The Proposed Tendering of Clyde and Hebrides Ferry Services: Problems and an Alternative Proposal

Final Submission to the Consultation Process

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This paper is submitted as part of the current consultation process organised by the Scottish Executive on Clyde and Hebrides Ferry Services, and which ends 16th March 2005.

I am grateful for past advice from many colleagues and interested parties on the issues discussed here, in particular Sandy Ferguson, Paul Bennett, Tony Prosser, Mark Furse, Jeanette Findlay, Drew Scott, participants at a seminar hosted by the Europa Institute, Edinburgh University March 11th 2005 and senior European Commission officials, Brussels 14th March 2005. I alone am responsible for any errors of commission or omission in this paper. It must also be emphasised that the views expressed here do not necessarily represent the views of any other individual, group, or institution.

The paper as presented to the Europa Institute, March 11th, will benefit from rewriting and further development in view of the valuable comments made there. However, given the imminent deadline for close of the above noted consultation, at this stage I am only changing the cover and contents pages; adding two Appendixes (4 and 5) on the Northern Isles and Gourock-Dunoon issues, and adding some final thoughts. This means that content and pagination of the original paper (pp. 3-44 inclusive) remains otherwise unchanged at this stage.

I have no objection to this submission being made public as part of this consultation process

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SUMMARY

The Scottish Executive is currently proposing to tender the Caledonian MacBrayne (CalMac) ferry network under EC State Aid legislation, replacing the current arrangement whereby state-owned CalMac is given an annual deficit subsidy to run these services.

It has been argued by the Executive that the present arrangement is unsustainable under EC state aid rules, and that point is agreed here.

It has been further argued by the Executive that competitive tendering is unavoidable under existing EC state aid legislation, and that point is disputed here.

It is also argued here that the proposed tendering arrangements have serious and fundamental flaws that could endanger the public interest, including the maintenance of essential services.

An alternative proposal, mindful of EC State aid rules, for the provision of Caledonian MacBraynes lifeline ferry service is put forward here. The proposal is based on actual experience at UK and wider levels and is suggested as an alternative to the competitive tendering of the CalMac network.

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*"**Bristow Muldoon** We note the tendering approach (for the CalMac network) that the Executive intends to take. Will you explain any other tendering approaches that the Executive considered and why you eventually decided on the tendering proposals that you have.*

***Sarah Boyack** Most recently we had the experience of the Northern Isles services tender. It was a useful exercise for the Executive to run through that process. The difference between the Northern Isles and the CalMac services is that there are an awful lot more CalMac services. We are well aware that the CalMac tender will be a more complex exercise."* (Transport and Environment Committee of the Scottish Parliament, June 2001)

"Reporters note that the Executive points to the Northern Isles Ferry contract as being an example of a similar process being undertaken without the need for an independent regulator. However, as has been noted in further submissions from Professor Neil Kay, this contract is not yet operational, so the regime has yet to be proven effective in practice." (Reporters to Transport and Environment Committee, Inquiry into Proposed Tendering of CalMac Services, September 2001)

"The Scottish Executive yesterday revealed that more than £13 million worth of additional subsidies have been ploughed into the ailing ferry services to the Northern Isles, as Nicol Stephen, the transport minister, announced the vital contract will be put back out to tender … the Executive has decided to retender the contract, more than three years *before it expires, because of 'financial difficulties' facing NorthLink."* (The Scotsman April 2004)[1]

1. Introduction

The budgetary and contractual difficulties encountered in the process of building the Holyrood Parliament may have been greater in absolute terms than those associated with the Northern Isles contract, but it could be argued that, in proportionate terms, the Northern Isles issue was potentially a much more serious affair. Ferry links to remote communities such as those associated with the Northern Isles and proposed CalMac tenders involve essential and lifelines services whose disruption can have serous consequences for the wellbeing of individuals, and indeed entire communities. However, to the best of my knowledge, despite the Fraser Inquiry[2], no-one's career or livelihood has been seriously threatened by the project to build the Holyrood Parliament. There was "no single villain of the piece" as Lord Fraser said in the press conference accompanying the publication of his report. Indeed, one net effect of the problems encountered in this

[1] Ferry Service has Received Large Subsidies, *The Scotsman* 9th April 2004.
[2] *The Holyrood Inquiry: A report by the Rt Hon Lord Fraser of Carmyllie QC*, Scottish Parliamentary Corporate Body, September 2004

project will have been to boost income and employment generation in one part of the Scottish economy, though an economist might raise some quibbles regarding public spending, opportunity cost, and income distribution.

The Fraser Inquiry revealed both systemic failures of governance and administration, which included major decisions being made on the Holyrood project by individuals and groups who did not have sufficient competence, capabilities and/or information to make soundly-based decisions on the technical and operational issues laid before them. The significance for the Northern Isles project is that many of these problems appear to have been replicated in that context. And the warning for the proposed tendering of the CalMac network is that from the earliest days when this issue first became public, the Executive has cited the Northern Isles contract as a model for, and forerunner of, the CalMac tender.

As far as the Northern Isles tender is concerned, various reasons have been cited as to why the tender broke down irrevocably, ranging from the Scottish Executive not having someone with clear responsibility for freight and livestock issues, the operator failing to heed expert advice, and unanticipated external events that affected the viability of the service.

It is important to note that none of the reasons cited for tender break down here constitute acceptable reasons for what must be seen as a major administrative failure. Firstly, it is the responsibility of the contracting agency to make sure that relevant structures, procedures and information are in place before the tender process starts. Secondly, if the winning bidder then encounters problems that are its fault, then it should either bear the these risks and costs itself, or if it withdraws (or is made to withdraw) there should be procedures in place to immediately instruct an operator of last resort to take over, as is common practice for other essential services. Thirdly, if there are ”material changes” such as unforeseen circumstances adversely affecting the viability of the tender that could not be foreseen by the contracting agency, then established mechanisms should be in place to resolve and deal with these unexpected events, and, if necessary, vary the agreed terms and conditions under which the tender operates.

None of this should be seen as surprising or controversial, and indeed the 2004 version of the Draft Invitation to Tender (hence DITT)[3] for the CalMac network identifies these three main issues and assigns responsibilities for these risks between the Executive and the tenderer appropriately. The problem is that it is one thing to recognise that these risks exist, quite another thing to set up appropriate procedures and mechanisms for dealing with them, and there is no evidence that this was done properly in the case of the Northern Isles tender. Had this been achieved, there should have been no need to retender the contract because the problems that emerged should either have been anticipated in advance, or managed appropriately as they emerged. If this is thought unreasonable, then I would cite the competitive tendering process in the UK essential services and utilities sectors (including rail, gas, electricity, and water industries) as

[3] Scottish Executive (2004) Clyde and Hebrides lifeline Ferry Services: Service Specification (Draft Invitation to Tender)

examples where there has been widespread implementation of competitive tendering without unplanned retendering becoming a major issue. If these sectors have been able to set up appropriate systems and regulatory controls that avoided this issue in such a wide variety of markets and technologies over several years, then there is absolutely no reason why the same could not and should not have been achieved in the case of the Northern Isles ferry tender.

As far as I know, despite the substantial numbers of contracts awarded under competitive tendering regimes in those sectors down the years, there is no parallel for an operator saying they could not continue with the contract under the present arrangement and the contract having to be put out to retender. The nearest example to it may be the forced retendering of Connex's South Eastern rail franchise in 2003. This itself was a highly controversial decision even though it was made by an independent regulator. It would be more difficult to envisage the Executive sacking any franchisee that was unwilling to go, even if merited, when politically it might be easier to just increase the subsidy. Which is one reason you distance the civil service from the operator by having an independent regulator and regulatory regime, to act both as source of competence and expertise and as a buffer between the operator and the civil service. .

There is little evidence that lessons learned from the Northern Isles case will help prevent similar, or even worse, problems emerging in the case of the proposed CalMac tender. If separate confirmation of this is required, then reference should be made to Paul Bennett's paper[4] and the written submissions made by Professor Tony Prosser[5], Captain Sandy Ferguson and myself to the Transport and Environment Committee of the Scottish Parliament June 2001[6]. Nearly four years later, the problems and issues we identified then are, for the most part, still observable in the current version of the proposed tendering of the CalMac network.

Indeed, there are features of the proposed CalMac tender that are potentially even more problematic than Northern Isles case. As the then Minister of Transport implied in 2001, the CalMac case is potentially much more complex than the Northern Isles tender. The Northern Isles tender involved only 3 (geographically proximate) routes and 5 vessels, the CalMac tender would involve a geographically dispersed network of 28 routes and 29 vessels. However, the winning bidder for the Northern Isles, Northlink, was also a joint venture between CalMac and the Royal Bank of Scotland. Since both of these companies were headquartered in Scotland they could expect to have a greater familiarity with local and national issues than a foreign company could reasonably be expected to possess, and both had deep pockets (or at least access to a deep pocket in the case of CalMac). The possibility of an Edinburgh-based civil service negotiating in the future with an overseas operator over the conduct of Clyde and Hebridean ferry services could raise further

[4] P. Bennett (2005) Competing for the island lifeline: European law, state aid and regional public services, Institute of Geography, University of Edinburgh, unpublished paper

[5] See particularly, A. Prosser (2005) *The Limits of Competition Law: Markets and Public Services*, Oxford, OUP for an excellent overview of current issues in this field.

[6] Transport and Environment Committee of the Scottish Parliament, Meeting 18, June 2001, Written Evidence TE 01/18/02, TE 01/18/03, TE 01/18/04, TE 01/18/05.

problems not seen in the Northern Isles case. And, again, it must be borne in mind that we are dealing with essential lifeline services whose disruption could cause severe hardship or even threaten the livelihood and the health of individuals and entire communities. Unlike other forms of public transport, there is often no practical substitute for CalMac ferry services as links to the outside world for those who are dependent on them.

The UK government has been highly critical of the potential adverse effects of the 1992 Maritime Cabotage Regulation in what is perceived to be the forced tendering of Scottish ferry services and has made these views clear in a communication to the Commission (see Appendix 2 here). The views of the UK government here would be echoed by many of those potentially affected by the present proposal to tender the CalMac network, and the views of the UK government may regarded as helpful in these regards. However, it is not known whether the Scottish Executive agrees with these views.

It is to possible problems with particular reference to the CalMac case that I wish to turn now, because I have argued for some years that the proposed CalMac tender has fundamental flaws that threaten the public interest and, at the very least, the Northern Isles case should serve as a early warning of possible systemic failures here.

If there could be said to be a single root source of the difficulties that are being faced in the context of the proposed CalMac tender, it is that the policy-makers responsible have framed the issue as one of responding to a new problem or constraint (here EC law on maritime cabotage) solvable using existing capabilities and solutions (notably in transport and procurement). This means the Executive's approach to the problem has been narrowly formulated and presented as a contractual (tendering) response to 1997 guidelines on maritime cabotage[7] which required tendering[8] but which have now been replaced by new (2004) guidelines on maritime cabotage[9] which does not specify that such a solution is required. Having set the agenda in this fashion, critics of the Executive's proposals have tended to focus on the issue whether or not tendering is required. While much of the criticism is well founded and must be made, it is inevitably limited in terms of potential policy-prescription in so far as such criticism understandably focuses on what is (and is not) required, rather than what is (or is not) desirable.

The first thing that should have been noted and emphasised by policymakers here is that EC law in this area should not be regarded and treated as just as an obstacle or barrier to be overcome. Instead the law is there for a purpose, and indeed that purpose is to serve the public interest. Unless this is understood, and the purpose of the relevant regulations understood and appreciated, any policy-formulation process is likely to be at best patchy and reactive.

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[7] European Commission (1997) Community guidelines on State aid to maritime transport (97/c 205/05)
[8] "for public service contracts to be consistent with the common market and not to constitute State aid, the Commission expects public tenders to be made"
[9] Commission communication C(2004) 43 - Community guidelines on State aid to maritime transport Official Journal C 013 , 17/01/2004 P. 0003 - 0012

Current competition and state aid competition policy and state aid legislation builds on principles established in the early days of what has now become the European Community. From the very start, a founding principle was to "promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion"[10].

In other words, its objective was to make its citizens better off. The Treaty also provided for a "common market" based on the free movement of goods, persons, services and capital. In that context, the principle of non-discrimination on grounds of nationality is central because a problem was that EC governments, left to their own devices, understandably wished to favour their own private and public enterprises.

In economic terms, all this is straightforward and owes much to earlier principles left behind by a man[11] buried in Canongate churchyard, not far from the Holyrood Parliament. The default assumption is that competition is good and monopoly distortions (which include discrimination of any kind, whether or not on grounds of nationality) are assumed to be bad. We teach that in basic Economics classes. Of course there are cases where the competitive ideal cannot always be attained, but these cases are recognized as well. An important principle in economics is that the purpose of competitive markets is not to enable firms to make a profit. It is to enable firms to seek profits, and in the process of competition, providing there is no discrimination in favour of one firm or group of firms, the consumer can be made better of. In short, the purpose of competitive markets is to benefit and protect the consumer, not to benefit or protect firms. Where rules are made with respect to firms' behaviour in competition policy, it is generally ultimately with the interests of the consumer in mind.

These points are worth emphasizing, since once we leave the simple world of the economic principles underlying such ideas as "free movement of goods, persons, services and capital" and enter the real world (and the legal frameworks intended to operationalise these principles), things inevitably get much messier, complex and confused. However, if we keep in mind that issues such as firms profits are means to an end and not an end in themselves, then some progress should be made – for example, the prime purpose of the EC's PSO (Public Service Obligation) is public service and protection of the consumer and taxpayers interests, not necessarily to make a profit for a firm. Notions such as "reasonable profit" and "non-discrimination" when they occur in such contexts are not there for their own sakes but as means to an end (though I speak as an economist, lawyers might disagree)

The second point is that while it would certainly be useful to have the Executive's legal advice in this area made public[12], too much should not be expected of such disclosure. While such openness would be welcome, it should be noted that such advice does not

[10] Article 2 of the Treaty of Rome, 1957.
[11] Adam Smith (1776) *The Wealth of Nations*, various publishers and editions.
[12] At the time of writing, the First Minister has reportedly noted that such disclosure may be possible.

take place in a vacuum and has to take account of not only the law but possible alternatives that have been identified for the lawyers and that are available for consideration. It is also likely to be crucially dependent on the questions asked. For example, if legal counsel is asked if there are any known ways of organising the operation of the Clyde and Hebridean ferries services without the need for tender, and without falling foul of EC State aid rules, the answer is quite likely to be "no". On the other hand, if legal counsel were asked if it was conceivable that ways could be found to organize the operation of that network without the need to tender, the answer might be much less certain, if an answer is possible at all.

2. Background to the present situation

Caledonian MacBrayne is a state-owned company, with sole shareholder Scottish Ministers. It operates subsidised 28 ferry routes, mostly in the north and west of Scotland. Between 1981 and 1992, three major policy decisions were taken over the future of the network as whole and its two busiest routes. Each of these decisions turned out to be highly controversial, and, perhaps coincidentally, each of these decisions has been the subject of considerable debate, and actual or proposed revision in recent weeks.

The first of these decisions in 1981 was the imposition of a frequency restriction on CalMacs's operations on the Gourock-Dunoon route to protect the business of the unsubsidized operator, Western Ferries, in the same market. The consequence of that restriction on was to create a protected market for the private operator such that now its volume of vehicle carrying is equal to about half of the volume carried by the entire CalMac network in the course of a year. The Minister of Transport announced in December 2004 that expressions of interest to run a second unsubsidised unrestricted ferry service in this market, this raising the possibility that major source of market distortion might finally be removed.

The second of these decisions was concluded in 1991 and resulted in CalMacs busiest route, Kyle Kyleakin, being replaced with the Skye Bridge. There is no need here to go over the controversy this exercise created, the decision to remove tolls on the bridge was taken by the Executive in December 2004.

The third decision was the EC's 1992 Maritime Cabotage Regulation. This decision was different from the other two in that not only did it affect the network as whole, the Executive was apparently unaware of this fact until some years later. It is this latter issue that will mostly concern us here.

