

# Scottish ferry policy and the Commission decision

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*This article is an update of an earlier review of Scottish ferry policy in this Commentary last year<sup>1</sup> (hence “Fraser Commentary Feb 09”) in the light of the outcome of the European Commission investigation into alleged State aid for Scottish ferries. The European Commission announced their investigation<sup>2</sup> into alleged State aid for Scottish ferry services in May 2008 (hence “EC May 08”) and their final Decision<sup>3</sup> was published October 2009 (hence EC Oct 09).*

*This update is intended to be read in conjunction with Fraser Commentary Feb 09 to minimise repetition of facts and arguments set out in that earlier article.*

The main conclusion here is that successive Scottish administrations have adopted what might be described an ostrich approach to ferry policy, burying their heads in the sand and hoping that nothing nasty will happen<sup>4</sup>, and that EC Oct 09 has done nothing to rectify this state of affairs. The context is set by arguments I made as far back as 2001 in evidence to the first Parliamentary Inquiry into the tendering of CalMac, that it was well established and accepted practice (as demonstrated in the case of the UK) that in an industry characterized by the provision of an essential services, three essential tools were needed: (a) an independent regulator; (b) a clearly defined Operator of Last Resort able to take over the contract immediately should the incumbent withdraw, or if withdrawal is threatened; (c) a well developed supporting statutory framework. As I noted in Fraser Feb 09, had the problem been properly defined, then policy makers would have been more likely to have anticipated and dealt with public interest issues that have arisen and may well arise in the future. These problems were compounded by other failures in terms of interpretation of EC law which limited what policymakers could and should have done.

These failures have numerous ramifications and we shall concentrate briefly on just six issues of concern as indicative of possible problems, or as major problems in their own right.

## 1. Altmark and the need to tender

EC Oct 09 confirms (para 165) that “in order to establish that there is an advantage capable of constituting State aid

in the sense of Article 87(1) of the Treaty, the Commission must assess whether the Altmark conditions are fulfilled”. The crucial point about this, as noted in Fraser Feb 09, is that I and two other academics had produced papers independently of each other which argued that there was actually no need under EC law to expose the CalMac network to the considerable and recurring delays and costs that a six-yearly tendering process would involve. As Fraser Feb 09 notes, I had pointed out that a coherent alternative to tendering could be fashioned consistent with EC law if the Altmark conditions were fulfilled. But as Fraser Feb 09 also notes, the then Scottish Executive rejected these arguments in 2005 claiming instead that the Altmark criteria were not applicable to such ferry services.

It is small comfort to note that we were right and the government’s legal advisers were wrong, because the result has been that the tender process did go ahead, and it is almost certain that such services will continue to be put out to tender. It is not that tendering is necessarily bad, indeed in many contexts it can be in the public interest, but as we shall see below, the failures by the government to accept the relevance of Altmark and alternatives to tendering when combined with other failures noted above raise real dangers and risks for the public interest here.

For the alternatives to tendering cited by us to be revisited at official level would require officials admitting error; would require them to be able and willing to fashion coherent alternatives to tendering under the Altmark conditions; and would require the European Commission to accept radically new proposals fashioned by the same sources that have just been investigated by them for alleged breaches of EC law.

All things considered, there may be thought to be little likelihood of such a reversal of policy taking place. The public interest would at least be served by a serious investigation as to why these failures took place, though that may also be unlikely to happen.

