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Lynne Geddes
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Date: 22 February 2018

Dear Sir/Madam

You are invited to the following meeting:

**Special Shetland Islands Council
Council Chamber, Town Hall, Lerwick
Wednesday 28 February 2018 at 10.00am**

Apologies for absence should be notified to Lynne Geddes at the above number.

Yours faithfully

Executive Manager – Governance and Law

Convener: M Bell
Depute Convener: B Wishart

AGENDA

- (a) Hold circular calling the meeting as read.
- (b) Apologies for absence, if any.
- (c) Declarations of Interest - Members are asked to consider whether they have an interest to declare in relation to any item on the agenda for this meeting. Any Member making a declaration of interest should indicate whether it is a financial or non-financial interest and include some information on the nature of the interest. Advice may be sought from Officers prior to the meeting taking place.

1. Shetland Islands Council's Response to the Scottish Government Consultation on the External Ferry Service Procurement Policy. Report to follow.

The following items contain EXEMPT information

2. Chief Executive Appointment – Update. Report to follow
3. Council Office Premises – 8 North Ness Update. Report to follow.



Shetland Islands Council

Agenda Item

1

| | | |
|----------------------------|--|------------------|
| Meeting(s): | Shetland Islands Council | 28 February 2018 |
| Report Title: | Shetland Islands Council's Response on the External Ferry Service Procurement Policy | |
| Reference Number: | DV-12-18-F | |
| Author / Job Title: | Neil Grant – Director Development Services | |

1.0 Decisions / Action Required:

That the Council **RESOLVES** to: -

- 1.1 **CONSIDER** the content of this report and provide views to be included in a response to the Minister for Transport and Islands on Ferry Procurement Policy.
- 1.2 **INSTRUCT** the Director Development Services, or his nominee, in consultation with the Leader and the Chair of Environment and Transport Committee, to draft and send a response to the Minister for Transport and Islands' letter of 31 January 2018 incorporating any views expressed by the Council.

2.0 High Level Summary:

- 2.1 The Minister for Transport and Islands has written to the Council Leader seeking views on the Scottish Ferries Procurement Policy review currently being undertaken by Scottish Government (letter attached as Appendix 1).
- 2.2 The Policy Review was announced on 2 February 2017 in a statement to Parliament from the Minister for Transport and Islands.
- 2.3 The main point of the review (covering only Scottish Government's three contracted services: the Clyde and Hebrides, Northern Isles and Gourock Dunoon) is to determine whether it would be possible to make direct awards to an in-house operator in the future, potentially removing the need for competitive tendering procedures.
- 2.4 The work to date has culminated in an interim report published on 20 December 2017 presenting the emerging findings of the work. The report is attached as Appendix 2.
- 2.5 Scottish Government is now undertaking a further round of engagement with stakeholders and agencies in the Northern Isles on the basis that previous engagement in the Northern Isles did not reach a conclusive view on future procurement policy.
- 2.6 The remainder of this report sets out the principal issues in the interim report, summarises views gathered from stakeholders and proposes issues to be considered by the Council in the course of establishing views on the future ferries procurement policy.

3.0 Corporate Priorities and Joint Working:

3.1 The Council's Corporate Plan states: -

There will be a programme of potential changes to our long-term external transport systems. This will aim to meet our economic-growth needs and will be set within a realistic funding programme.

3.2 The Council works closely with ZetTrans, as the main partner, to deliver its transport priorities along with NHS Shetland and Highlands and Islands Enterprise.

4.0 Key Issues:

4.1 Appendix 1 to this report contains a letter from the Minister for Transport and Islands inviting the Leader's views on the future of ferry services procurement policy in Shetland.

4.2 Appendix 2 to this report contains the interim report of the ferry services procurement policy review.

4.3 The report is summarised below in the following five specific areas: -

1. Legal Framework
2. Stakeholder Engagement
3. Value for Money
4. Future Operating Models for Ferry Companies Owned by the Scottish Ministers
5. Implications for Ferry Services

Legal Framework

4.4 The legal framework surrounding the provision of ferry services is very complex. In its simplest terms, ferry services must be tendered in order to comply with EU legislation unless it can be shown that the manner in which services are provided comply with what is known as the Teckal exemption.

4.5 There are three tests to demonstrate Teckal compliance. These are the functions test, the control test and the private capital participation test.

4.6 Scottish Government is confident that a Scottish Minister owned company (i.e. Calmac) would meet the functions and private capital participation tests.

4.7 However, as matters currently stand, there is less certainty that it would pass the control test. To pass the control test the company must be directly accountable to Scottish Ministers and that is not the case at the moment although Calmac is a wholly owned company of Scottish Ministers. The issue is that Calmac is governed by a Board which may not be sufficient in terms of direct control by Scottish Ministers. This area needs further research.