The present Consultation Paper[13] for the proposed CalMac tendering process states:

> *"The Altmark case concerned the question of whether a payment constituted state aid. The requirements for public tendering of ferry services stem from the Maritime Cabotage Regulation. This regulation has a different Treaty base to the State aid*

[13] Scottish Executive (2004) *Clyde and Hebrides Ferry Services: Service Specification: a Consultation Paper*.

rules. The Altmark judgement therefore does not affect the issue of whether public tendering is required.

The Maritime Cabotage Regulation states that, where a Member State concludes public service contracts or imposes public service obligations, it shall do so on a non-discriminatory basis in respect of all Community shipowners. The Commission could not envisage any circumstances in which the requirements of this regulation could be satisfied in relation to the Clyde and Hebrides services without tendering. The Altmark judgement did not change its view on this issue in any way."[14]

The Altmark case[15] is discussed in this context in Bennett (2005)[16]. There are two points that need to be dealt before we can make a start on this issue. The document states:

"*The requirements for public tendering of ferry services stem from the Maritime Cabotage Regulation*".

However, the 1992 Regulation does not actually specify a requirement to tender, the Altmark judgment does not specify a requirement to tender, the 2004 guidelines does not specify a need to tender. Where the need to tender seems to come from was the 1997 guidelines written for the 1992 Regulation, and these earlier guidelines are now superseded by the 2004 guidelines. These new guidelines state:

"PUBLIC SERVICE OBLIGATIONS AND CONTRACTS

In the field of maritime cabotage, public service obligations (PSOs) may be imposed or public service contracts (PSCs) may be concluded for the services indicated in Article 4 of Regulation (EEC) No 3577/92. For those services, PSOs and PSCs as well as their compensation must fulfil the conditions of that provision and the Treaty rules and procedures governing State aid, as interpreted by the Court of Justice.

The Commission accepts that if an international transport service is necessary to meet imperative public transport needs, PSOs may be imposed or PSCs may be concluded, provided that any compensation is subject to the above-mentioned Treaty rules and procedures.

The duration of public service contracts should be limited to a reasonable and not overlong period, normally in the order of six years, since contracts for significantly longer periods could entail the danger of creating a (private) monopoly."[17]

The guidelines mention PSOs and PSC's as alternatives and do not mention PSO as necessarily contingent on need to tender. So there would not appear to be any automatic

[14] Ibid, Annex A.
[15] Case C-280/00 Altmark Trans GMBH (2003) ECR 1-7747
[16] Op cit.
[17] Official Journal C 013 , 17/01/2004 section 9.

need to tender. The fact that tender may be the most obvious method of dealing with this issue is a separate matter.

These points are important to bear in mind in assessing the current arguments put forward by Fergus Ewing MSP[18] and George Lyon MSP[19], the former arguing against tendering and the latter arguing that tender is inevitable. At this point I must add a personal note which is inevitable given my role as participant observer in these matters down the years. I have worked closely with both MSPs on ferry matters, as well as other MSPs (including especially Jim Mather MSP). Indeed in the case of George Lyon I and others are currently actively working with him in the issue of Gourock-Dunoon services where his input and advocacy has been important in helping achieve a major change of policy based on community views and sound economic arguments. The CalMac ferry network is crucial to his Argyll and Bute constituency and he is one of the most knowledgeable and involved of MSPs on this issue.

In his article George Lyon notes that in repeated visits to Brussels over the years the answer to the question of whether there was an alternative to tendering was "no". Then he notes

> *"In my last correspondence of February 2004 with Fotis Karamitsos, Director of Maritime Transport Commission, he stated in his reply to that question 'I can confirm that under regulation 3577/92 a tender procedure is needed with respect to all islands'.*
>
> *There was some hope that tendering could be avoided after … Altmark Unfortunately in reply to my question to the Director of Marine Transport at the EU Commission on whether this ruling applied to ferry services he stated ' the Altmark judgement could in no way affect the community rules on market access to maritime cabotage that is regulation 3577/92'".*
>
> *Whether we like it or not, it does appear that the EU Commission believes that tendering subsided ferry routes is the only way to comply with their rules."*

On the face of it, that does look very clear. It would seem from this that tendering is required under the 1992 regulation, and Altmark "in no way" affects the 1992 regulation. But in this case, as in so many others, timing and interpretation matter.

Firstly, right up to early 2004, as noted above, the 1997 guidelines interpreting the 1992 regulation specified "the Commission expects public tenders to be made" (bearing in mind that no mention of tenders was made in the 1992 regulation itself) . There is more evidence that that this would seem to be the guidelines that Karamitos is referring to when he mentions "between islands" since the 1997 regulation in this context refers to "island cabotage". But when the 2004 guidelines were issued, not only has all reference

[18] Fergus Ewing, Return to Tender, *Transport Quarterly, Holyrood Policy Journal* , February 2005, p.19.
[19] George Lyon, Save our Services, *Transport Quarterly, Holyrood Policy Journal* , February 2005, pp. 20-21

to tenders disappeared in those guidelines, so has all reference in this context to "island cabotage" or island-only services, this largely due to the indefatigable efforts of Professor Sir Neil McCormick (then MEP) in promoting to the Commission the interests of mainland-to-mainland ferry services on the CalMac network, such as Gourock-Dunoon. Therefore, it would seem to be the case that the Commission official is referring to guidelines which were in the process of being replaced by the new ones. And as we have noted, these new ones do not mention either tenders or islands in this context[20].

Secondly, as far as the remarks by the Director of Marine Transport are concerned, this reply from the Commission official is technically correct, Altmark does not "affect" the rules as embodied in the 1992 Regulation per se. However, that is not the whole story. Firstly, as we have noted, these (1992) rules do not specify need to tender, and in any event the fact that Altmark does not "affect" these rules does not negate the possibility that Altmark may be of assistance in helping interpret these rules (indeed it is difficult to believe that Altmark did not influence the framing of the new 2004 guidelines). The Commission official's comments here are a bit like saying that an expert's book on how to play football does not affect the rules of football. That may be strictly true, but the book may help you play the game, and in some cases may help advise how the rules might be changed for the better, if and when they come up for revision.

Altmark may be interpreted in a number of different ways since it is likely to have profound legal, political, social and economic consequences across the European Community. We will draw on Altmark in the limited sense of providing expert guidelines on State aid issues that may provide useful in formulating policy at national and sectoral level. For present purposes, we will also take the 1992 Maritime Cabotage Regulation as a given, and concentrate on how the CalMac case may be dealt with in this context. The further possibility that there may also be arguments for modifying this Regulation is acknowledged, but that is something that would have to be dealt with separately by policymakers and politicians if it is deemed to be necessary.

In short, while the statements given by the Commission officials may be taken as factually correct, at least around the time they were made[21], they do not justify the conclusion that this means that tender must be the only way that Community rules can be satisfied in this regard.

The other issue to be taken up considering the Executive's consultation paper is with respect to the statement above that:

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[20] In fact there is further evidence that Karamitsos is not referring to the new 2004 guidelines. Mr Lyon has previously kindly furnished me with a copy on this letter, and the fuller quote is "a tender procedure is needed with respect to all islands *with a traffic volume of more than 100,000 passengers per year*". Karamitis then refers to a communication from the Commission on this which came out in 2003 before the new 2004 guidelines were issued.

[21] There is question of timing here in that the new (2004) guidelines appeared in the official Journal 17th January and came in force on the day of publication. The letter to George Lyon from Karmamitsos is dated February 2004. Had Karamitos been referring to these new guidelines, he should not have been expected to make reference to either tenders or islands. The fact that he did would suggest he was still referring to the 1997 guidelines.

"The Commission could not envisage any circumstances in which the requirements of this regulation could be satisfied in relation to the Clyde and Hebrides services without tendering".

This does seem to be a strange way of pursuing this issue, both in terms of formulating policy and in regard to the apparent perception of the Commission's role with respect to national and sectoral policy. The Commission's role is complex, and indeed its powers have been criticised in terms of it acting as "police, prosecutor, judge and jury" in this context[22]. But both the Commission itself and national authorities (such as the UK) have emphasised in recent years the need to entrust the formulation and implementation of competition and regulatory policy to national agencies within member states. That is why specific regulatory principles such as RPI-x and safeguards such as operator of last resort are often the subject of much attention by policy-makers at UK level but not at EU level. It is not that the EC thinks these are unimportant *per se*, it is simply that these are not usually seen as its concern. It is for the national authorities to formulate and implement policy in these areas, bearing the public interest and EC law (including State aid) in mind.

For the Executive to ask the Commission if it could envisage circumstances in which the requirements of the maritime cabotage regulation could be satisfied without tendering is rather like a football manager asking the referee if it would be possible to play the game without using a 4-4-2 formation. Not only is the formulation of tactics not the referee's responsibility, if he or she did give advice on this, other teams would, quite reasonably cry foul. So I am not surprised the "Commission could not envisage" alternatives to tendering here. It could not, and should not. Tendering is the obvious default strategy in such cases, but that is not to say that it is necessarily the only one. However, it is for national agencies to come up with other ways of playing the game and still staying within the rules, it is not the referee's job to do this[23].

There is a subtler problem with the Executive saying the "Commission could not envisage" alternatives to tendering. This may give the impression that it was the responsibility of the Commission to come up with solutions here, and if alternatives had not been identified, then the blame lay with the Commission for the failure to identify alternatives. For the reasons discussed above, that would not necessarily be a fair representation of the situation.

The result of the Executive's narrow reading of the problem was that when the EC State aid rules issue was finally brought into the public domain in April 2000, the Executive couched it in terms of; "Failure to comply with Community rules could ultimately lead to 'infraction proceedings' by the Commission, which could involve, for example, the

[22] Rodger, B. J. and A. MacCulloch (2001) *Competition Law and Policy in the European Community and United Kingdom*, London, Cavendish, p.31

[23] Indeed, even if the Commission did see its role as formulating national policy and options in this area, it simply does not have the resources to deal with the complex and varied mix of problems that emerge at national and sectoral levels. See Rodger and McCuolloch *ibid*, p.31.

cessation of aid to these lifeline services. Non-compliance with the rules is not, therefore, an option"[24].

Since the CalMac ferry network (like most ferry services in Scotland) is heavily subsidised, the threat of cessation of aid implied a concomitant cessation of lifeline services, or at best just an expensive rump service in the case of these few routes that might conceivably survive. The public was presented with the position that there was no alternative to tender. There was neither the time nor the opportunity given for substantive debate over options given the timescale envisaged (one year to first tender). It is notable that the public comments by successive Ministers of Transport over this issue have been expressed in almost the same terms since April 2000, suggesting a fairly set view of what has to be done. This is characterized by the comments of one coalition MSP who voted with the Executive on their failed motion 8th December 2004; "every time, the answer from Brussels has always been… the Executive must comply by carrying out a tender…..failure to comply …. (leaves) the islands at risk of losing their lifeline ferry services"[25]. The title of the article was: "CalMac tender 'inevitable'".

There is no question that this argument was made sincerely and in good faith. But such arguments have been repeated in different forms for about five years whenever alternatives and arguments against tendering are produced. They have to be examined in terms of what would be the implications of instructing these lifeline services to cease immediately and indefinitely – which is what is implied here. There is a high degree of hardiness and self-sufficiency on the part of islanders and others dependent on ferry services, but even a few days of disrupted services (e.g. due to weather) can cause hardship. For many island communities there are no alternatives to ferry links except for possible emergency air services. If disruption was more prolonged (e.g. several days) then real problems of shortages of essentials, including food, and medical emergencies would begin to emerge. A more prolonged disruption across the network would lead to calls for a state of emergency being declared – much as if whole parts of the Alps had been cut off indefinitely because of avalanches. Only this would not be a natural disaster, it would be a man-made bureaucratic disaster. The media coverage (and not just in Europe) and the political fall out for Brussels would be considerable.

I say this not to belittle the seriousness of the situation, nor do I question that powers exist which could lead to such a situation. It is certainly the case that the Executive is in trouble because its predecessors in the Scottish Office seem at best to have been remiss when the 1992 regulation (which has caused all these problems) was passed without any apparent active involvement or attention from the UK and Scottish authorities. But that is not the same as creating a fear that there is a real and present risk that Brussels will require the complete cessation of lifeline ferry services to fragile communities that are highly or totally dependent on them. That would create a major economic, social and political disaster. If there is a risk of that, we should be far from even contemplating such a possibility if the Executive is dealing with these issues properly in consultation with Brussels. All the signs are that the Executive has been showing even more willingness

[24] Scottish Executive (2000) *Delivering Lifeline Ferry Services: a consultation paper*
[25] Dunoon Observer and Argyllshire Standard, 17th December 2004

and eagerness to conform to EC law and Brussels advice than is the case for many other EC governments such as the Spanish and French. So the risk of cessation of services should not be an issue. The "tender or risk everything" approach does not create a constructive backdrop for discussing and debating what is a crucial policy issue for whole swathes of the Highland and Islands and I hope we can move towards more constructive debate and a robust defence of the interests of fragile and vulnerable communities.

In this respect, it is important to note what the 1992 regulation and Altmark actually says:

The 1992 regulation states:

> ***Article 4***
> *1. A Member State may conclude public service contracts with or impose public service obligations as a condition for the provision of cabotage services, on shipping companies participating in regular services to, from and between islands.*
>
> *Whenever a Member State concludes public service contracts or imposes public service obligations, it shall do so on a non-discriminatory basis in respect of all Community shipowners. 2. In imposing public service obligations, Member States shall be limited to requirements concerning ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel.*
>
> *Where applicable, any compensation for public service obligations must be available to all Community shipowners*

The Altmark judgment is discussed in Bennett (2005) and Prosser (2005, pp.144-45). It set out four conditions that compensation must satisfy if it is to not constitute state aid:

> *(1) The recipient undertaking must actually have public service obligations to discharge and those obligations must be clearly defined.*
>
> *(2) The parameters on the basis of which the compensation is calculated must be established both in advance and in an objective and transparent manner.*
>
> *(3) The compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant receipts and a reasonable profit.*
>
> *(4) Where the undertaking is not chosen in a public procurement procedure, the level of compensation*

must be determined by a comparison with an analysis of the costs that a typical transport undertaking would incur (taking into account the receipts and a reasonable profit from discharging the obligations.)[26]

In the Altmark judgment, the court encouraged member states to select the public service operators through a public procurement procedure, in *the absence of which* the compensation shall have to be determined based not on the actual costs of the undertaking entrusted with the PSO, but on the cost of a "typical undertaking, well run and adequately provided with the means of (performing the public service)" – in other words, a normal, efficiently run company as benchmark. Again, the Court allows for the service provider to make a "reasonable profit".

3. The Executive and the proposed tender

It is relevant and indeed essential to consider how the Executive (and its predecessor, the Scottish Office) has handled this issue to date. The point is <u>not</u> to allocate blame or responsibility for problems that have emerged to any individual or group. In any case, even if that was the intention, the Fraser Inquiry shows how difficult it is to identify individual accountability and responsibility in such cases, which is in indeed one of the background problems. It is rather to identify what could be called a "pattern of behaviour" in other contexts, and the usefulness of such an exercise is to signpost what might be expected from the same sources in the future in this context.

Also, the discussion here should not be seen as pro or anti competitive tendering. Competitive tendering can be a very useful device in the right circumstances and Bennett (2005)[27] gives an excellent and balanced overview of the theoretical and empirical issues involved in competitive tendering. The question is whether this is an appropriate approach in this particular context, in particular the implications of the Executive's proposal.

There are a number of features and issues that could be identified here, but some important ones are;

- The 1992 Maritime Cabotage Regulation was framed without any apparent involvement or representation of UK / Scottish interests and to the extent it did respond to special interests and consideration (e.g. derogations) it tended to reflect lobbying of Mediterranean nations.
- The fact that the 1992 Regulation had implications for Scottish ferry services went apparently unnoticed by the Scottish Office/ Executive for an unknown number of years.
- When the announcement[28] of the alleged need to tender was made in Spring 2000, it was stated that "the Executive are aiming to have the first tender in

[26] See Prosser (2005) op cit pp.144-45.
[27] Op cit
[28] *Delivering lifeline Ferry Services*, Scottish Executive 2000.

place by Spring 2001" in other words in about 12 months. That was nearly five years ago and there is no reason to believe we are any closer to putting that first tender in place now than we were in Spring 2000.