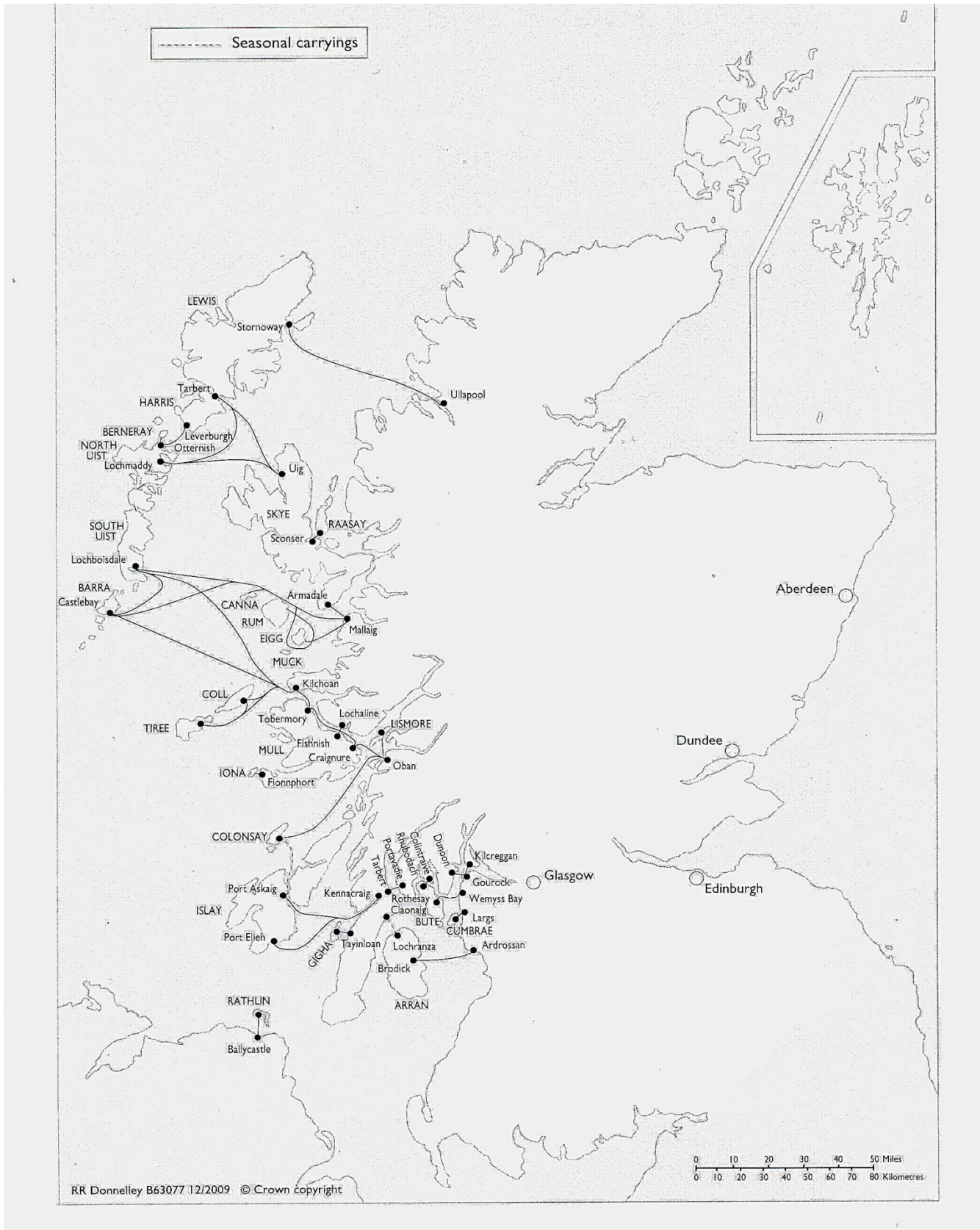
## 2. Public service obligations and Altmark in Scottish ferry services

As discussed in Fraser Feb 09, public service obligations (PSOs) have a clearly defined role and status in EC law. The imposition of PSOs is stated by the Commission as a precondition for any subsidy for EC ferry services. Yet as noted in Fraser Feb 09, the government echoed its predecessor in rejecting arguments that there was a need for PSOs for any of its subsidised ferry services.

This was at least folly, because it would have been possible to state that the public service contracts (PSCs) contained and helped deliver the requisite PSOs here. They chose not to adopt that solution but to reject PSOs just as the relevance of the Altmark principles had been rejected.

It was therefore not surprising, indeed almost inevitable, that when the Commission made their announcement of

Figure 1: Caledonian MacBrayne ferry routes



intention to investigate these services for supposed breaches of State aid legislation, that suspected failure to apply clearly specified and justified PSOs and adhere to the Altmark principles figured repeatedly in the EC May 08 charge sheet. Yet EC Oct 09 subsequently found that the government and CalMac were largely innocent of these charges.

