA 2\) - GOV.UK](#)). Therefore, the Plymouth ZEBRA 2 project has competitively secured funding from the DfT and hence is assumed to have been judged as compliant with all the requirements of the Fund and one of the best 25 projects, with regards to Value for Money, nationally.
- 2.7 The Council therefore remains satisfied that the Subsidy is proportionate to the specific policy objective, noting the forecast air quality and decarbonisation benefits being valued at more than £20 million over the lifetime of the buses<sup>iv</sup>, and limited to what it necessary to achieve it, by dint of the data on which the subsidy has been calculated and the retention of a contingency sum, only to be paid if and when necessary.

## 2 Design of the Subsidy

- 3.1 The Statutory Guidance<sup>v</sup> paragraphs 3.76 to 3.107 comments on the design of a subsidy. The Council recognises, that "*certain features and characteristics can make a subsidy more likely to have distortive impacts on competition or investment*".<sup>vi</sup> Further, consistent with the guidance the Council previously identified relevant features and put in place arrangements to reduce the potential distortive impacts on competition or investment of the grant; the purpose of such being to help ensure compliance with Subsidy Control Principle F. More particularly, these arrangements are set out in the legally binding Collaboration and Grant Agreement dated 3 September 2024, between

the Council and PCL as well with Cornwall Council (as the other part principal funder of the subsidy) and Go Ahead Group (the parent company of PCL).

- 3.2 A copy of the said agreement was considered as part of the original Assessment, forming Document 10 in the Supporting Evidence submitted to the SAU. However, the Council recognises that although the relevant obligations in effect address the points raised in the Report, they were not specifically mentioned in the Assessment. Consequently, pertinent points are now addressed below. In considering the Report, the Council has also reviewed its position regarding the various questions mentioned in the paragraphs of the Statutory Guidance noted above.
- 3.3 The Council has considered a range of alternative subsidy instruments to secure the key policy objective of decarbonisation.<sup>vii</sup> Given the opportunity presented by central government's ZEBRA 2 Fund to specifically address the national market failure for bus operators to acquire ZEBs – a problem particularly apparent in the Southwest <sup>viii</sup> and for Plymouth given its specific characteristics<sup>x</sup> - the Council remains satisfied that the only way to achieve the key policy objective of decarbonisation (in a timely manner and to the degree which the proposed grant will deliver, with the benefit of the Collaboration and Funding Agreement), is by means of the proposed subsidy by grant.
- 3.4 Turning from its consideration of what instrument should be used for the subsidy above, to questions as to whether the subsidy could be made available to other competitors and / or for them to compete to 'win' the subsidy award, the Council also refers to the evidence set out in the Assessment. In particular, the Council previously considered the breadth of beneficiaries and the selection process before determining to proceed with the application for the ZEBRA 2 grant with Plymouth Citybus Ltd.<sup>x</sup> . The effect of such is that the opportunity for the subsidy was not only shared with other potential bus operator beneficiaries, but open to any to express interest in partnering the Council in its application for DfT funding. Further, in deciding not to pursue the subsidy opportunity, the other operators supported PCL in its application.<sup>xi</sup> This position remains unaltered.
- 3.5 In respect to the size of the subsidy, the Collaboration and Grant Agreement includes a cap on the grant awardable to PCL, there being a specified maximum amount. Further, payment of any part of the grant is subject to detailed financial requirements (see for example clause 6 of the Agreement at pages 13 to 15 of 39). Furthermore, all the parties to the Agreement have agreed that the grant shall not be increased beyond the specified limit, any overspend in delivering the Project being the enforceable liability against PCL (see clause 4.14).
- 3.6 To further ensure that the level of the Subsidy is no more than needed, the Council has previously ascertained that PCL has not received (nor is expected to receive) any other subsidy for a similar purpose to that of the Project. Moreover, there is a specific requirement in the Agreement that both PCL and its parent company notify the Council in the event that they propose to apply for any third-party funding for the Project and that they both obtain the Council's approval prior to making any application (see clause 4.9.3 – 4.9.5). This ensures that the Council can review the level of the Subsidy if additional funds are potentially available.