- In the April 2000 consultation paper, the Executive stated: "Ministers believe there could be advantage in reviewing the legislation in the longer term. Whilst it would not, in any case, be possible to have new provisions in place for the first tender exercise, for subsequent exercises new legislation might be introduced to set the framework". But this is putting the cart before the horse, if legislation could be required to protect the public interest, it should be in place before the first tender, not after it. You do not use lifeline services as a learning opportunity for subsequent "review".
- In their press release on this issue, the Executive stated: "The Commission could not envisage any circumstances in which the requirements of this regulation could be satisfied in relation to the Clyde and Hebrides services without tendering."[29] But as noted above, it is not the responsibility of the Commission to envisage such circumstances, it is the responsibility of the Executive.
- The Northlink retendering issue may be cited as consistent with the pattern of behaviour being established here[30]. It should not have had to happen had there been a properly constituted regulatory regime in place.
- After at least five years the Executive has failed to resolve the crucial issue of Operator of Last Resort (what happens if the incumbent operator defaults, withdraws or is made to withdraw in the middle of a tender. This issue is absolutely critical in the provision of essential services that must be provided on a continuing (e.g. daily) basis, and clear provision has been made in the supply of other essential services of this nature in the UK such as water, gas, and electricity to be able to instruct another operator to step in immediately should this necessary. The Operator of Last Resort provision is rather like the "hit ball twice and you are out" rule in cricket; you usually do not notice it, and it only affects behaviour if it is not there in the first place, which is why you have it. The Executive still not been able to resolve this issue[31] at this point and the issue and detailed discussion of it is carried out here in Appendix 3.
- In 2001, nine months after the original intention to tender the CalMac network was made public and after a public consultation exercise which included plans to break up the CalMac network into a series of tenders, the Executive issued a press release, which stated "on the packages of (CalMac) routes to be tendered, the Executive's strong preference, based on the results of consultation, is to tender the network as a whole." But you do not "base" such a complex technical and administrative outcome just on the results of a

[29] *Executive confirms need to tender ferry services*, Scottish Executive News Release, 25th June 2004,
[30] *Boyack Plots Course for future of Highlands and Islands Ferry Services*, Scottish Executive News Release, 23rd January 2001.
[31] The Executive have now avoided dealing with this issue by making it the responsibility of VesCo to solve (See DITT, sec 1.3.6). For the reasons outlined in Appendix 3, there is no reason to believe that VesCo will be any more able to find satisfactory solution to this issue that the Executive has at this point

consultation exercise with users, you come to it with a coherent strategic plan, fleshing out the regulatory and statutory frameworks to make your chosen solution work. In this context you have public consultation throughout this process as an input, not as a "base". Ironically, this was the right decision (the Executive goes on in the same press release to also justify the decision on technical and economic grounds) but taken for the wrong reasons.

- There is also the case of the issue which is not an issue; that is, little or no consideration has been given this by the Executive, at least in public. The issue is that CalMac presently has assigned social and public interest objectives and responsibilities consistent with its background and history. Here regulation for the public interest has been self-regulation. But now CalMac is being expected to compete on a level playing field for the network with commercial operators and it will be expected that commercial objectives will have to donate in CalMac if it is expected to win the tender. As things stand, it would seem that CalMac's (self)-regulatory function will disappear with no obvious mechanism to replace it.
- The Executive announced in December that it would be inviting expressions of interest for a commercial operator to run without subsidy on the Calmac Gourock-Dunoon route. Following some public controversy, particularly with which the way the intention was announced and a threat of strike action from the RMT union, the Executive has subsequently announced that it is putting this issue on hold until there have been further discussions with the Commission.

If there could be said to be a pattern of behaviour here, it is that the Scottish Office/ Executive's actions in this context have been driven by events and third parties rather by the administration taking control and leading the policy-formulation process itself. Further, its actions in these areas show that, with depressing consistency, the Executive apparently lacked either the inclination or the ability to identify and choose the right course of action.

The issue to be faced now is that these problems are likely to be only minor inconveniences in comparison to the problems the Executive are likely to encounter if they go ahead with their plans to tender the CalMac network. To put it at its baldest, they are planning to put a state-owned industry out to tender in a single chunk with no dedicated statutory framework, no properly formulated regulatory structures and processes in place, not even the minimum safeguard of specifying how the crucial and basic question of Operator of Last Resort will be settled. This is rather like selling a car knowing the brakes are faulty and the seatbelts do not work properly. It would be irresponsible to say the least to sell a car in such a condition, and I have no hesitation in saying that it would be irresponsible to say the least if the Executive went along with its plans for tendering the CalMac network on the basis outlined here, especially since I and other have been pointing out many of these flaws for at least four years, including in evidence to the Transport Committee of the Scottish Parliament and in submissions to consultations on the issue held by the Executive.

In the next section I will point out some of the potential problems with the proposed tender of CalMac services.

4, Some problems with the proposed tender arrangements

Perhaps the easiest way to approach the potential problems raised by the Executive's prose tendering of CalMac's services is to ask the simple question; if the Executive's solution is such a good idea, why did the UK government not solve the problems of the governance and regulation of their formerly nationalized industries in much the same way, especially in the fields of essential services and transport? After all, the Executive's proposed system of simply allocating the rights to operate the service by having an open system of tender bidding on a least-cost 6-yearly cycle would seem to avoid the need for legislation and regulatory controls, and, if nothing else, would seem have the merit of simplicity.

The answers to why such a proposed regime would not provide adequate safeguards for the public interest are contained in a body of work, both theoretical and empirical, that has emerged in recent years. In economics, the research on auctions and bidding systems has been mostly conducted within work on the economics of information, transaction cost economics, principal-agent theory, and game theory perspectives[32]. The issues that have emerged in these perspectives include asymmetric information (where one party has access to information not available to the other party), opportunism (self-interest seeking with guile), hold up problems (threatening to walk away from the contract unless it is renegotiated to the contracting party's advantage), and moral hazard and adverse selection problems (the latter two problems are well known in insurance markets but are also issues in contract theory and auction design).

Much of the regulatory controls and safeguards that have been put in place over two decades and more in the UK context are, at least in part, designed to deal with potential problems of opportunistic behaviour on the part of economic actors (the contracting agencies, as well as the contractors) and make sure that the pursuit of private self-interest on the part of these actors is aligned as closely as possible to the pursuit and maintenance of the public interest, both ex ante and ex post the award of the tender.

If there is one lesson that can be learned for the design of regulatory regimes from all this research and actual experience, it is that a good gamekeeper has to think like a poacher. That is, if the controls and safeguards preventing anti-competitive opportunistic behaviour are lax or not in place, some or all actors in the process are liable to take advantage of this weakness. This is consistent with fundamental principles of economics as set out by the man in Canongate Kirkyard.

The regime proposed for the CalMac tender is highly vulnerable to such abuse, and it would be straightforward for other gamekeepers (regulators) from UK public services

[32] The literatures here are both technical and voluminous, but most of the topics and problems of relevance here are covered in O. E. Williamson (1985) *The Economic Institutions of Capitalism*, NY, Free Press and P. Milgrom and J. Roberts (1992) *Economics, Organization and Management*, New Jersey, Prentice hall

and utilities to point out the large holes in the fence here that an opportunistically inclined operator might slip through here. But, ignoring for the moment the crucial questions of who is now going to take responsibility for the strategic development of the industry and innovation, it would be sufficient here to point out that the potential problems created by lax or inadequate protection of the public interest here fall into two main categories, *ex ante* the award of the tender, and *ex post* the award of the tender.

The main problems *ex ante* the award of tender fall into three main categories, the possibilities of the "winners curse" (elements of which may have been in play in the case of the Northern Isles contract), adverse selection, and the peculiar status of the incumbent CalMac. The "winners curse" is commonly observed (or at least cited) in the case of merger and acquisition bidding activity. It can be simply explained as follows: parties interested in bidding for control of an asset may differ in the information they have available to them as to the true underlying value of the asset or the venture in question. Incomplete information regarding the true value of the asset or venture may encourage some parties to take an overly-optimistic view of the underlying value of the asset or the venture, and likewise other selective and biased exposure may encourage other parties to take an overly-pessimistic view of its true underlying value. Even if optimism cancels out pessimism on average for the group of potential bidders as a whole, clearly the overly-optimistic bidders are likely to bid the highest price (or in this case, the lowest subsidy) so the winning bidder is likely to be one that has an unrealistically optimistic view of the prospects of the asset or venture.

The winners curse is normally just a problem for the winning bidder (and in the case of acquisition, the shareholders of the winning firm). In the case of tenders, a well designed protective regime should enable the agency to metaphorically shrug its shoulders and say that the tenderer's problems are its to deal with. It <u>does</u> become a problem when the tenderer claims to be able to blame the agency awarding the tender for inadequate or misleading information (the Northern Isles contract) and it also becomes a problem if there is no obvious replacement operator (an Operator of Last Resort) that can be immediately called on to step into the breach if the tender says it cannot continue with the contract on the present basis (the Northern Isles case again). In those circumstances, what was an *ex ante* problem of incomplete information creating a winners curse can become an *ex post* problem for effective contract administration.

The second main problem of adverse selection may be created to the extent opportunistic operators are attracted to the auction since they perceive profit opportunities for strategic game playing post-tender afforded by what they would see as a lax regulatory regime. In recent years the absence of adequate regulatory oversight have been at the heart of what many have identified as market failures in command economies in transition and developing countries. If this comparison seems fanciful or strained, then I would point out that I had to consult literatures on tender and contracting failures in Third World

countries before I found persistent patterns of regulatory or administrative failures that appeared to be of the same order as the Northern Isles case[33].

A further *ex ante* problem relates to the peculiar position of the incumbent CalMac. In repeated auctions where the incumbent loses the right to the tender, it (and its rivals) know that if it loses the tender this time it may come back next time at the normal recontracting stage. But on the assumption that its presence on the Northern Isles is at an end, if CalMac loses its tender (and its network) just once, then it would no longer have any obvious raison d'etre and would presumably be wound up. Bidders would know this, and know that bidding unrealistically low just once would be likely to have the dual advantage of permanently eliminating both the incumbent and the operator that the Executive could most obviously be able to designate and instruct as the Operator of Last Resort. Once the new operator takes over the tender and the network, the elimination of CalMac means that the field would now be opened up for the new incumbent to engage in a wide variety of opportunistic strategies, including contract renegotiation, all this aided by incomplete information and regulatory weakness on the part of the Executive.

This leads us to the *ex post* problems that this weak regime would entail. There are an abundance of what would be described as principal-agent problems following the separation of ownership and control here. For example, you are less likely to look after a asset properly if you rent or lease it (whether a car or a house), especially on short term basis and this 6-year contract would be a short term basis here. More generally, it would be naïve to believe that firms would pursue anything other that their own narrow self-interest and would not take full advantage of any structural and procedural weaknesses in the set up, that is after all, why authorities over the world commit so much effort and resources to prevent and rectify such behaviour.

But the most serious *ex post* problem is what has been described as the hold up problem in principal-agent and transaction cost literatures. To consider how this might emerge, we can start with the Northern Isles situation. There is no evidence that there was any adverse selection or moral hazard problems here, and that the two respectable companies that formed the Northlink joint venture were anything other than honest and truthful in their dealings with the Executive. But suppose the process throws up an opportunistic tenderer who is prepared to misrepresent and abuse its position, threatening to walk away from the contract unless it is renegotiated to its satisfaction. How will the Executive anticipate that abuse, how will it prove that the operator is abusing its position, what will it do if the company does walk away and the Executive has no competent and qualified Operator of Last Resort that could be instructed to take over immediately? The Executive has not the inhouse competences for satisfactory policing and monitoring of such contracts, no credible option for immediately replacing an operator if necessary, and

[33] See, for example, Jerome, A. (2004) Infrastructure Privatization and liberalization in Africa: the Quest for the Holy Grail or coup de grace? 4th Mediterranean Seminar on International Development , Mallorca, Spain http://www.uib.es/depart/deaweb/smed/pdf/jerome.pdf, on weaknesses of regulatory frameworks and contractual problems , especially section 4.1 and table 4.3 on reasons for contract breakdown between African governments and contractors in water supplies.

it has already demonstrated in the Northern Isles case that legal remedies are not an option it would readily consider.

If such a scenario is easy to imagine in the Northern Isles case with a simpler contract and two domestic companies in the tender, it is likely to hold even more strongly in the CalMac case. The lesson from regulatory history is that if operators can find ways to pursue their self-interest because the controls and sanctions have been poorly designed or are ineffective, they will. And in the case of the proposed CalMac tender, the risks to the public interest of that point being proven is not one that responsible authorities should take or be allowed to take.

5. An alternative proposal

It is proposed here that the structures and processes for the organization of Clyde and Hebridean ferry services as presently provided by CalMac could be set up in such a way as to be consistent with EU law in this context without invoking the need to tender. The reasonableness of the proposal will tested against Altmark's conditions.

The first step would be to ring fence, and separately account for, the act of leasing of CalMacs vessels from CalMac's operational activities. In the DITT, this is proposed to be done through setting up a separate vessel owning company (VesCo) to lease these vessels to OpsCo, (the tenderer). Whether or not such major reorganisation would still be necessary, or whether it could now be left to setting up an appropriate accounting mechanism for internal transfer and leasing of assets within Calmac, we can leave as an open question at the moment. But it will be still important to have such ringfencing, since while EC State aid rules recognise the possibility of PSO and subsidy on a route by route basis, the provision of assets such as vessels must be done on a commercial basis. In short, it is the operations which can be subsidised, not the leasing or purchase of vessels. So it is important to have open and transparent accounting mechanisms in place to demonstrate that there is no disguised or hidden subsidies to CalMac taking place through the leasing process.

The second step would be set out CalMac's obligations on a route by route basis expressed in terms of the fares and service specifications in similar fashion to that set out in DITT (eg maximum fare and minimum service levels). These would be the basis for justifying PSOs on a route by route basis.

The third step would be to appoint an independent Regulator for Clyde and Hebridean ferry services to protect and advance the interests of users, ensure that ferry services are delivered effectively, regulate prices and services, make sure that essential services are secure, that CalMac is meeting its social and environmental responsibilities, and that the company is complying with EU and UK competition and State aid legislation.

Since the Regulator would be largely taking over roles that were historically the responsibility of CalMac, but which now, if only by default, would be seen to go to the Scottish Executive, the cost implications of setting up and running the new office could be seen as largely one of reassigning budgets to follow the reassignment of

responsibilities. It might funded on a cost-neutral basis by transfer of budget from Transport Division of the Scottish Executive, in allocative terms such redistribution might also constitute a Pareto-improvement. Location of the operator at a port near some CalMac services (e.g. Oban) would be highly desirable, both in terms of distancing the regulator from the Executive and in keeping him or her informed of technical and operational issues of CalMac services as well as awareness of users, including councils, interests[34]. Even if some additional resourcing is required, it would be a small price to pay if it were to help avoid or deal with contractual problems such as the Northern Isles case, or worse.

As Prosser (2005) points out, there is no one model for how a regulator or regulatory agency operates in the UK, or its terms of reference. However, the case of CalMac is interesting because the various elements that are of importance here can be seen in a variety of regulated industries at UK level, e.g. the need to maintain continuous flow of essential or lifeline services (eg gas/electricity and OfGem), regulating prices and services for a heavily subsidised transport service (rail and SRA/ORR) and regulating an industry where there is one dominant supplier (e.g. postal services and Postcomm). In each case there are lessons to be learned that could be useful in framing the role and responsibilities of the regulator here. If nothing else, the very variety of issues requiring regulation that the CalMac case raises demonstrates the need for an independent regulator in this industry.

One possibility that could be also explored is whether the Northern Isles service could come under the office of this Regulator at some point. In the interim, if retendering does go ahead with the Northern Isles service, it could be useful to have CalMac designated as Operator of Last Resort for that network. This will at least deal with one of the possible regulatory issues that remain with submitting this service to competitive tender.