If the Commission had found the charges as set out in EC May 08 justified, then in principle it could have led to the bankruptcy of CalMac. The government's opinion as reported prior to EC May 08 was that "If found guilty the commission could request that CalMac, which is wholly owned by ministers and does not have large reserves of money, could be forced to repay subsidy which would potentially bankrupt the company and could leave our most fragile peripheral communities with no links to the mainland - or other island communities."<sup>5</sup>

It is worth noting that the dangers were of government's own making, not only by creating what was seen by the Commission as *prima facie* cases of breaches of EC law, but also for failing to put in place the safeguards (such as Operator of Last Resort) that would guarantee the smooth continuance of these lifeline services to these same vulnerable communities in the event that the incumbent operator was unwilling or unable to continue.

This was an occasion when weakness (on the part of the government) was strength. As I noted at the time<sup>6</sup> with respect to the potential bankruptcy of CalMac for failing to adhere to EC law, I doubted whether that would be allowed to happen, and so it has proved. The government of the time and its predecessors had put the Commission into an impossible situation where the stark choice was between finding (as charged) that the government had failed to have clearly specified and justified PSOs and adherence to the Altmark principles, in which case the remedy could lead to the collapse of an entire transportation network providing essential services to vulnerable communities; or the Commission could conclude (as they did) that despite having rejected PSOs and the Altmark principles, the government somehow did indeed have properly constituted PSOs across the board and had also adhered to these same Altmark principles.

If the first scenario facing the Commission could have come out of a disaster movie, the second had more the taste of Alice in Wonderland.

Given these two choices, the EC Oct 09 Decision was undoubtedly the right one in terms of the public interest, as I had noted prior to EC May 08; "Were Brussels to close down the ferry services, the outrage would not only be felt in Scotland, but across Europe,"<sup>7</sup>

The problem is that while the Decision was the right one in terms of the alternatives, it does not provide a solution to the problems that policy makers have created here, and we turn to some of these now.

### 3. Cherry picking

The most obvious opportunities for cherry picking in ferry services depend on the nature and characteristics of the route in question, but (just as in postal services) will typically target high value and/or low cost services. In an unregulated ferry market this is likely to be cars and commercial vehicles, freight, short crossings, seasonal traffic, and/or highly trafficked routes. The corollary holds; cherry pickers are less likely to be interested in off-season, foot passenger, longer crossing, and/or lightly trafficked routes.

Cherry picking is not automatically against the public interest especially if there can be competition amongst cherry pickers within a given market (as in some cases of postal services). However, in the ferry markets served by CalMac, the likelihood of competition between cherry pickers for particular services on a given route is likely to be small and if cherry picking takes place on a given route it is likely to lead to a local monopoly. There is little if any evidence that such markets are likely to be contestable in practice, especially since there may be incumbency advantages such as sunk costs and timetable slots (for the incumbent) and entry costs (for a possible entrant). The deficiencies outlined in Fraser Feb 09 to the effect that there is no independent industry regulator and statutory framework for this industry means the industry is highly vulnerable to all the adverse effects that unregulated cherry picking and local private monopolies in essential services can entail.

### 4. Strategic behaviour on the part of bidders

The implications of the Government's failures to adopt normal regulatory safeguards and to have a pre-defined qualified Operator of Last Resort contracted to take over (overnight, if necessary) in the event of the incumbent operator defaulting (or threatening to default) on the contract means that there is no real alternative but to continue with the tender once it is up and running. This will not be lost on future potential bidders for the network.

CalMac will have to defend its right to run the network every six years and if it loses just once in the tendering process this will effectively eliminate it once and for all as an operator - or at least as an operator with the resources and capabilities necessary to run such a network.

Bidders will be well aware of that, and also will be aware of the deficiencies regarding the absence of a pre-designated

Operator of Last Resort. There will be an incentive to under-bid CalMac on the bidding process (and under EC law the least subsidy bid must be accepted) knowing that once control of the network is secured, the winning bidder will be able to renegotiate terms mid-contract. They will know the government will have no alternative but to pay up or face the cessation of essential services to vulnerable island communities. History suggests that when the market is faced with such opportunities, the market will exploit them.