- 3.7 As noted in the Statutory Guidance, time-limited and one-off subsidies are likely to lead to less distortion. The Collaboration and Grant Agreement for the Project provides relevant protection in this regard, the timespan over which the Subsidy is available being restricted under the terms of the Agreement. The grant is payable in instalments which are directly related to PCL's delivery of key milestones set out in the Agreement and which expire no later than 31 March 2026.
- 3.8 Consistent with paragraph 3.98 of the Statutory Guidance, the Council has considered how the Subsidy will affect the beneficiary's costs. As a one-off subsidy which supports the funding of an initial investment (i.e. the purchase of ZEBS and the set-up costs of the charging infrastructure), the Project is less distortive particularly given the minimal adverse impact on competition (as explained in detail in the Assessment)<sup>xii</sup>. Importantly, the subsidy will not cover or supplement PCL's 'day-to-day' costs, which would more likely adversely impact competition and investment in the UK and internationally.
- 3.9 Again, in line with the Statutory Guidance, the Collaboration and Grant Agreement for the Subsidy includes performance and monitoring requirements to secure the delivery of the decarbonisation policy objective. For example, not only is there a requirement for the parties to the agreement to collaborate to produce a final report which will assess the outcomes of the Project but there are milestones dates for central elements of the Project concerning the acquisition of the ZEBS, the use of the ZEBS on specific routes and the development of the infrastructure (failing which subsidy instalments will not be paid), but also requirements to discontinue use of older fleet buses and to make charging infrastructure available at cost to community groups. The Agreement includes provision for thorough Project Management and Operation (clause 5). This includes the appointment of individual project officers for each party and a Council Project Manager who will have day to day oversight of the Project and individual party compliance with the Agreement. In the (unlikely) event of any differences between the parties, the Agreement provides a mechanism for speedy dispute resolution (see clause 26) and sets out the circumstances where the grant may be 'clawed back' by the Council (e.g. material breach of the Agreement by PCB or the parent company as per clause 17 (Dispute Resolution) and the further actions to be taken in the event of early termination of the Agreement as per clause 18 (Consequences of Termination)).
- 3.10 Dealing with the question of ringfencing referred to in the Statutory Guidance at paragraph 3.102, the Collaboration and Grant Agreement includes specific provision limiting the use of the Subsidy (as well as the parent company's 'match funding') to the purposes of the Project. This will avoid any potential for the Subsidy to be used to cross subsidise other areas of PCL's (or indirectly, the parent company's) business.<sup>xiii</sup>
- 3.11 Finally, for the avoidance of doubt, it should be noted that that the Subsidy does not involve a situation giving rise to potential subsidy race referred to in the guidance at paragraph 3.107.

#### 4 Further considerations

- 4.1 In considering the appropriateness of the subsidy, in light of the CMA's advice, the Council have also taken due regard of the wider observations for how the

Assessment could be improved. All suggestions have been considered, the most pertinent issues in the Council's opinion being noted below.