The fourth step would be to have the Auditor General to set up procedures both now and on a regular basis in the future to assist the Regulator, to make sure that CalMac is fulfilling its designated responsibilities, with specific reference to EC State aid requirements. The auditing, both now and in the future should bear in mind the point made by Bennett: "if one or more routes were potentially profitable, then a public subsidy could act to protect the shipping company by creating a barrier to entry to potential competitors. This rationale, if it were ever invoked, would be the most unacceptable under European state aid legislation"[35]. If independent audit does reveal that there may be such profitable routes in the CalMac route, then EC State aid legislation suggest that no barriers should be put in the way of commercial entry and operations on such routes. It is appreciated this might conflict with pursuit of network externalities by CalMac, and it is not a straightforward question. However, it should be emphasised that if the consequence of keeping most of the network together in a stable and sustaineble organisational framework is recognising the possibility of opening up a route or routes to

[34] As long as dangers of regulatory capture are guarded against.
[35] Bennet, op cit, p.6.

outside competition, then this may be essential for achieving that goal. Open, transparent and independent auditing would be an essential part of this process[36].

The fifth step would be to have CalMac instructed to pursue its operations on a least cost, non-profit basis with 100% clawback of any profit made. If this seems unusual or unreasonable, in principle it is not so different from the way that CalMac is expected to operate at the moment where it gets a deficit subsidy on an annual basis from the Executive for losses incurred in the course of its operations. While clearly it will be important to consider the form of corporate governance that CalMac would operate under in this new arrangement (e.g. not-for-profit organisation?), this might be less important than might be thought at first sight since the Commission is less concerned with the form of governance (e.g. public versus private organisations) and more with the economic consequences of that organisation's activities and behaviour in specified markets.
It might also be helpful in a state aids context to restrict CalMac's sphere of operation to its Clyde and Hebridean services only, at least for the foreseeable future. The reason for this is that one concern in the field of state aids is that having a protected base in one market may enable such an operator to take unfair advantage of this in competing against other operators in other markets. Rightly or wrongly, this is a complaint being made currently by commercial operators in the context of the terms and conditions under discussion for the renewal of the BBC's charter. Also, in this context, such unfair advantage on the part of CalMac was a reportedly a complaint made informally by unsuccessful bidders for the Northern Isles contract, which CalMac won as part of the Northlink joint venture. While some of this might be put down just to sour grapes, and while the measures suggested elsewhere in this note should prevent CalMac from taking unfair advantage of its position in the Clyde and Hebridean network, such a measure would help reassure the Commission that there was no likelihood of spillover effects from this public service area to other commercial activities or to other public service contracts

The roles and responsibilities of the operator, the regulator, auditing agencies and the Executive, and relationships between these various bodies can be established, drawing on the experience and lessons learned from regulation of public services in the UK in recent years. All of this should be couched in an appropriate legislative framework, and, as with the previous point, should draw on the experience and lessons learned from regulation of public services in the UK in recent years.

Would such an arrangement potentially be consistent with EC State aid law and in particular, the 1992 Maritime Cabotage regulation? As a first approach to this we can use the four Altmark conditions as litmus tests as to whether this proposed arrangement could raise State aid considerations

> *(1) The recipient undertaking must actually have public service obligations to discharge and those obligations must be clearly defined.*

[36] To date, Calmac has argued that none of its routes are profitable.

There has been considerable discussion of this issue with the Commission over several years and even the contentious issue of mainland to mainland ferry services (which appeared to be excluded from consideration since the 1992 Regulation specified PSOs were only allowable for island cabotage) has been resolved to the Commission's satisfaction. This stage appears to have been satisfactorily concluded, at least in principle, and provision could also be made for appropriate revision of PSOs in the future.

> *(2) The parameters on the basis of which the compensation is calculated must be established both in advance and in an objective and transparent manner.*

This is the purpose of putting in tight and rigorous auditing and regulatory regimes and procedures.

> *(3) The compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant receipts and a reasonable profit.*

We discuss how this condition might be satisfied below

> *(4) Where the undertaking is not chosen in a public procurement procedure, the level of compensation must be determined by a comparison with an analysis of the costs that a typical transport undertaking would incur (taking into account the receipts and a reasonable profit from discharging the obligations.)* [37]

We also discuss how this condition might be satisfied below. As Prosser (2005, p.145) notes, this may prove a difficult condition to satisfy in some cases, for example if there is a single supplier and no efficiency benchmark against which to compare costs.

We can approach this issue in the context of the CalMac network by pointing out that there two separate tenders have been proposed for this, one for the network as a whole and one for the Gourock-Dunoon route in a particular in particular. The basic set up in the case of Gourock-Dunoon was described some time ago as follows:

> ***"Speaker:*** *Mr. Darling* ***(Edinburgh, Central)***
>
> *"The Clyde crossing is also an important issue. It illustrates exactly where public service and private enterprise mix--or do not mix, as the case may be. Let me take the Secretary of State back to what happened when privatisation of the Gourock-*

[37] See Prosser (2005) op cit pp.144-45.

Dunoon route was considered. An inquiry was set up because the then Secretary of State was under considerable pressure to help those who operated Western Ferries. It is nonsense to have made Caledonian MacBrayne cut its crossings from Gourock and Dunoon from two to one an hour, with the result that one expensive ferry is tied up for substantial parts of the day to make it more profitable for the private operator.

That private operator is operating three or four ancient vessels, purchased from a company that used to cross to the Isle of Wight. Caledonian MacBrayne was made to restrict its services simply to give the private sector operator a chance. That is not fair competition. It was rigged from the start to help the private operator. There was a negative public subsidy to keep a public asset tied up at a pier rather than providing the necessary service." Commons Hansard, 14 Dec 1988 (Column 1014-1015)

Mr Darling views on this issue have not been recorded as far as in known following his appointment as UK Minister of Transport, but the basic arrangement including frequency restriction on CalMac that he described some years ago is still in place today.

Interestingly, Mr George Lyon MSP has just made public a letter he has received from Western Ferries. He says:

"*In a recent letter to me, Western Ferries made it quite clear that they are seriously considering making a complaint to the European Commission about having to compete against subsidised competition and asking them to rule it an illegal state aid thereby forcing Caledonian MacBrayne off the route*[38].

It would be quite interesting if Western did make a complaint to the EC on these grounds and the Commission asked Mr Darling, who is both Minister for Transport and Secretary of State for Scotland, his opinion on these matters. Mr Darling is clearly informed on this issue and based on his past recorded opinion would be likely to agree with Western that there has been unfair competition resulting in too much subsidy (see also the 2003 opinion of the UK government on these issues, end of Appendix 2 here). But his opinion as to whose fault that is would very likely differ from that of Western, and the outcome of any complaint might not be entirely to Western's liking.

On the question of the CalMac service itself, if a PSO is awarded for this route, the Executive proposes that it should be awarded on the same basis that prevails today, that is only the passenger aspect of the service would be subsidised, secondly the frequency restriction (which we note Mr Darling implied was anti-competitive) should still apply and thirdly that the bidders should be prepared to bring their own vessels to the route.

Setting aside for the moment the issue raised by Mr Darling as to whether or not the private operator is benefiting unfairly from a restriction on competition (a point which I

[38] "Dunoon Gourock 'a political football"' *Dunoon Observer and Argyllshire Standard*, Friday 4th March, 2005, p.2.

have endorsed in a separate report)[39], there are real problems is establishing clear comparators and benchmarks based on the fourth Altmark condition in this context. Because operators would have to bring their own vessels to the route, the "analysis of the costs that a typical transport undertaking would incur" is complicated by the fact that it is not immediately obvious what type and numbers of vessel would be deployed (fast ferry, passenger only, or passenger and vehicle carrying, etc). Further, analysis of the costs and subsidy that would be required is also complicated by the fact that this would depend on the market share that the operator could expect to win from Western.

Consequently, an overall assessment of the likely costs and subsidy (if any) that a "typical transport undertaking" would incur in this context is not straightforward, consistent with the points made by Prosser (2005) above. It could be possible to find ways around the fourth Altmark condition without the need for tender (and I have suggested one way in a previous submission to an earlier consultation on this exercise), but it has to be noted that this could still be a hurdle in the absence of tendering. However, I and others have argued separately[40] that it could be possible to run a second commercial service in this market on the CalMac route without the need for subsidy, and in December the Minister announced that he was market testing this. An invitation for expression of interest from operators in this possibility has been subsequently placed in the Official Journal. While this exercise has subsequently been put on hold until further clarification (unspecified) has been received from Brussels, this solution has at least the potential for dealing with the issue of Gourock-Dunoon without having the complications involved in PSOs and subsidies.

Turning to the question of the main network bundle, it might be expected that the fourth Altmark condition would be even more difficult to satisfy in the absence of tender, given that there are 27 other routes and the PSO for each route would be for all categories of users (not just passengers as in the Gourock-Dunoon case). But, in fact, the process of satisfying the fourth Altmark condition without tendering should in principle be much more straightforward in the case of the main network than it would be in the case of any separate Gourock-Dunoon PSO.

The first thing to note is that there is general confusion as to what can be expected from a PSO and tender process in this context. For example, an article in the Herald newspaper, 16th December 2004 stated: "there are ongoing issues with the cost, frequency and speed of CalMac journeys which could benefit from a competitive tender."

As we have seen, that may or may not be the case in the Gourock-Dunoon context; cost, frequency and speed of journey could depend crucially on the solutions that the winning bidder brings to the tender process, and its performance in competing against Western in the unregulated vehicle-carrying market post-tender (since an economically viable solution here would involve the joint product dual purpose passenger and vehicle carrying vessels).

[39] N. M. Kay, S. Ferguson and R. Smith (2004) *Economics of the Gourock-Dunoon Fernes*, report prepared for DGFG and FSB.
[40] Ibid.

However, it is certainly not the case for the network as whole that that competitive tendering would or could make a significant difference to the "cost, frequency (or) speed" of CalMac journeys. The reason for this is that the specification of the PSO at route level in each case squeezes significant discretion out of the major elements that could otherwise normally be expected to affect costs and subsidy, assuming that the auditing and regulatory processes make reasonably sure that CalMac runs a tight ship.

This point lies at the heart of the argument for the alternative approach so more detailed discussion is carried out in Appendix 1. However, the main reasons for this lack of discretion can be summarised as follows.

Firstly, operators would have little or not discretion over the fares and prices to charge. They would be unable to raise fares because they would be capped at inflation-adjusted levels. They would not wish to reduce fares because the demand for various categories of user on various routes tends to be inelastic (especially so in the short term), and this has been confirmed by a consultants report for the Executive (see Appendix 1). This is to be expected given the monopoly nature of such services. Consequently, any price decreases would result in net loss of revenue. So fares would be effectively frozen at current levels in real terms for the duration of the contract.

Further, the default requirement is that, except in special circumstances, operators would be bound by the conditions of the tender to lease what are presently CalMac's own vessels. In principle, there is discretion at the margins for the winning tenderer to bring in their own vessels, in practice this would only happen in exceptional or unlikely circumstances. This is because, as the UK government noted in 2003, "the needs of the (CalMac) service require unique bespoke ferries not available anywhere else in the world"[41]. Not only are vessels built specially for CalMac, they are typically built for specific routes and specific types and level of service[42], such as the new vessel for the Wemyss Bay - Rothesay route currently under construction. It is true that when a new vessel joins the CalMac fleet there may be some redeployment of vessels often reflecting growing demand in other parts of the network, but this is an occasional opportunity where the options are strictly limited, reflecting the high degree of customisation of these vessels and is certainly not something that would require competitive tendering to signpost the best or most obvious solution to the Executive.

Indeed, not only would competitive tendering add little, if anything, to the assimilation of new vessels within the CalMac fleet, it would remove the capability to generate and evaluate new strategic alternatives, such as new ships, since CalMac would be eliminated or at best have its role and capabilities reduced to just that of another bidder for operational services on 6-year contract basis. The responsibility for planning and building new ships would presumably go by default to the Executive, who do not have the competences required for such a task. On the other hand, the proposal in this paper could accommodate strategy development and implementation by assigning

[41] See Appendix 2 here.
[42] In transaction cost terms, there would be said to be a high degree of asset specificity.

responsibility for managing this process to the Regulator, in consultation with CalMac and the Executive and other interested parties, such as councils and users.

The leasing of the vessels must be done on the basis of commercial rates in this case, these rates could be independently evaluated and audited. Beyond that, other obvious major categories of costs include manning levels. These are typically set by Maritime and Coastguard Agency (MCA) regulations and are determined by factors that can include design of vessel and passenger capacity (not demand). To an outside observer this can make CalMac's manning levels appear at times excessive, especially if there is excess capacity on a particular run. But it is important to note that such a conclusion would be unreasonable and that this is typically a non-discretionary element in the operation of individual vessels, decided independently of the operator for health and safety reasons, and a constraint which an outside commercial would face just as CalMac does.

Other major categories of costs include fuel costs, which must also be regarded as a largely non-discretionary element dictated by market conditions, timetables and frequency of operation, all of which have be regarded as givens by the operator, the latter dictated by timetable and frequency obligations imposed by the tender conditions.

Provision is also made in the proposed tender for the encouraging of unsubsidised "innovative" approaches and improvements by the tenderer outside the tender itself. In fact, it would be unlikely that the tenderer could find any scope for such "improvements" given the constraints the operator would face in fulfilling existing timetables and other limitations such as working time directives. And the fact that the existing services are already so heavily subsidised makes it very unlikely that there would be scope for finding peripheral or marginal services on top of these that would be both profitable and unsubsidised.

In fact, when the various sources of revenues and costs that are likely to be encountered by any operator are examined, it is difficult to identify major elements that may be regarded as discretionary to any significant degree. It is important that this exercise is conducted thoroughly, because any weakness is such examination might lead to vulnerability on State aid grounds. There are only three potential soft spots in terms of CalMacs costs and revenues that might be incurred under a PSO regime that I could identify as potential issues in a run through the PSO conditions as set out in DITT.

The first is the recent implementation of shore-based ticketing, particularly on the Clyde runs. This has been a costly exercise to implement and administer and it has been alleged to be an expensive waste of public money. CalMac have defended the practice saying it was forced by new anti-terrorism requirements. Whether or not the system is necessary under new anti-terrorism security arrangements is a technical security issue but should be easily resolved as such, and if it is necessary, then it does not automatically raise audit issues.

The second issue is overheads, particularly headquarter costs. Again, there has been allegations in the past that there may be padding and waste at that level, and it is certainly

the case that such costs are often more difficult to both control and justify than costs of operations such as operating vessels in this instance. It is not possible to know whether such allegations are true without an external audit and here is a case where the Auditor General should be asked particularly to set up mechanisms to review, both immediately and in the future on a continuing basis, to ensure that CalMac does not run any State aid risks in this context, and to instruct immediate action be taken if and where it does (or could) raise such risks.

The third and final issue is terms and conditions of employment. As well as the physical capital displaying a high degree of customisation with respect to the CalMac network, the collective human capital here also reflects high degrees of specific experience and knowledge accumulated in what are some of the difficult operating conditions in Europe. But one publicly stated concern is that an opportunistic operator would cut costs by degrading terms and conditions of employment and bringing in cheap foreign crews. There would be some constraints on this such as need to adhere to MCA restrictions and English speaking requirements for crews on passenger vessels. The DITT also instructs the bidders to frame their bids on the assumption that TUPE will apply and makes provision for 100% clawback of any gains that would accrue to the operator if TUPE turns out to not apply. So there would be no net gains to the operator either way, it has to cost on the assumption that TUPE will apply. Also if the operator relies on natural employee turnover to change and degrade conditions for new employees, there would normally be only limited and marginal opportunity for this in the space of a 6 year time horizon[43].

Having said all that, once all the other areas associated with the PSOs that could influence the costs and revenues of an operator are scrutinised, and if normal auditing and regulatory controls are in place, modifying terms and conditions of employment to reduce costs stick out as possibly the last potential area that an operator may decide it could do things that CalMac could not do, or was unwilling to do. How could this issue be dealt with?