There are other lessons from history as I noted in Fraser Commentary Feb 08 with respect to NorthLink. This company informed the Scottish Executive that it could no longer realistically deliver its contractual obligations to the Northern Isles over the four years remaining of the contract for ferry services. The Scottish Executive concluded Northlink was heading for insolvency and unless additional subsidy was paid, lifeline services could have been interrupted. Significant additional subsidy of about £43mill was then paid.

There is no suggestion that Northlink was behaving strategically and that its difficulties were anything other than real and not contrived. The important point was that the government had no alternative to pay up because of the situation that was of the government's creation. These failures may not be limited to the Northlink contract in the future, yet these risks have been created and deemed acceptable by policy makers in the face of all that is accepted as good (and indeed necessary) practice in such contexts.

## **5. Gourock-Dunoon**

On 31 December, the Scottish Government issued a tender notice for the Gourock-Dunoon public service<sup>8</sup>. Presently the public service there runs a mixed vehicle and foot passenger service, vehicle-carrying in unsubsidized competition with Western Ferries, a commercial operator. The present subsidy for the public service is for the carriage of foot passengers only. Although the new contract is for a subsidized service on a route classifiable as a public service route under EC guidelines, there is no maximum fare or minimum fare specified in the contract notice as would be permissible with PSOs, and operators are expected to supply their own vessels, unlike other CalMac routes where the government builds and supplies the vessels. Thus obviously precludes bidders opting to build their own vessels since the contracts will only be for six years, which means that they will have to find whatever is available on the second hand market. This by definition is composed of vessels not explicitly designed for that route, and biased towards the obsolete and inefficient.

The official report into the Gourock-Dunoon ferry market<sup>9</sup> conducted by Deloitte Touche for the Scottish Executive confirmed that the most efficient and least subsidy method to provide for the subsidized foot passenger market was with combined vehicle and passenger vessels to help to offset the subsidy needed for the low revenue / high cost foot passenger market. However these vessels usually have to be designed and built specially, as is demonstrated in other CalMac routes in Scottish waters, so it is highly unlikely that the two modern vehicle-passenger vessels that the Deloitte Touche report identified as needed for this route will be secured by any potential bidder for this tender.

The importance of Gourock-Dunoon can be seen from the map (Figure 1). The Gourock-Dunoon ferries cover a short distance, for much the same reason (and serving much the same function) that the Forth Bridges provide over on the East Coast of Scotland, in transport terms and geographically these ferries are the mirror image of the Forth Bridges. The Gourock-Dunoon ferries are an essential and intrinsic part of the West Coast transport network with the road alternative involving an 84 mile detour.

There is no guarantee as to what, if any, bids will be received for this new tender. The last tender for the service led to no bids at all and CalMac continuing with the public service by default, leading to accusations of the government having failed to abide by EC law.

Given what appears to be (at best) a very thin second hand market for suitable vehicle-passenger ferries, it is entirely possible that the public service route will become passenger-only, giving the private firm Western Ferries the status of sole operator of vehicle carrying traffic Gourock-Dunoon. This in turn raises a range of problems and issues which policy-makers have created, some of which are covered in the next section.

## **6. Reconciling private interests and public interests**

Normally the question of reconciling private commercial interests with the public interest when dealing with an industry providing an essential service is the job of an industry regulator in the context of a dedicated statutory framework with back up from a pre-specified Operator of Last Resort. However, as we have noted, there are no such provisions in Scottish ferry policy.

To consider some of the issues that this has raised, we shall consider possible indicative developments involving just one private company, Western Ferries and some of its publicly stated interests in other ferry routes.

First, Western Ferries have already stated that they are bidding for the Gourock-Dunoon public service, and as we have noted in the previous section even if they are unsuccessful this could still lead to the private firm being the sole operator of vehicle-carrying ferries Gourock-Dunoon.<sup>10</sup>

Second, Western Ferries have also recently announced their intention to mount a commercial challenge to CalMac's Arran-Brodick public service<sup>11</sup>, and in the opinion of Professor Alf Baird of Napier's Transport Research Institute, competition between the two operators would be unlikely to be sustainable in the long run<sup>12</sup>, raising the possibility that the private operator could crowd out the vehicle-carrying public service operator on this route also.