- 4.2 Firstly, with regard to framing of the policy objectives to be met by the subsidy throughout the report the Council are clear that, as evidenced by the assessment of the Energy and Environmental Principle A the principal policy objective of the Project is to decarbonise public bus services and improve air quality – see Step 1, Section 1 (page 10) of the Assessment. The wider benefits, such as increased bus patronage, improved bus services and greater accessibility, are incidental to the core objective of the Project. The Council therefore very much welcome the positive feedback of the SAU on how the expected emissions abatement have been calculated and described.<sup>xiv</sup>
- 4.3 Mindful of the policy objectives, as clarified above, the Council acknowledges that directly linking the emission abatements, to the description of market failures would be an improvement and as such makes the following additional observations:
- In the case of the ZEBRA project, the market failure occurs because the business as usual decision of bus companies – including PCL – that is financially rational to them<sup>xv</sup> is not socially desirable as it leads to the investment in diesel and not zero emission buses<sup>xvi</sup>.
  - The market failure occurs because of the existence of positive externalities, specifically a positive contribution to the decarbonisation of Plymouth's transport system – in support of the City's net zero commitment – and the improvement in air quality with associated health benefits (Evidence). The Council (and Cornwall Council for the communities within the Rame) are therefore able to make society collectively better off by intervening to incentivise PCB to introduce ZEBs.<sup>xvii</sup>
  - Through doing so the Council are satisfied that the Subsidy also has an important equity objective through seeking to improve the health of some of Plymouth's most deprived communities (such as the communities of Devonport and Stonehouse, where health is typically worse than in less deprived communities in the city) through improved air quality; an objective which will be achieved due to these communities being served by the ZEBs enabled by the subsidy.
- 4.4 In response to the dual loan and subsidy funded incremental introduction suggested in the Report, the Council confirms such is not possible due to the DfT terms and conditions of the ZEBRA 2 fund which limit the funding the period.
- 4.5 With regards to the suggestion that the Assessment could have been improved by the assessment of more alternative approaches, separate to ZEBRA 2 funding, the Council remain satisfied, based on the operators established economic behaviour, as summarised in the Step 2 Conclusion within the Assessment, that the Project is only proceedable due to the success of the Council's bid to the ZEBRA 2 Fund and hence is constrained by what ZEBRA 2 can fund – i.e. either electric or hydrogen buses, with the rationale for investment in electric as opposed to hydrogen buses being clear (Summary of Subsidy Control Principle E Assessment\_).

4.6 Finally, with regard to the Assessment considering the potential impact of the Subsidy on the likelihood of new services being introduced, by a competitor, on the ZEB routes, the Council are satisfied that the impact is low, on the basis of the support of the bus operators on the Plymouth Enhanced Board for the project<sup>xviii</sup>.

## 5 Conclusion

5.1 Having considered the Report in its entirety, the Council is satisfied that the proposed grant to PCL is consistent with all the Subsidy Control Principles and Energy and Environment Principles within the Subsidy Control Act 2022.

5.2 The Subsidy will allow the introduction of 50 ZEBs on routes serving some of the most deprived communities of Plymouth and is the only immediate mechanism for doing so. This position properly reflects the existing market failure, the default position of PCL understandably being to invest in diesel vehicles, not ZEBs, despite the existence of the positive externalities associated with emission abatement quantified as having a value of more than £20 million over the lifetime of the buses, and this figure being conservative given that it excludes benefits to be derived from the cascade of the older PCB vehicles out of the fleet and greater bus patronage.

**Dated: 31 October 2024**

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<sup>i</sup> One calendar month from publication on subsidy database; Part 5A Competition Appeal Tribunal Rules 2015

<sup>ii</sup> Memorandum of Understanding Between DfT and PCC – Schedule 3 of the Collaboration and Grant Agreement which forms Document 10 of the Assessment

<sup>iii</sup> Section 1 of the Summary of Step 3 Assessment (pgs 42 – 43 of the Assessment)

<sup>iv</sup> Assessment of Energy and Environmental Principle A

<sup>v</sup> [UK Subsidy Control Regime: statutory guidance](#)

<sup>vi</sup> Para 3.76 [UK Subsidy Control Regime: statutory guidance](#)

<sup>vii</sup> Step 1 Subsidy Control Principle E Assessment

<sup>viii</sup> Step 1 – Section 7 of the Assessment

<sup>ix</sup> Step 1 Subsidy Control Principle A Assessment – section 4.2

<sup>x</sup> Step 3 – Section 6 of the Assessment

<sup>xi</sup> Letter of support from the Plymouth Enhanced Partnership Board (Document 12 of the supporting documents submitted with the Assessment)

<sup>xii</sup> Step 3 – Section 6 of the Assessment

<sup>xiii</sup> See for example clauses 4.3 (Funding), 4.9.5 (The Operator and the Parent Company) and 17.4 (Termination)

<sup>xiv</sup> Paragraph 1.6a of the Subsidy Advice Unit Report

<sup>xv</sup> Plymouth Citybus Subsidy Control Statement (Document 11 of the supporting documents submitted with the Assessment)

<sup>xvi</sup> Plymouth Citybus Corporate Plan (Document 9 of the supporting documents submitted with the Assessment)

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