At this point we are touching on complex and difficult issues such as employment law and employment protection. These issues certainly could not be resolved within the scope of this piece, even if it lay within my limited competence to fully deal with. But I do not think we need to get involved in these matters in this context, because I think that this potential soft spot can be dealt with by looking at it from a different angle. The most straightforward way to approach this issue is by reference to the market. There is an active labour market here, and there are established or going market rates for officers and crew with appropriate levels of qualifications and experience. CalMac operates in this market and tends to pay around the going market rate[44]. On the one hand, that tends to be consistent with it paying no more than a "typical transport undertaking" would incur in

[43] There is also the question offshoring of national insurance contributions which is presently apparently a practice in some other shipping companies. Irrespective of the moral or public interest issues here, if this is required to avoid State aid issues, there is presumably no reason why CalMac could not also do this if necessary.

[44] This based on advice from industry expert, but obviously could be easily verified.

this sector (the fourth Altmark condition). But, most crucially, if there were profit opportunities for commercial shipping and ferry companies in the UK from undercutting the going labour market rate and terms offered by CalMac in their own commercial market segments, this practice would be observed across the sector. The fact that it is not, tends to confirm that for one reason or another they are unable to do so. The most obvious reason that they cannot do so is that if they did undercut the going market rate, they would be unable to find and/or retain sufficient employees to maintain their present level of operations. And if that holds for these firms, it presumably would also hold for CalMac. And if it holds for CalMac, it would also hold for any operator taking over the CalMac network And if it holds for these firms, any proposal to achieve cost advantage and undercut CalMac's terms and conditions of employment would not be credible and sustainable, at least not without threatening the stability and viability of the operation of what are essential lifeline services.

In short, the existence of an active competitive labour market and alternative market opportunities turns what looks at first sight to be an area of discretion and control on the part of an operator, into one in which they actually have very limited discretion. The man in the Canongate Kirkyard would see this as being very much in the public interest, as much as would the European Commission.

Tentatively, this would seem to remove the last remaining major soft spot and potential source for real discretion in terms of profit-seeking for any operator running the CalMac network.

To summarise, providing that CalMac is, has been made, or is in the process of being made, demonstrably lean and hungry using the tools and institutions discussed above, then if the analysis above is correct, there would be no further significant discretionary areas for boosting revenues and/or reducing costs. There then should be no way that a commercial party could make a credible case though a technical proposal that it could beat cost-only non-profit CalMac on subsidy and still make a "reasonable profit", providing, once again, that the auditing and regulatory regime has been not only been rigorous, but also can be demonstrated to be so to the Commission.

From an economic perspective, a crucial question in State aid terms is whether this would lead to overcompensation of CalMac. The comparator for that from the fourth Altmark condition would be the compensation that could be expected for a "typical transport (here maritime) undertaking" undertaking the same PSO duties as CalMac and making a "reasonable profit". If the structures and controls outlined here are in place, then rather than cost-only non-profit CalMac being <u>overcompensated</u> using the fourth Altmark condition as benchmark, its cost-only basis would mean it was <u>undercompensated</u> in these same terms. This is not illegal under State aid law, but what it should do is give it a sufficient comfort zone to buttress it against any allegations or complaints of misuse of State aid. The intention is that this should make it defensible both in terms of the letter and the sprit of EC State aid and maritime cabotage legislation. "The objectives of the Commission are to uphold the principle of non-discrimination between Community shipowners as well as ensuring that any state aid required is proportionate to the objective

of providing the necessary level of public service."[45] This approach should be able to both ensure and demonstrate that aid is not disproportionate to the necessary level of public service.

This brings us to what could be described as the crux of the State aids question. The 1992 Maritime Cabotage regulation (which, as we have noted, is still is the rule of law here) states.

> *Whenever a Member State concludes public service contracts or imposes public service obligations, it shall do so on a non-discriminatory basis in respect of all Community shipowners … Where applicable, any compensation for public service obligations must be available to all Community shipowners*

The question of how the opportunity for compensation could be made available to all shipowners is clearly a legal question. The Executive advertised the opportunity for commercial operations on the Gourock-Dunoon route in February 2005 by simply inviting expressions of interest, and if it was, for example, possible to satisfy this aspect of the Regulation by informing community shipowners that they are welcome to submit technical proposals and alternatives if they wish, then that should certainly be considered. A third party has also suggested that it might be possible to ask the Commission for a letter-of-comfort, this being an administrative letter sent to the notifying parties confirming informally and without any reasoning that the Commission sees no grounds for action against since the arrangement does not restrict competition and/or affect trade between Member states. But the key issue is whether or not the proposal here would be sustainable under EC State aid law, and if it is, then whatever means are found for demonstrating this to third parties, compulsory tendering should not be seen to be a necessary or desirable condition to demonstrate compliance in this context.

At the same time, the proposal may be at seen as being at too early a stage for the Commission to give a final opinion at this stage, or they may reject it outright. I would argue that the proposal would be made defensible under EC State aid legislation, and even if the worst case happened and the Commission rejected this proposal outright, this should not necessarily be regarded as the end of the matter. As Altmark shows, the Commission is not the ultimate authority in these matters within the EU, and if there is political will to push forward with proposals along the lines set out here, then an initial negative response for the Commission should not be regarded as meaning that the proposal could not, or should not, be pursued.

6. The Position of the Commission

There are several reasons why the Commission could actually be receptive to proposals that help resolve the impasse that has built up over this issue.

[45] Commission Answer to Question no 44 by Neil MacCormick (H-o441/01): Subject Scottish West Coast Ferries.

1. Honest intent. There never has been any suggestion that the Executive has been anything other than eager and willing to adhere to both the letter and spirit of EC law in this area, and indeed in Brussels it must appear as a model of responsibility compared to some other states (such as Spain) in the context of maritime cabotage. If the proposal also is clearly framed and implemented to adhere to the spirit and letter of EC law then the Executive's track record in this context could be helpful in communicating this as a serious and responsible proposal.

2. Image. The EC has had a very bad press on this issue in Scotland, much of it may be regarded as unfair and not their fault. But fair or not, the reality is that the EC has been shouldering much of the blame and responsibility for what has gone wrong so far. As argued above, if the CalMac network does actually go out to tender, matters could deteriorate even further and the EC could again (and again, quite possibly unfairly) be expected to be receive much or most of the blame, quite possibly at a time when the proposed new EC Constitution is very much a live political issue.

3. Spirit of Altmark. The political and legislative context has changed markedly since the 1992 Maritime Cabotage regulation was framed and although it still serves as the binding legislation for decision-making in this context, it is difficult to believe that the sensible principles set out in Almark would not be seen as helpful today in fleshing out some of aspects just sketched in the 1992 legislation, such as the role and nature of compensation and the possibilities for monitoring compliance. If the 1992 Regulation was to be reconsidered today, the lessons of the last few years would probably suggest that there was scope for rewording and improving the Regulation in the light of Altmark, and, at the very least, Altmark may assist in interpreting the 1992 legislation today.

4. EC Sanctions. Parties potentially affected by this issue in Scotland have been consistently advised that the EC has the power to impose sanctions on the Executive, these could include instructing the cessation of subsidy to CalMac ferry services, and this has been mostly joined (with the exception of a few months post-Altmark) with advice that tender was necessary to avoid these potential sanctions. This threat would mean the immediate cessation of all or most essential transport links to remote and vulnerable communities in the EU. For the reasons discussed, the mistake is to read that threat on narrow legal grounds rather than wider grounds, including economic, social and political. It is one thing to possess the means to pursue a course of action, quite another to do so. Much of modern analysis of strategy in business and politics is based on the notion of *credible threats* (for example in nuclear deterrence[46]). If there are no realistic circumstances in which it would be reasonable to conceive of the threat being carried out, then it should not be allowed to influence the policy-making or strategy-formulating process.

It must be emphasised that none of this should be read as being disrespectful or unmindful of the very real powers and responsibilities that the Commission possesses here, nor should it be taken as advising that the law should be disregarded in this context.

[46] Dixit, A. K. and B. J. Nalebuff (1991) *Thinking Strategically: the Competitive Edge in Business, Politics and Everyday Life*, NY, Norton, pp. 126-31..

On the contrary, the "realistic circumstances" that I envisage includes the Executive continuing to make serous and committed efforts to respond to EC law in this context, and as long as it does that, the notional threat of termination of aid and services in this context should be disregarded since for economic, social and political, if not legal, reasons it is not a realistic or imminent threat. It is in the Commission's interests as well as the Executive's that a mutually agreeable and sustainable solution is found to this issue. This point is important because as I have argued above, the history of all this has been characterised by the Executive responding to events rather than taking control of the process. But it is difficult to think of tomorrow if you think someone has a gun pointed at your head.

5. Weakness as strength. The Executive would appear to be in a very weak position on this issue, with few options open to them. They lost the vote in Parliament in December on the proposed tender, public opinion is broadly hostile to the proposed tender, and they must still develop ways of complying with EC law. In fact, there has been considerable research in the area of strategy that shows that the fewer the options, the stronger a position can become if it is used to credibly communicate to the other party that there is no choice but to follow a selected course of action. Burning bridges (or ships) behind you[47], demonstrating poverty and inability to pay to a supplier threatening a price hike, or tying yourself to your predecessor's spending plans, all have the virtue of communicating to other parties that your options are limited, supporting your arguments that you have no choice but to follow a selected course of action. The fact that the Executive's position of weakness is unintentional, while Gordon Brown's tying the Labour government to Conservative spending plans in 1997 was deliberate, does not affect the point that the Executive's weakened position may reinforce the credibility of any argument to Brussels that they have no choice but to follow a selected course of action - whatever that course of action turns out to be in the end.

6. Norway and the EC. It was argued above that it has been a mistake to analyse and treat this as just a narrowly defined contractual issue in maritime cabotage under EC law. Another dimension here that should be of concern to policymakers in Brussels are the possible implications for external relations, especially those potentially affecting a state that may one day seek accession to the EC, that is Norway. The official EC position is that they hope that Norway will again consider applying for membership of the EC at some point in the future. Given the importance of ferries in the Norwegian transport infrastructure and the importance of subsidies in maintaining that infrastructure, what could be a regional problem when encountered in a Scottish context could translate into increased resistance to accession at national (Norwegian) level if, as is likely, the Norwegians reacted in similar fashion to the Scots to proposals to tender out their ferry network to the lowest bidder on a six-year basis. And any adverse consequences encountered in the Scottish context would be likely to be used by anti-EC parties in that country.

[47] Dixit and Nalebuff, *op cit*, pp.152-57.

A caveat is that the part of the Commission that takes decisions on this (Competition Policy / State aid) may not be the part that sees other issues that might be raised by this (e.g. EC Constitution, external relations) as their responsibility

Individually, each of these arguments may suggest that the Executive may find the Commission more flexible and helpful than they have generally been credit for in this case. Indeed, some of the points above may help explain why the Commission has already been demonstrably sympathetic and helpful in this context in some instances (e.g. the case of mainland to mainland ferry services). Together, the various points suggest that there may be considerable scope for finding genuine consideration in Brussels to coherent and viable plans for dealing with this issue and working with the Commission.

7. Conclusions

Whatever steps are taken in this context in the future, the prime guidelines which are used to frame and test policy should not be the 1992 Maritime Cabotage Regulation (or its guidelines and/or successor legislation). It should be Article 87(1) of the Treaty of the European Union (formerly Article 92 of the Treaty of Maastricht) which states:

> *" any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market."*[48]

If policy makers consistently frame their solutions to follow the spirit as well as the letter of that sentence (while being mindful of the provision allowed for public service obligations and public service contracts), and see it as a desirable goal in itself rather than a problematic barrier to be overcome, then the chances of running foul of EC law may be reduced or eliminated. It is only after this process has been gone and proposals subjected to an initial evaluation on these grounds that consistency with any specific maritime cabotage law or guidelines should be evaluated.

A problem with the public debate so far is that it has been framed in terms of "tendering necessary" versus "tendering bad". The proper foundations for constructive debate is to recognise that EC State aid legislation is intended to make EC citizens better off, and to explore how the organisation and control of industry can be improved with that aim in mind..

The consultation period for the proposed CalMac tender ends March 16th 2005. This would be an appropriate time to review this and any alternative proposals for the future of Clyde and Hebridean ferry service. It is absolutely crucial that the Minster has professional and informed advice independent of the normal channels that normally advise him. The best way to achieve this would through review of proposals by legal, economic and administrative experts (practitioners / academics) in the fields of EC state aids / regulation of industry, with special reference to UK essential services. These

[48] See Prosser (2005) op cit, p.142

should have no direct links with the Scottish Executive. Private consultants in the field should be avoided at all costs at this stage since private consultants are too likely to be influenced by what they think their client wishes to hear, which in this context they would be too likely to construe as the Scottish Executive.

Assuming that a proposal along the lines suggested here is thought worthwhile developing, this could be done by a group drawn from same pool of expertise identified in the previous point, again with no direct links with the Executive.

If I have seemed a little critical of the executive side of Scottish governance here, such criticism has been absolutely essential. If the proposals here were to be put to the Minister and he handed it over to his officials to work on, based on past experience it would unlikely to re-emerge out the other side in a workable form, if it re-emerged at all. Even if the right decision was made, it is one thing to make the right decision in principle, quite another to implement it, as the confusion and current strike threat over the implementation of the decision to invite expressions of commercial interest in the Gourock-Dunoon service shows. The right decision was made, the problem currently lie in the way it has been executed. That is why independent expert advice and review is essential to carry this issue forward.

The competence of individuals within the Executive is not at issue here, indeed I certainly know that the expertise to evaluate the economic side of the proposals here exists within the Scottish Executive. I know that, because I and many of my colleagues in Scottish economics departments taught many of these government economists and/or they are former colleagues, and I know they have the expertise and ability to review much of the economic arguments here. But, if they have been involved in this process, then it is not in evidence here, which is further support for the earlier point that this new problem has been dealt with internally as needing old, narrowly defined solutions.

The clear support of the Scottish Parliament for a coherent alternative to the tendering of CalMac's services (framed to be sensitive to Article 87 and EC maritime cabotage law) could strengthen the case of those arguing for such an approach to Brussels. Whatever the individual reasons MSPs had for voting against or abstaining in the vote in December, the collective decision of Parliament as expressed in the vote here was the right one.

The Local Government and Transport Committee (and it predecessor) of the Scottish Parliament has played a valuable role in scrutinising proposals in this area over the last five years and it is hoped they could continue to play a central role here. If the Executive had listened to, and acted on, the arguments and reservations expressed by its predecessor (Transport and Environment Committee) four years ago, we might not have wasted so much time and resources in getting to this point.

I would caution against a pick'n'mix approach to the elements of the proposal here, each of the elements discussed above constitute essential parts of the whole proposal, and if any aspect is varied or dropped, the consequences for coherence of the proposal must be thought through. And the phase that "the status quo is not an option" may be a much-

abuse one, but it applies here. Just as the Executive's present proposals for the tendering of CalMac's services would be unsustainable and against the public interest, so past and current arrangements would not be sustainable under EC State aid law.

I believe that if these structures and processes are set up with Article 87 seen as a continuing litmus test for the formulation and implementation of policy and practice in this area, then the operation of CalMac's services along the lines sketched here would be justifiable as wholly compatible with the common market, and defensible as such.

Neil Kay
6th March, 2005

APPENDIX 1

CALMAC NETWORK UNDER PSO REGIME

This Appendix explores some aspects of CalMac's ability to vary costs and revenues under a PSO regime, assuming tight regulatory and auditing control.

In order to increase profits a firm must increase revenues, decrease costs, or both. The main ways that a firms may try to increase revenues is through varying price, new product introduction and/or advertising campaigns. The main ways that firms can reduce costs is though increased efficiency and/or cost reducing technological improvements.

If we take the specifications of the tender as set out in the 2004 version of the Draft Invitation to Tender (DITT) as starting point, we can look at the scope an operator would have to increase profits in the course of a 6-year contract to operate the CalMac network.