Third, Western Ferries have a long-standing and publicly stated interest in running a service from Bute to Ardyne Point on the Cowal Peninsula<sup>13</sup>, once the public road and associated infrastructure have been upgraded by the local council. This route lies between both the Colintraive-Rhubodach and Rothesay-Wemyss Bay CalMac ferry routes from Bute (see figure 1), with Ardyne Point lying on the same peninsula as Colintraive. For most travelers, the route at Ardyne would be a direct substitute for the Colintraive ferry, which could well see a crowding out of that public service for much the same reason that the CalMac Arran service could be crowded out by Western Ferries.

However, the Ardyne service when combined with Western Ferries Gourock-Dunoon service using the Cowal Peninsula as a land bridge could also prove an alternative to the Wemyss Bay / Rothesay service for many travelers from Bute to Inverclyde and Glasgow (less so for travellers from Bute to Ayrshire direction). Since Western Ferries service would be a commercial service, this could lead to a repetition of complaints that Western have made in the case of Gourock-Dunoon that their commercial vehicle-carrying service was facing unfair competition from the subsidised CalMac service. That again could be seen as legitimising for Bute a repetition of what happened on Gourock-Dunoon where the public vehicle-carrying service was first restricted, and may now be terminated, as a consequence of measures taken by the government to insulate the Western Ferries service from competition from the public service.

I would emphasise I am not commenting on the likelihood of any or all of this happening, this is just reporting Western Ferries publicly declared interests and possible plans, and their possible implications. Nor should this be seen as voicing any opinion on the economic costs and benefits of actual route options such as short crossings. And there are also other scenarios such as the possible extension of the government's pilot RET (Road Equivalent Tariff) scheme into the Clyde routes that would affect these possibilities.

However even the most likely and most immediate scenario in which Western absorbed all of CalMac's Gourock-Dunoon vehicular traffic would lead to an outcome in which the private operator on this one route would be carrying about two-thirds the volume of cars carried by what was left of the CalMac network.<sup>14</sup>

The fundamental point of concern, of which Western's plans are indicative, is the potential nature and scale of scenarios associated with such plans and possible outcomes. The four public service routes discussed here shown in Figure 1 (Arran, the two Bute routes, and Gourock-Dunoon) carried 451,000 cars in 2008, the rest of the CalMac network carried 662,000 cars in the same year, while Western Ferries carried 588,000 cars.<sup>15</sup>

An extreme scenario in which competition from Western Ferries leads to the company absorbing all the traffic from these four CalMac routes would on the 2008 figures lead to Western Ferries carrying 50% more car traffic than would be left for the rump of the CalMac network. In such a scenario a commercial firm would be sole operator for several routes classifiable under UK and EC rules as public service routes and so eligible for the imposition of PSOs such as maximum prices and minimum frequency. But since this government and its predecessor have chosen not to make use of the tools that UK and EC law has given it, and set up a proper regulatory framework, it is questionable whether such measures would be implemented.

In such circumstances, there is no suggestion here that Western Ferries and other potential commercial entrants would be doing anything other than pursuing legitimate shareholder interests under the existing law. But as we teach in Economics 101, private interest is not always fully reconcilable with the public interest, especially where the provision of essential services by private local monopolies is concerned. The failures of successive administration to recognize and deal with that simple point are likely to be felt by vulnerable and fragile communities for generations to come.

## Conclusion

The Commission Decision on alleged State aid to Scottish ferries has done nothing to mend structural fault lines running through policy-making in relation to public services provided on the Scottish ferry network. The Commission cannot be blamed for these failures which are not their responsibility, but the lack of willingness on the part of successive administrations to deal with these failures raises serious risks to the public interest, most especially for the taxpayer, the users, and the communities who depend on these essential services.

## Addendum

The present Scottish Administration has been carrying out a “Ferries Review” of policy in this area, the Review was originally ordered under the previous Labour/LibDem administration. As this Commentary was going to press, the Herald newspaper reported that a government memo made available to the newspaper indicated that the date of publication for the Review was “in reality” likely to be later than the latest date for the next Scottish parliamentary election due May 5, 2011 (*CalMac review advises break-up, Herald, 7th February 2010*). In short, the present administration will simply have started a Review ordered by its predecessor, and then passed on to its successor any decisions about publication, and any decision or decisions as to what, if anything, should be done about the Review. If any further evidence were needed of the ostrich-like behaviour I describe in my article, this timely example would be difficult to surpass.