Revenue side

Starting with the revenue side, there would be virtually no scope to vary price, either up or down to increase profits. DITT (Section 3.8.1 and 3.8.9) indicates that the winning tender would be subject to fares caps based on existing (inflation adjusted) prices (net of berthing and harbour dues). So that effectively eliminates the scope for price increases. As far as the scope for fare decreases is concerned, a review of CalMac's fares structure by MDS/EKOS[49] found that elasticity of demand was less than one for all categories of users on all routes, signifying that if the company reduced fares on any route or market segment, it would lose revenue.

In short, the combination of price caps and low elasticity means that there would be no real scope for the tenderer to vary prices and increase profit.

The DITT (section 2.3.4 and 2.5.31) encourages the pursuit by the operator of "innovative revenue streams", but as noted in the text above there would actually little if any scope for the operator to do that in practice. The possibility exists of varying the demand side through advertising, but the problem with assessing the economic justification (and potential) of advertising expenditure is represented by the (possibly apocryphal) marketing director who said he was sure that half his advertising budget was wasted, but he was not sure what half. In fact, there would be little scope for an operator to use advertising to enhance profits in this context.

In general, you do not go to Mull so you can use the Oban-Craignure ferry, you use the Oban–Craignure ferry so you can go to Mull. For most users (hauliers, commuters, even holiday makers), the ferry is a means to an end rather than an end in itself. That being the case, if advertising is to be effective at all, has to be targeted at the level of the product itself rather than the means of achieving it, which in this case would be marketing the Highlands and Islands in general, or Mull in particular.

[49] MD/EKOS (2001) *Caledonian MacBrayne Fares Review Study*, Scottish Executive.

If this is doubted, then we can draw a lesson from Sherlock Holmes' curious case of the dog that did not bark. It will be recalled that the curious thing about the dog was that it did not bark. Bridges and ferries perform similar technical and economic functions as alternative means of spanning tracts of water; ferries are generally deployed where long distance or low volumes would make bridge building uneconomic. But if it makes sense to advertise ferries, why then do we not see the revenue potential of bridges such as the Tay Bridge, Erskine Bridge and Forth Bridge being more fully exploited through advertising campaigns (for as long as tolls exist on these facilities)? Why, just like Conan Doyle's taciturn canine, is there little sign of activity on this front? The answer cannot just be congestion, because both ferries and bridges typically have both capacity constraints and spare capacity that can be managed with the help of economic tools, for example peak load pricing.

The obvious answer is that such transport links are not only means to an end, in such cases alternative means are typically not available, or only available at unacceptable levels of cost or inconvenience to the user. Advertising can take two main forms in economic terms, it can be informational (telling the consumer that the product exists) or persuasive (encouraging the consumer to switch to your brand or variant of the product). Beyond basic timetabling and fares information, there is no obvious justification for major expenditure on either form of advertising by the ferry company here. If the traveller does not know that the ferry to Mull (or the bridge to Dundee) exists, this need for information more likely reflects a failure on their part, or on the part of some other agency, such as the tourist board. Also, where you find serious commitment to persuasive advertising on the part of ferry operators, it tends to be the case that other products or brands are competing with it, such as in the case of the cross-Channel ferries competing with the Channel Tunnel and low cost airlines. In general, these conditions do not hold in the case of the CalMac network where there is typically no cheap or easy alternative to the service.

These points are reinforced by the short term nature (up to 6 years) of the tender period. Even if the operator thought they could somehow stimulate extra demand by advertising, building up a brand name and company image (which can be an extremely lengthy process taking years or decades) is unlikely to be a preferred option the more competitive the tender process, and the more likely it is that the residual benefits of your advertising would accrue to some other operator after your time running the network is up..

This discussion is especially pertinent in that CalMac recently made its first venture into the world of TV advertising with its "have a Caledonian MacBraynewave" which featured a young lady, her washing machine and the Caledonian MacBrayne ferry company. In the light of the preceding discussion, there is an obvious answer to the question of why did CalMac not do this before; it was almost certainly not thought worth the expense. What is less obvious is why the company is doing this now, and who the company is trying to persuade of the virtues of CalMac.

In short, apart from basic information, there would exist little, if any, scope for an operator to increase profits by using advertising as a tool in this context.

Cost side

One way to approach the scope for discretion on the cost side is to identify what are the major categories of cost that an operator is likely to incur on the CalMac network. The Deloitte Touche report[50] into one of CalMac's routes (Gourock-Dunoon) gives a breakdown of the costs incurred on that route. Deloitte Touche found that the major components of operating costs were: crew costs 32%; repairs and spares 12%; fuel 6%; berthing dues 11%; shore based labour 6%; and overheads 16%. No other single item accounted for more than 3% of operating costs.

Such an audit may be taken as indicative of some major categories of cost that might be incurred more widely in the network[51], though CalMac owns its own linkspans on this route, so the berthing dues reflect only those incurred at council-owned Dunoon side where the facilities are council owned, and it owned its own vessels on this route. Post-tender, an operator on such routes would also have to pay leasing charges to VesCo for the vessels and necessary infrastructure.

Under EC rules, vessels will have to be leased at commercial rates to the winning bidder and as DITT (Section 3.4.5) specifies "all tenderers, in their dealings with VesCo will be treated equitably", So there is no apparent room for discretion as far as leasing costs are concerned. Similarly. DITT (section 3.5.7) notes "charges will be offered on an equivalent basis to all tenderers" in the case of VesCo port and berthing facilities (but see 3.8.1 for "net of harbout dues"). In cases where there is no well developed market for ports and facilities (e.g CalMacs linkspans), commercial comparators and standard charges could be established, just as in the case of CalMac's vessels which will have to be charged to it at commercial rates, whether or not the tendering solution is adopted. DITT (Annex 22) indicates that ship fuel costs may be regarded as a "material change" if it varies by more than 10% in either direction from a base price, provision would have been made to adjust subsidy in the appropriate direction.

For the reasons discussed in the main body of the article, the operator (whether or CalMac) under the PSO regime discussed with the Commission would have little or no significant discretion over costs and revenues, certainly not sufficient to raise State aid questions if a tight regulatory and auditing regime was imposed on a cost-only non-profit operator

[50] Deloitte Touche (2000) *Final Report: Options for the Ferry Services Between Gourock and Dunoon,* Scottish Executive 5/5/2000:
[51] Though if this route is tendered, it will be tendered separately from the main network bundle.

APPENDIX 2

UK GOVERNMENT RESPONSE TO THE EUROPEAN COMMISSION'S GREEN PAPER ON SERVICES OF GENERAL INTEREST, MAY 2003

SELECTED EXTRACTS

This is the fullest known statement of the UK government's position on the EC Maritime Cabotage Regulation, these extracts come closest to summarising a UK position on this.

(Q.6) What has been the impact of sector-specific regulation so far? Has it led to any incoherence?

16. In general, the impact of the Community's market-opening legislation has been beneficial. This is kept under review at sectoral level, often through arrangements explicitly set out in Community legislation. Clearly, there is a common need for consistent and transparent implementation by Member States of regulatory frameworks agreed at Community level.

17. An example of incoherence is maritime transport, where PSOs operate and specific regulations and guidelines already exist, these currently do not take account of specific contexts i.e. Scotland's unique fleet, mainland to mainland routes and services working as one network. As a result, lengthy negotiations took place with the Commission before the service could be tendered.

(Q.21) Are you aware of any cases in which Community law, and in particular the application of State aid rules, has impeded the financing of services of general interest or led to inefficient choices?

37. There have been a number of cases where state aid rules have impeded the financing of services of general economic interest, delayed their delivery, or led to a sub-optimal choice. Maritime transport, for example;

- The Cabotage State aid rules have greatly impeded the ability to run public service ferry operations in Scotland, making no allowance for the very specific circumstances there. The geography of Scotland's West Coast and the needs of the service require unique bespoke ferries not available anywhere else in the world. In an industry where vessels have an average life of 30 years and other infrastructure (such as harbours) has a life of 60 years a short term contract is a strong disincentive to an operator to invest in the hardware. A special arrangement had to be agreed with the Commission which provides for the establishment of a vessel and harbour owning company which will in turn lease those assets to the successful operator. This ensures both continuing investment in the infrastructure and the availability of these assets to the next operator. This is however an artificial barrier and distances the development of the fleet from its operation. The short length of the contract is also a disincentive to the operator to develop the service except where there would be immediate benefits to them.

38. The recent ECJ judgment on Altmark Trans introduces a welcome clarification into the relationship between services of general economic interest and the state aid rules.

(Q.23) Are there sectors and/or circumstances in which market entry in the form of «creamskimming» may be inefficient and contrary to the public interest?

43. An important factor to consider is whether incentives for "cream skimming" may arise from particular regulatory barriers imposed by government or by virtue of the particular market arrangements. Therefore, there should be not be innate presumption that market failure automatically justifies government intervention. In general "cream skimming" is an inefficient means of market opening. Such an approach may lead to certain sectors of the community being overlooked as operators will automatically choose the most advantageous areas, undermining services to remote areas, or only undertake profitable services. This can lead to the state having to pay subsidy or increase the subsidy in order to ensure that all parts of the community are served. For example;

- The Western and Northern Isles ferries services in Scotland where market operators attempting to cream off profitable services resulted in the Authorities having to pay increased subsidy to maintain essential services.

Comment: The UK governments' position on EC Maritime Cabotage law here is robust and sensible. However, para 17 suggests that it is assumed that tendering has taken place, as indeed it was originally intended to do by the time of this communication. The case or cases of creamskimming referred to in para 43 is/are not specified, but the only known case where there has been sustained and persistent behaviour consistent with this is Gourock-Dunoon, as discussed by Mr Darling above.

The full UK government response is available on line at http://europa.eu.int/comm/secretariat_general/services_general_interest/docs/public_authorities/repres_uk.pdf

APPENDIX 3: ISSUE OF OPERATOR OF LAST RESORT

The issue of Operator of Last is crucial in the provision of essential or lifeline services. It is solved at UK level either by having a body whose statutory responsibility is to step in and perform this function of required, or by having another existing operator within the jurisdiction of the relevant authorities obliged to do so if instructed. When the Executive first proposed the tendering arrangement for CalMac they apparently did not realise that it would be difficult or impossible for either arrangement to hold in this case.

The Executive issued a press release 23rd January 2001 where it stated;

"the vessel owning company should act as an operator of last resort"

Captain Sandy Ferguson wrote to the Executive 24th January 2001 pointing out that VesCo would not be certificated to act as an operator of ferry services by the MCA. He received a letter from the Executive in March acknowledging this point, and the same month the Executive wrote to the Transport and Environment Committee[52] stating;

"perhaps 'provider of last resort' is a more appropriate term"

However as we have pointed out, the designation of 'provider' of last resort suffers from the same problems as 'operator' of last resort. Both terms are commonly used by recognised authorities in the context of essential services but tend to refer to entities that are themselves qualified to operate or provide such services – and as has been pointed out to the Executive and MSPs, VesCo would not be qualified in this regard. I received a letter from the Minister Sarah Boyack, 12th April 2001[53], stating

"perhaps 'procurer of last resort' is a more appropriate term"

However, while "procurer of last resort" is indeed an appropriate term to describe the role that the Executive envisages for VesCo, it is not a role that is generally considered appropriate for the provision of essential services. A systematic websearch has found only one known use of the term, this was in discussion of cases where the "distribution business should be required to procure a meter reading service of last resort" (Office of Electricity Regulation, Annual Report, 1998". The Report stated that in this context the distribution service would be "procurer of last resort".

The problem with a contractually-based system of "procuring" is that it does not guarantee immediate and continuing provision of a service if it cannot be backed up with powers of statutory obligation or direction. This illustrates the difference between essential and non-essential services. If consumers and communities on islands and peninsulas served by CalMac cannot get essential or lifeline services such as water, gas, electricity and ferry service on a continuing basis, their welfare (and indeed health and

[52] Letter 16th March 2001 from Minister of Transport Sarah Boyack to Andy Kerr, Convenor, Transport and Environment Committee.
[53] Letter 12th April 2001 from Minister of Transport Sarah Boyack to Neil Kay.

safety) may be seriously threatened. The same cannot be said if they cannot get their meters read.

That is why the issue of an operator or provider of last resort that can be obligated or directed to provide lifeline services has to be settled in advance of competitive tendering. You do not try to "procure" a safety net once the emergency has arisen, by that time it will be too late.

The text of the section of the Minister's letter to me of 12th April dealing with last resort issues reads as follows:

> *"…you raise concerns about the Executive's proposals for a VesCo to act as 'an operator of last resort'. Your view appears to be based on the assumption that the Executive intends that the VesCo should deliver this function at its own hand should the need ever arise. This assumption is misfounded.*
>
> *The Executive intends the VesCo to be a streamlined company whose core functions focus on vessel leasing. However, as an extra safeguard, the Executive also proposes that the VesCo should have the function of acting in a management role to procure services as necessary, should an operator fail to meet its contract to deliver lifeline ferry services. I believe this will provide a useful backstop during this period of change. We do not envisage that the VesCo would crew vessels itself but would contract with an operator, in consultation with the MCA as necessary, to safeguard services until such times as the situation was resolved through redress through the contract and/or retendering as appropriate. Indeed perhaps 'procurer of last resort' is a more appropriate term to depict the management role we envisage the VesCo as having in this* regard."

The Executives position on this question has once again changed and is now recorded in the Draft Invitation to Tender as follows:

> *VesCo will also be responsible for providing an Operator of Last Resort function (in the event of termination of contract, breakdown of contract, or similar event) which will provide an important safeguard through this period of change. This could be done in two ways, either at VesCo's own hand or through an arrangement with a shipping provider by way of a retainer. VesCo will be responsible for considering these options and putting arrangements in place before the new contract begins.* (DITT, section 1.3.6)

There is no evidence that ether route would prove effective or workable. The Executive's changing position on this issue both demonstrates that there is a major problem of substance in dealing with this issue, and also there will issues of process, that is that this problem was not thought through properly in 2000 when the proposal to tender was announced, and it is clear that it still has not been properly thought through.

APPENDIX 4: THE RETENDERING OF NORTHERN ISLES SERVICES

In my evidence to the Transport and Environment Committee 18th June 2001 I said in the context of the bid for the CalMac network: "there will be strong incentives on the part of a private firm to put in a loss-leading bid to get rid of CalMac permanently from the scene. Once it is incumbent, it will be in a strong bargaining position to renegotiate or breach contract, especially if there is no CalMac and there is no (Operator of Last Resort)".

A corollary of the Executive's position that the Northern Isles contract is a model for the CalMac tender is that it is vulnerable to the same weaknesses and threats that I mentioned in my above evidence in the context of the CalMac tender. In the report of their Inquiry to the same committee September that year, the Reporters (Maureen Macmillan MSP and Des McNulty MSP) point out (see their quote at the start of the main paper here) that I merely argued that since the Northern Isles contract was not yet operational, "the regime has yet to be proven effective in practice".

Clearly I could not say more than that, even if I wished to, since the contract had been then awarded to Northlink. For me to repeat such concerns in those circumstances may have been seen as unduly alarmist and would have been certainly ridiculed and rejected by the Executive, and indeed I might have found myself vulnerable to legal action by Northlink for suggesting that they would have been prepared to act opportunistically and "renegotiate or breach contract".

In fact, I am pleased to again confirm what I said in the main body of my paper here that there is no evidence that Northlink did act opportunistically and was not anything other than responsible and honest in its subsequent renegotiation of its contract with the Executive. But the simple fact that the Executive's handling of the initial contract meant that the Executive had no fallback position and no alternative but to continue the contract with Northlink confirms that it had no option but to concede to terms of a renegotiated contract that were fully acceptable to Northlink.

In fact, I was less concerned about the possibility of opportunistic misrepresentation and forced renegotiation (the "hold up problem") in the case of the original Northlink tender because the joint venture involved two respectable and highly competent firms headquartered in Scotland that the Executive could deal directly and face to face with, and also because it actually owned CalMac, the operational side of the joint venture.

These background conditions do not hold in the case of the Northlink retender, and for reasons I go into below, CalMac will be highly unlikely to win the retender, either through Northlink or on its own, even if it takes forward its declared interest from last year in the retender.

For those reasons, I now adapt my prediction for the CalMac tender to apply to the Northern Isles:

" Once any firm secures the Northern Isles contract it will be in a strong bargaining position to renegotiate to its advantage or breach contract in the course of the contract since there will no be statutory framework reflecting the special needs of the sector, no independent Regulator to monitor and police compliance, and no Operator of Last Resort for the Executive to turn to. The result is that contract breakdown and subsequent forced renegotiation is not just a possibility, it is almost automatically programmed into this retender and all subsequent tenders of the Northern Isles service given the structural flaws and weakness built into the contract regime here. At the very minimum, this will lead to overcompensation of the incumbent considered in EC State aid terms, at the very worst it will lead to disruption or cessation of essential lifeline services"

I am not being duly alarmist in making these statements, indeed I feel I have a responsibility to point out the consequences of policy in this area. If it is in shareholders and managers interests to take advantage of strengths in their position and weakness in the other party's position, it must be assumed they will. That is after all the virtues of the capitalist system and the incentives it provides. In general, the system can work well and smoothly with the commercial and public interest coinciding, but there will be cases where the commercial and public interest may conflict. This is one such possible case. It is up to policy makers to fashion controls to protect the public interest and deal with these potential problems and the lesson of the past several years in this case shows the policy makers here are either incapable of doing so or unwilling to do so.

The original Northern Isles contract to serve the Northern Isles was advertised in 1999. In October 5th 2000 NorthLink won the £12 million a year contract. In October 2002 it commenced operations. In April 8th 2004, the Scottish Executive announced retender and revealed they had put an extra £13.4 million into NorthLink over the previous 18 months, but had been unable to resolve the financial problems facing the company. More extra money was expected to be used to subsidise the service until the new contract comes into operation this year[54].

On the 10th April 2004 I wrote a detailed letter to the Minister of Transport (copied to several involved parties, including the Reporters for the Transport and Environment Committee of the Scottish Parliament) urging at the very least that the opportunity be taken in the process of retendering to recognize the need, and make provision for an Operator of Last Resort.

On the 18th May 2004, ten shipping companies were reported to have completed a pre-qualification questionnaire for the Northern Isles retender[55]. On the 27th May 2004, about seven weeks after my letter of 8th April to the Minister warning once more of the dangers to the public interest of retendering the Northern Isles contract without a statutory framework, a regulatory framework and a clearly defined Operator of Last Resort, the Executive issued a consultation paper and draft invitation to tender for the retender.

[54] Shetland News 9th April 2004
[55] Shetland News 18th May 2004

There was no indication that any of the points that I and others had made had been acknowledged or recognized, specifically there was no mention of operator of last resort[56].

Just before that, on the 21st May 2004, I had received a reply to my letter from an official of the Transport Division of the Executive which stated, *inter alia*:

> *We also have to look at the implications of such an arrangement (Operator of Last Resort) in the Northern Isles situation. We are in no doubt that there needs to be a contingency plan in place, and our recent experience in the NorthLink contract has demonstrated the importance of maintaining services. An operator of last resort arrangement, however, would involve additional costs and value for money issues, and we do not know what these might be and what risks such an operator might or might not accept. We would need to consider whether such an arrangement would necessarily eliminate all of the potential problems you identify, since much of that would depend on the terms and timescales involved. We would also need to be clear what the position was in relation to any similar problems arising with such an operator. We will therefore be looking at all of these arguments over the coming months as part of the preparation for the Northern Isles tendering exercise, and as I explained above we will take into account the points you have made.*

It is difficult to fully express the sense of deep frustration and concern that I feel in having to repeat the same arguments in submissions to committee, in consultations and in correspondence with Ministers, officials and MSPs in this and related matters over the past five years, only to receive a reply like this. The reply should be read carefully because if there is one statement over the past few years that demonstrates that Transport Division of the Executive is not the appropriate body to deal with these issues and does not have either the will and/or the capabilities to provide a workable solution to these problems, it is that statement.

I am not suggesting that the Division is anything other than competent in the tasks they have been assigned in the past, and other tasks they may be assigned in the present. But, as I suggested in the main paper, the fundamental problem here is that the problem has been defined narrowly as one in transport (specifically maritime) services involving a new constraint (EC State aid rules) to be dealt with using and adapting established practice and procedures (here in contracting and procurement) and they have demonstrated that they are not the appropriate vehicle for dealing with the new problems these raise.

The reality is that the problem should instead be defined as one of providing and maintaining an essential service with due care and attention paid to how compliance can be monitored and assured, continuity of service guaranteed, and the public interest, (including as represented in EC law) pursued. Once again, I have to repeat that for the introduction of competitive tendering into essential services such as water, electricity,

[56]See http://www.scotland.gov.uk/consultations/transport/nilfc.pdf

gas, and rail (and like CalMac routes, the Northern Isles routes here are described as "lifeline" in the announcement of the Northern Isles retendering), three things are usually involved; a dedicated statutory framework dealing with the specific problems of the sector; a Regulator; and provision for an Operator of Last Resort who can be instructed to immediately step in if instructed to do so.

None of these things are in place in either the CalMac tender or the Northlink retender. As for the Division's response above, it reveals a complete lack of understanding and recognition at the administrative core here as to the purpose and need for such a basic safeguard as Operator of Last Resort.

The issue is not whether it would "*involve additional costs and value for money issues*", the whole point about Operator of Last Resort is that it is to guard costs and protect value for money. It is not an optional extra you can think about dropping off the specifications here, it is an absolutely essential safeguard.

If Transport Division "*would need to consider whether such an arrangement would necessarily eliminate all of the potential problems you identify*" then if they are not aware of the years of accumulated experience and practice in this area, they are not capable of making considered policy decisions on the issue.

Further, if Transport Division, "*do not know what these (costs and value for money issues) might be and what risks such an operator (of last resort) might or might not acc*ept" then they simply do not have the competences or capabilities to begin to deal with this issue.

Once again, as I have before, I would make the plea not to simply rely on my conclusions here, the Minister, MSPs and the Local Government and Transport committee should get expert outside advice in these areas, not from most transport sectors (except for rail), but from those with experience in the introduction of competitive tendering into other UK essential services such as water, electricity and gas.

A further point that should be clarified is whether the Division were aware of the possibility the Commission gives for "light PSOs" on third parties on a route outside the main PSO, whether this would have been possible here, whether this would have dealt with at least some of problems encountered on the tender, and if not then why not. The concluding section here discusses that issue further.

As of 9th March 2005, the Transport Division of the Scottish Executive confirmed by telephone that no Invitation to Tender had yet been sent out, and indeed that the tender documents had not been finalised. In view of the very real risks the retender entails, that is perhaps no bad thing, but its does raise further questions as to why the delay?

There is a further point that one of the companies which had expressed an interest was CalMac. But it is difficult to see how CalMac could pass the first hurdle of a pre-qualification questionnaire designed to test a candidates ability to deliver and support the

proposed venture, since CalMacs whole existence as a qualified operator is predicated on winning the tender for its own network, the implication being if it did not it would be wound up or reduced to shell or rump status unable to deliver the managerial resources experience and support that might be needed in the course of the Northern Isles contract.

If a foreign bidder, whose whole existence hung on winning a single contract bid due in a few months, bid for the Northern Isles, it would be unlikely to be judged a credible and financially robust bidder and would be unlikely to get through the initial screening process. If I know that, then other bidders know that, so if CalMac gets though the initial screening stages on a similar basis, the Executive can expect legal complaints from bidders. All this leads to the conclusion that, at the very least, one way or another, the next operator of the Northern Isles service is very likely to be a private firm headquartered outside Scotland. That should not be a major problem in the context of a well-designed regulatory structure and process. But for the reason outlined above, and as the Holyrood project vividly demonstrated, it could seriously add to what are already severe control and information problems here.

My conclusion on the Northern Isles contract is that if it would not be in the public interest for it to go ahead on the basis planned, and at least the dependent communities have the security of being in the hands of CalMac as operator just now. The present situation is not ideal, but it could be worse. There should be no rush to retender because of the public interest and State aid issues it would raise. Opportunity should be given to review the Northern Isles services just as with the CalMac network.

APPENDIX 5: GOUROCK-DUNOON

Western Ferries have recently indicated[57] that they are considering legal action alleging unfair competition and illegal State aid, claming that they are facing a subsidised operator (CalMac) on the Gourock-Dunoon route where Western operate without subsidy, and that there is not a level playing field.

The market here is also very important both because of its strategic role in the West of Scotland transport network and also because the Executive's recent invitation for expressions of commercial interest has sparked the current decision by the RMT union to take strike action across the CalMac network.

Western would appear to have a *prima facie* case under EC law. CalMac does receive a subsidy which, as far as is known, is not offered to any other operator including Western. This would appear to be potentially discriminatory under EC law, favouring one operator over any other, including Western.

Further, at the very least, if compensation is available to fulfill a public service obligation on specified grounds to one operator, then the 1992 Maritime Cabotage Regulation stipulates that such compensation should be available to all shipowners. So if CalMac is receiving subsidy to carry passengers (but not vehicles or CVs) on the Gourock-Dunoon route, there would seem to be a *prima facie* case that Western (and indeed any operator who wishes to enter the market) should also be given the opportunity to receive such subsidy, on equal grounds.

The first question to settle is whether the Executive has any right to impose public service obligations, and award compensation contingent on these obligations being fulfilled, in the case of Gourock-Dunoon.

The answer to that is that Article 4 of the 1992 Maritime Cabotage Regulation specifies that public service obligations can be imposed for maritime cabotage for regular services "to, from and between islands".

This clearly would exclude mainland to mainland services such as Gourock-Dunoon and Tarbert-Portavadie on the CalMac network, which is why there was subsequent strong representation by Professor Sir Neil MacCormick and the Executive to recognise the special cases of these routes.

As a consequence, in the 2003 Communication, the Commission stated

> *"According to the wording of Article 4(1) of the Regulation, public service links have to serve routes to, from and between islands. Long estuaries or fjords which lead to a detour of about 100 km by road may be treated as islands for the purposes of this section as they may cause a similar problem by isolating conurbations from*

[57] Communication to George Lyon MSP, op cit

each other. The ratio between the distance around the estuary and the distance across should be around 10 or greater."[58]

It may seem surprising that the lower Clyde Estuary may be treated as an island by Brussels, but the important point here is not the geographical definition but the legal definition for the purposes of EC maritime cabotage and State aid law. That being the case, certain things follow from that definition.

Firstly, Gourock-Dunoon qualifies for island status under the 2003 Communication by virtue of the fact that travel would entail a long detour if the ferries were not available.

Secondly, it is for Member Stases (or devolved authority) to determine which routes require public service obligations, but if PSOs are imposed they must be imposed in non-discriminatory fashion[59].

Thirdly, these same authorities can impose PSO with requirements on "ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel"[60].

Fourthly, any compensation for PSOs must be made available on a non-discriminatory basis[61].

Fifthly, the 1992 Regulation applies whether or not subsidies are granted for PSOs[62].

So what does this mean for Gourock-Dunoon and Western Ferries's threatened legal challenge? What follows is one interpretation of the circumstances, clearly the points below will be subject to further discussion and may be tested in Court, especially if Western carries out its threat to complain under State aid legislation.

The first point is that it appears that the Executive would be able to award PSOs and compensation for PSOs to shipowners in this market, but it must be done evenhandedly. If the Executive imposes a PSO on passenger fares and conditions, then if it imposes it on CalMac and offers subsidy to Calmac for carrying out the PSO, it must impose the same PSO on Western and offer the same compensation on the same terms to Western on route.

So if a PSO cap was imposed on CalMac passenger fares here, the same PSO cap should be imposed on Western passenger fares here and Western would be entitled to claim for the same level of compensation (e.g. subsidy per passenger) as CalMac.

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[58] Section 5.1.
[59] Section 5.2, ibid
[60] !992 Maritime Cabotage regulation, op cit, Article 4
[61] ibid
[62] 2003 Communication, op cit, Section 5.7

However, the 1992 Regulation also specifies that PSOs may include a specification or requirement on "capacity to provide the service", so if Western wish to claim a subsidy for this PSO, they might be expected to provide relevant facilities, e.g. CalMac either provides or pays for (in dues to the Council) waiting rooms, toilets and other shore-based facilities for passengers at both ends of this run. Western does not provide such facilities, and this could be a reasonable part of a PSO imposed on all operators on this route, including Western.

So the payment of subsidy on just one operator here could be regarded as a distortion in the market. However, there is a second potential source of market distortion in the form of the frequency restriction on CalMac which is only allowed to run one ferry an hour while Western has no restriction and in practice runs up to four an hour. This restriction was intended to balance the other distortion (payment of subsidy to CalMac) but just as two wrongs do not make a right, so two distortions do not a level playing field make.

There have been two major market effects of this second distortion. The first market effect of the second distortion is almost certainly to greatly increase the subsidy incurred by CalMac as discussed earlier since it lead to underutilization of assets, and spare capacity.

The second major market effect of the second distortion is to greatly increase Western's profits since on a route like this, vehicle based travelers especially will tend to opt for the frequent service.

The net result is that, according to Scottish Business Insider, Western is now one of the most profitable companies in Scotland[63]. Clearly to the extent the two distortions have influenced the market they have not balanced out (even though the latter was intended to counterbalance the former) and Western benefited hugely from having a protected market. Any claim Western may have against CalMac that they have suffered on subsidy restriction grounds could be countered by a claim by CalMac that Western has more than benefited financially on frequency restriction grounds.

At the moment the Executive are market testing to see if what is presently the CalMac service could be run without the need for PSO and subsidy, in other words to see if competition in this market between Western and a second operator would be sufficient to deliver what the Executive regards as economic and social objectives on what is defined as an island route.

If such a second operator cannot be found, the Executive reserves the right to award a PSO in this market. As discussed above, it would seem that the PSO (and any contingent compensation e.g. subsidy for passengers) would have to be applied to all the operators evenhandedly, to prevent distortion of competition on the route.

At the moment the option on the table for a PSO is just for passengers' fares and frequency of service for CalMac. But there is no reason in principle why the PSO could

[63] Information supplied by George Lyon MSP.

not also be for, say, vehicle fares and conditions for service, just as on CalMac's other route where PSOs are being applied, if the Executive deemed this necessary or desirable to help economic and social objectives such as regional development for vital "island" services here. At the moment, these restrictions on vehicle fares on other routes are expressed in terms of fare freezes in real terms, but there is no reason in EC law why they could not be expressed in the form of price reductions (as can be done in other regulated sectors) on these other routes, and for Gourock-Dunoon.

However, if such price (and other) controls in the form of PSOs were applied on CalMac or any other operator on the Gourock-Dunoon service, they would also have to be applied equally to all other operators on the route, including Western, irrespective of whether or not they receive or ask for subsidy. Otherwise the market would be distorted and there could be discrimination.

So by treating the Gourock-Dunoon route as a vital island service, on a legal par with geographic islands such as Colonsay and Barra, since 22nd December 2003 the Commisson would have appear to have given the Executive the powers under EC law to regulate terms and conditions (including fares, frequency and facilities) for all operators on the Gourock-Dunoon route (presently Western and CalMac) in the public interest, whether or not these operators receive subsidy, and whether or not these operators are profitable.

This clearly open up very interesting possibilities for pursuing economic and social objectives for communities dependent on the Gourock-Dunoon ferry services.

Western Ferries have promised a "users charter" to guard fares if they became the monopoly operator on this route, but clearly such a charter would not be necessary or appropriate. As the Commission notes in their 2003 Communication, it is for the relevant authority (which here would be the Executive) to decide what should be a public service obligation and how it should be expressed, "it is not for shipowners to set public service obligations"[64]

At the moment, the market testing process is underway and my personal opinion would be to encourage this to go ahead as stated with no proposed restrictions at the moment. However, it is sill worth noting that the Executive still has tools at its disposal, granted to it by the 1992 Regulation and the 2003 Communication, that would allow it to intervene and correct for market failures. For example, if it was decided that it was socially and economically desirable to encourage use of public transport (e.g. links with bus and train) and encourage car pooling, then PSO intervention could aim for low passenger prices which might be compensated with subsidy on a passenger per capita basis. Further, if subsequently it decided that vehicle prices were too high and restricting economic and social development on this "island", then a cap or fares reduction might be considered (perhaps without subsidy) on vehicle/driver fares.