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## References

<sup>1</sup>Scottish Ferry Policy Fraser of Allander Economic Commentary February 2009, Vol 32 No 3 pp. 45-58, [http://www.strath.ac.uk/media/departments/economics/fairse/backissues/Fraser\\_of\\_Allander\\_Economic\\_Commentary\\_Vol\\_32\\_No\\_3\[1\].pdf](http://www.strath.ac.uk/media/departments/economics/fairse/backissues/Fraser_of_Allander_Economic_Commentary_Vol_32_No_3[1].pdf)

<sup>2</sup>State aid C 16/08 (ex NN 35/07 and NN 105/05) — Subsidies to CalMac and NorthLink for maritime transport services in Scotland: Invitation to submit comments pursuant to Article 88(2) of the EC Treaty <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:126:0016:0042:EN:PDF>

<sup>3</sup>Commission Decision of 28.10.2009 on the State aid No C 16/2008 (ex NN 105/2005 and NN 35/2007) implemented by the United Kingdom of Great Britain and Northern Ireland Subsidies to CalMac and NorthLink for maritime transport services in Scotland [http://ec.europa.eu/energy/coal/state\\_aid/doc/decisions/2008/2008\\_0016\\_uk\\_c.pdf](http://ec.europa.eu/energy/coal/state_aid/doc/decisions/2008/2008_0016_uk_c.pdf)

<sup>4</sup>I am well aware that ostriches have been unfairly maligned and that they do not indulge in such behaviour, indicating that bird sense can sometimes be superior to human sense.

<sup>5</sup>CalMac ferries ‘could go bust’ Rob Edwards, *Sunday Herald*, 23 March 2008 <http://www.robedwards.com/2008/03/calmac-ferries.html>

<sup>6</sup>Ibid

<sup>7</sup>Ibid

<sup>8</sup>See tender notice at [http://ted.europa.eu/Exec?DataFlow=N\\_one\\_doc\\_access.dfl&Template=TED/N\\_one\\_result\\_detail\\_curr.htm&StatLang=EN&docnumber=1636-2010&docId=1636-2010](http://ted.europa.eu/Exec?DataFlow=N_one_doc_access.dfl&Template=TED/N_one_result_detail_curr.htm&StatLang=EN&docnumber=1636-2010&docId=1636-2010)

<sup>9</sup>See Final Report: Options for the Ferry Services Between Gourock and Dunoon, Scottish Executive, <http://www.scotland.gov.uk/library2/doc15/fogd-00.asp>

<sup>10</sup>Western Ferries says tax question will not scupper route bid, The Herald, January 19th, 2010, <http://www.heraldsotland.com/business/corporate-sme/western-ferries-says-tax-question-will-not-scupper-route-bid-1.999753>

<sup>11</sup>Western Ferries sets its sights on Arran, Arran Banner, 2nd October, 2009, [http://www.arranbanner.co.uk/news/fullstory.php/aid/2063/Western\\_Ferries\\_sets\\_its\\_sights\\_on\\_Arran.html](http://www.arranbanner.co.uk/news/fullstory.php/aid/2063/Western_Ferries_sets_its_sights_on_Arran.html)

<sup>12</sup>First challenge to CalMac in 40 years, The Scotsman 6th January 2010, <http://news.scotsman.com/inverness/First-challenge-to-CalMac-in.5958172.jp>

<sup>13</sup>Western Ferries had frequently voiced an interest in the past in running a service between Ardyne and Bute, (but) they would not provide the shore infrastructure” Dunoon Observer 24 November 2006. See also Ardyne Point, Cowal Environmental Statement, Non-Technical Summary Sir Robert McAlpine Ltd May 2007 <http://www.southcowal.org/docs/ardyne/FINAL%20Ardyne%20point%20NTS%20-%20May%202007.pdf>

<sup>14</sup> Scottish Transport Statistics no 28, 2009 edn, Scottish Government, <http://www.scotland.gov.uk/Resource/Doc/933/0092536.pdf>

<sup>15</sup> Ibid