[64] 2003 Communication op cit, footnote 13

This suggests that the opportunities afforded for using EC maritime cabotage law as a positive and active tool helping promote the public interest for the furtherance of economic and social objectives as they relate to vital island and peninsular transport links are much greater in the context of Gourock-Dunoon than might previously have been recognized.

While the formulation of such objectives should clearly be in the hands of the Executive and the Parliament, its pursuit is best handled by a professional and independent Regulator and is just one more reason why such a Regulator is needed.

FINAL THOUGHTS

On BBC Radio Scotland on 15th March, the day this submission was being finalised, an MSP mentioned me by name and suggested the proposal outlined in here implied that setting PSOs on a route by route basis along the lines suggested here could lead to the break up of the network and threaten the single bundle solution.

There is a danger of confusion here which is important to deal with before we go further. PSOs must generally be awarded on a route by route basis because it is would be impossible or impracticable to do otherwise. PSOs are about matters such as fares and frequency, and by their nature these matters will tend to be route-specific in a case like the CalMac network, so PSOs have to be set at the level of the route.

After that issue is settled, the question then becomes one of how the routes should be bundled for management and operational (or even tender, if tendering) purposes, e.g. 10 bundles, 3 bundles or one bundle. That is a separate question and the Commission says in its 2003 Communication[65] that the "the most appropriate size of bundles should be decided by taking into account of the best synergy to be made in meeting transport needs" (section 5.5.3).

So the question of PSO at route level, and the size of the bundle of routes for operational or management purposes are quite separate and should not be confused.

The following are some concluding thoughts, some of it informed by very positive and productive discussion with various individuals following the initial distribution of the paper since 6th March.

I conclude, as I started, with the point that competitive tendering may be the obvious way by which the 1992 Maritime Cabotage Regulation can be adhered to. The Commission also makes clear that, in its view, it is the best way "in principle" of dealing with these issues. But for the reasons outlined here, it may not be the best way in practice in certain contexts. It is not required by the Regulation, and it may be neither necessary nor sufficient to demonstrate adherence to both the spirit and the letter of the law in this context. It is argued here that there may be a better way of promoting the public interest and protecting Stare aid from abuse in the case of the ferry services we have been discussing.

Defining the problem

The fundamental argument here is that the basic problem has been defined too narrowly by the Executive as:

> *How to run a transport undertaking in the context of a 1997 Guideline that requires competitive tendering.*

[65] Op cit

How you define a problem, and who you ask to answer it, will determine the answers you get. If you ask Transport Division of the Executive the answer to the question above, you finish up with where we are today, which is very much where we started in April 2000 with the proposed tender not really any closer.

In fact, the problem should be posed as follow:

> *How to run an essential service on a continuous non-interrupted basis while being responsive to the public interest, including social, economic, regional objectives in the context of statutory obligations, including EC State aid law.*

If you pose the question in that fashion you do not ask Transport Division how to deal with it, you ask a utility regulator (e.g. electricity, gas, water or even rail).

Cherry picking and profitable routes

One issue which has been as raised and discussed is the cherrypicking or cream skinning of commercially attractive routes by operators. There are three points that could be made in this connection.

Firstly, CalMac has claimed that in the past that it does not have any profitable routes so there would be no routes per se to cherrypick (though it leaves open the possibility that segments of routes - eg freight - might be open to cherrypicking). It could also be argued that services on most CalMac routes would clearly not be delivered to the same quality or conditions if left to market forces, so PSO and subsidy is clearly necessary for the majority of routes, possibly all of them. So if this is a problem at all it should be a marginal one.

Secondly, if, however, subsequent route-level auditing for PSOs of the type suggested in this paper here does indicates some routes are profitable, then it does raise questions as to whether a PSO is legitimate. A PSO is "any obligation imposed upon a carrier to ensure the provision of a service satisfying fixed standards of continuity, regularity, capacity and pricing, which standards the carrier would not assume if it were solely considering its economic interest"[66]. If the operator is making a profit on a route under present conditions and restrictions then it may be difficult or impossible to square this with a PSO status on that route.

If there is a problem here it may reflect that fact that policy makers have downgraded regional and social objectives on the network relative to commercial objectives in recent years. Four years ago I submitted a Note on a fares review on CalMac services conducted by MDS/EKOS for the Executive in which I suggested there was a need for reassessing the basis on which the economic effects of price changes on CalMac routes. I argued it was (and believe still is) dominated by consideration of commercial and financial consequences, not social and regional developmental consequences. I argued then that; "joined up policy thinking reveals that there are many ways that local economic

[66] Delivering Lifeline Ferry Services, Scottish Executive Consultation Papar, April 2000.

development can be stimulated through grants and subsidies in the regions of Scotland. If we consider reductions in ferry fares for local residents, local businesses and tourists, the analysis in this Note suggests that reductions in ferry fares may be a highly effective method compared to alternative methods."[67]

As far as I know, there is nothing to say that, present levels of fares and frequency of service need be those that should be fed into the PSO for each route, present levels have been chosen as default for the basis for the proposed PSOs. But of course, the more that a policy of low prices and high levels of service is pursued for genuine social and economic reasons on any route, then the less likely a carrier would assume these responsibilities if it were solely considering its own economic interest, and the more it is likely to justify and require a PSO.

If such policies are pursued for legitimate social and economic reasons, and if policy makers genuinely believe and can argue that, say, lower fares and/or higher frequency of service should be pursued by subsidised activity for economic and social reasons on a service, then that should be expressed through a PSO. Alternatively, if it looks like a service could be profitable without subsidy at current levels of prices and service, then it suggests that a PSO is less justifiable, if it is justifiable at all. It may also suggest that commercial and financial objectives are dominating over social and economic objectives, and it could suggest that service provision may be achieved through market forces. This latter approach may of course be one legitimate policy objective, but I do not think it is necessarily the best way to approach questions of social and regional cohesion and development in the Highlands and Islands.

In other words, as far as I can see, whether or not a desired service is or could be commercially profitable (with implications for PSO status) is not something that should be regarded as independently determined outside of government policy. It is something which itself at least partly determined by what the government wants for public interest reasons, and what is subsequently decided to be put into the PSO in terms of fares and levels of service.

This is another example of the overly narrow specification of the CalMac services as just a transport problem that I mentioned in the main text. If you want to use these lifeline links as tools to pursue social and economic objectives for fragile and vulnerable communities, then the more you do this, the more subsidy and PSOs become required across the board. But the more you narrowly define the issue in terms of the financial implications of running a transport service, the more commercial implications and profit become the issue, and the less justified PSO can become, if it is justified at all.

[67] Comments on Caledonian Macbraynes Fares Review Study by MDS/EKOS, N. M. Kay, Submiitted to Scottish Executive, January 2001, available from author at neilkay@aol.com

Again, either policy route may be legitimate, but the more the government emphasises the latter, the more difficult it can be to justify the restrictions on competition that a PSO can involve. If you want to pursue the former route, you will not achieve that by leaving responsibility for ferry services in the hands of Transport Division, who will still tend to see the problem as a transport problem with financial implications. This is another reason why an independent Regulator is needed, mandated to take into account the wider economic and social agenda.

Thirdly, it has been suggested that both Northlink and CalMac have suffered because of cherrypicking on routes (see also UK Governments comments in Appendix 2). Alternatively, it has also been suggested that a "light PSO" can help deal with these problems. An exclusivity provision could also be of relevance. "Light PSOs" and exclusivity provisions are described in Section 5.5.1 of the Communication[68] referred to in footnote 20 of the main paper here. If "light PSOs" or exclusivity provisions could help deal with the problem of cherrypicking and knock-on effects for public subsidy (I do not have enough information to hand to judge if it could or could not in the cases to date), then the question is raised as to why it was not used in the cherrypicking cases alleged by CalMac and Northlink.

I do not know for certain at this point, but one possible reason why light PSOs or exclusivity provisions may not have crossed the radar screen of the Executive (if it has not) may reflect the fact that the 1992 Regulation was largely designed to reflect the conditions of Mediterranean countries, some of which may have multiple operators. That was one of the problems noted earlier in the main paper. Two or more operators on a route has not been a major issue in Scotland in recent years (with the exception of Gourock-Dunoon). It is something that becomes of potential relevance when you have cherrypicking and market entry, which is what has been clamed has happened recently on at least two other Scottish routes.

Given the substantial sums of increased public subsidy alleged to have been incurred as a consequence of so-called cherrypicking, the Executive should be asked if they were aware of "light PSOs" or exclusivity provisions, which appear to be designed to deal with questions of market entry as observed in the Northern and Western Isles; if there were not aware, why not; if they were aware and did not use them, why not?

This also reinforces the need for a professional independent Regulator. A Regulator would be expected to know about light PSOs and exclusivity provisions, would help inform the public and the operators about their existence, would have the responsibility for deciding the potential applicability of light PSOs, and exclusivity provisions and would monitor their operation.

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[68] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions (22/12/03) on the interpretation of Council Regulation (EEC) No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States (maritime cabotage)

Over compensation, non-discrimination, compensation open to all, and the threat of legal challenges

Ultimately Clyde and Hebridean ferry services, in whatever form, have to pass State aid legal tests, specifically the 1992 Regulation. There are a number of inter-related issues here relating to questions of potential over-compensation, non-discrimination, compensation open to all, and the possibility of legal challenges.

I have looked at these issues as an economist, and to the extent that competition and State aid laws are built to a great extent on economic arguments, that is justifiable. I have also tried to take into account the EC law in this area to the best of my ability, though clearly the arguments must be looked at by professionals in the area of competition law and State aid.

As an economist, I am content that the system suggested here, if applied in properly and transparently, could ensure and demonstrate that there would be no overcompensation of CalMac for the operation of Clyde and Hebridean Ferry Services, indeed there would be undercompensation in so far as there would be no component of "reasonable profit" as mentioned in the Altmark guidelines.

I would also argue that it could be seen as non-discriminatory in economic terms since demonstrably and transparently efficient cost-only operation would mean it would not be depriving other operators of economic gains in the form of profit.

As far as compensation open to all (the 1992 Regulation) is concerned, the parallel question is whether tendering is necessary (or even sufficient) to demonstrate this point. It is certainly the most obvious, but that is not the same thing. This aspect might be pursued if operators could in principle be free to raise counterproposals for consideration with the Executive, if the arrangements were set out in the Official Journal it would aid transparency in these regards and help reinforce non-discrimination, and there are possibilities such as letters-of-comfort which might also be helpful in this context - though such letters, if they are possible at all here, would have to be earned. If an operator subsequently puts a proposal that would claim to undercut audited and regulated cost-only non-profit CalMac while still allowing that operator a reasonable profit, then it should certainly be scrutinized by the Executive. If the Executive subsequently rejected it on the grounds that it was not a credible proposal, then the operator would have potential for recourse to the Commission and the Court if necessary. But these routes exist anyway whatever the Executive does, the way forward here is to provide arrangements which adhere to what the State aid Law was trying to achieve, objectively and transparently.

On that last point, the threat of legal challenges, the bad news for the Executive is that these threats exist now and will exist in the future, whatever it does. Western Ferries has written to George Lyon MSP to say they are considering legal complaints against CalMac on State aid grounds (they have not made public whether their threat is restricted to Gourock-Dunoon or also includes the network as a whole)[69].

[69] But see Appendix 5 here

I would also note that I was told in 2004 by a senior manager and reliable source in one of the companies that lost out in the original tendering exercise to Northlink that they had been approached by another losing bidder who wanted to discuss lodging a joint complaint against the Northern Isles contract being awarded to CalMac. I do not know what grounds they were going to base their complaint on, and in the event, no complaint was made as far as I know. However, this time the rushed nature of the process (with at least one company noting they only had days to complete the required documentation to express an interest) and the curious status of CalMac in the process (see Appendix 4) is even more vulnerable to complaints.

If the Executive continues to take a short-term reactive approach based on a desire to avoid legal threats from the Commission or operators, not only will this fail in its objectives, it will actually create legal challenges, the very thing they are trying to avoid.

Instead, if the Executive should frame the problem as noted above, as one of running an essential service on a continuous non-interrupted basis while being responsive to the public interest, including social, economic, regional objectives in the context of statutory obligations, including EC State aid law.

This will not guarantee that the threat of legal challenges will go away, indeed it could be argued that the potential for these helps keep the system honest, and transparently so, and that the threat of, and opportunity for, legal challenge is a healthy and integral part of any functioning system (though I appreciate that last point might elicit a shudder from a civil servant). If the Executives frames and pursues the problem properly it will not magic legal or any other problems away. But it will have more chance in the medium to long term of serving the public interest and complying with all the constraints, including EC law, in this context.

Taking matters forward

What is needed from Parliament and the Executive is the will and the determination to fashion a workable regime for these essential services under EC State aid rules, and what is needed from the Commission is a small amount of slack sufficient to explore the viability of alternatives. It should be appreciated that wholehearted attempts are being made to comply with the EC State aid laws here, so threats of dire consequences of what might follow if competitive tendering is not pursued would be unnecessary and indeed would be counterproductive. For example, it has been suggested that if attempts are made to deviate from competitive tendering, then the Commission might revisit the issue of whether or not the routes could be tendered in one bundle and require that CalMac be broken up into 3 or 4 bundles as was originally indicated, by area, or by type of service (e.g. large vs small vessels), or even break the service up entirely and require tender on a route by route basis.

However, there would be absolutely no economic, social or legal justification for using such a tactic to force acceptance of what is essentially an unworkable solution in this

context. Whatever the reasons for the emergence of the single bundle proposal, it is - and has been - justified on economic and technical grounds because of the network economies it affords, such as shared administration, systems, vessels, work force, sales and distribution.

Similar arguments hold for retaining First Scotrail, the rail operator, as a single bundle. In principle, First Scotrail could have been broken up by area (Highland, East Coast etc), by type of service (inter-city vs local services) or even on a route by route basis (Aberdeen –Edinburgh, Edinburgh–Glasgow etc). If you want a simple response to why not break up CalMac, then just ask the question why not break up First Scotrail? The answer is because would sacrifice significant network economies and add significantly to subsidy and State aid. And that is not what the law is intended for.

The single bundle should not be seen as a "concession" which could be revisited by the Commission unless competitive tendering goes ahead. Single bundle is a coherent and sensible economic solution in itself and should be seen as such.

Again, it is worth repeating that the Commission's own view on what should determine bundle size are stated in its 2003 Communication[70] where it states "the most appropriate size of bundles should be decided by taking into account of the best synergy to be made in meeting transport needs" (section 5.5.3).

That is the Commissions own stated view of how bundle size should be decided and no other view should be permitted to allow this question to be revisited. The question of whether or not competitive tendering should be applied to these services is another important question but should be seen as a separate issue. The questions should not be seen as falsely and unjustly dependent on each other in any way. Any suggestion to the contrary should be rejected, especially if such arguments are used to try to scare individuals or groups into accepting competitive tendering, a return to the ducking stool approach mentioned below.

A final comment: the Ducking Stool test

At the moment, the way the alternatives are being presented and discussed is reminiscent of the old ducking stool test for witches, where suspected witches were presumed guilty until proven innocent and were ducked in a pond. If they survived, they were deemed guilty and burnt at the stake, if they drowned they were pronounced innocent. Here vulnerable communities are being threatened with the loss of their lifeline services if CalMac does not prove its innocence by going to tender, but if it does go to tender it opens up the system to the potential costs, risks and abuses documented by myself and others which could also lead to the loss, or at least the disruption or degradation of these essential services. In either scenario, there is too strong a risk that the public interest would be drowned out, which is not what the common market and State aid legislation is intended to be about, and I know is not what the Executive or the Commission intends.

[70] Op cit

But unless the space and opportunity is given for reasoned debate in this context, there is real risk that is what will happen.

Thankfully, ducking stools are no longer seen as the most appropriate device for establishing how guilt or innocence should be judged, few believe in witches anymore either. All that is asked here in the first instance is a willingness to bring together the experts in the area and explore arguments that there could be another way of dealing with what are major public interest issues. Ducking stools are no way to conduct reasoned and constructive debate in a mature society, and it is time we moved on from that.