4.8 There are further legal issues to be considered also which means more time is required to establish a robust policy position.

Stakeholder Engagement

- 4.9 Local Communities and stakeholders served by the Clyde and Hebrides Calmac services expressed a general preference for a direct award for an in-house operator.
- 4.10 The initial consultation by Transport Scotland in Orkney concluded a clear preference for tendering.
- 4.11 In Shetland the Transport Scotland consultation conclude a more neutral position by some with a proportion of stakeholder expressing a preference for tendering.
- 4.12 Therefore Scottish Government is once more seeking views in Shetland to check whether views have evolved since the first consultation.
- 4.13 Since the first consultation officers, through engagement with stakeholders on other work, have picked up a significantly stronger view that tendering services yields a better outcome for the islands than direct award.

Value for Money

- 4.14 There is some evidence that tendering can present different creative and innovative service solutions. Any direct award to an in-house company would need to include mechanisms to deliver similar levels of continuous innovation and service delivery improvement.
- 4.15 A direct award to an in-house operator, in full compliance with the Teckal doctrine and the State aid rules, is capable of providing similar levels of efficiency and service delivery to that which might otherwise be obtained from tendering.
- 4.16 A direct award to an in-house operator would avoid the high costs of tendering, allowing savings from the tendering process and operator returns to be reinvested in public services.
- 4.17 A direct award would also allow longer-term investment planning.

Future Operating Models for Ferry Companies Owned by the Scottish Ministers

- 4.18 The immediate focus is on the changes required to the current corporate company framework for David MacBrayne Limited and its operating companies in order to satisfy the Teckal control test.
- 4.19 Further consideration can be given to alternative operating models, such as the creation of a new public sector body, or transfer to an Agency of the Scottish Government, once the immediate question of changes required to the current corporate company framework to satisfy the Teckal control test has been addressed.
- 4.20 The costs of any significant restructuring of current company structures, including potential tax liabilities, will have to be assessed against value for money. Further specialist analysis on potential tax implications will inform the costs associated with required changes to the current operating model and any future alternative models.

Implications for Ferry Services (focussing on Northern Isles)

- 4.21 Arrangements are in hand to extend the term of the current Northern Isles ferry services contract until October 2019.
- 4.22 A decision on whether to make a direct award or continue tendering the Northern Isles ferry services will be taken in the Spring of 2018.
- 4.23 The decision to be taken in the Spring of 2018 will consider progress made on the further analysis of the Teckal exemption and the State aid rules. It will also take account of local community views and the remaining timeline in which to complete a competitive tender, should that be required.

Issues Raised by Stakeholders

- 4.24 It is approaching 16 years since the first of the tendered contracts for Northern Isles commenced (October 2002) and over that time there has been two different providers on the network.
- 4.25 Feedback suggests that, although service levels have remained at a standstill and are now inadequate to meet the growing demands and opportunities, all user sectors in Shetland (fishing, aquaculture, agriculture, hauliers, wider business community) and those undertaking personal/ leisure travel, feel service quality has improved with regard to: -
- Responsiveness
 - Reliability
 - Customer care
 - Stakeholder engagement
- 4.26 As a consequence the widely held view is that the last tender for Northern Isles Ferry Services has provided a good outcome.
- 4.27 In contrast, stakeholders recollection of the previous two contracts is that services were not as well delivered and feel that the culture of the previous operator (a partnership between Calmac and Royal Bank of Scotland) meant the service was not delivered as efficiently (which is evidenced by a higher subsidy requirement) and contract delivery was not at all responsive to needs. There is a widely held view amongst stakeholders that an in-house provided service may mean a return to this sort of experience.
- 4.28 On balance the opinion of stakeholders in Shetland falls strongly on the side of tendering future Northern Isles Ferry Services.
- 4.29 On a broader basis the Council may wish to consider some additional perspectives.

Long Term Planning

- 4.30 Any procurement policy must accommodate the need for effective long term planning of services and capital investment requirements.
- 4.31 Looking firstly at an in-house policy it may be that with the capacity to directly control service delivery and decisions regarding operational detail, long term

planning could be more straight forward and have higher levels of certainty. This is perhaps evidenced by what is seen on the Clyde and Hebrides network where Scottish Government has been able to plan and implement a significant programme of service improvements and investment in vessels and infrastructure.

- 4.32 Having said that, in a tendered services policy it would be entirely possible to undertake long term planning and implement that through tendered contracts.

Funding of Vessels/ Infrastructure in the Future

- 4.33 It is widely recognised that Scottish Government is constrained in the way that it can raise funds to invest in services and infrastructure. This is a potential barrier to service improvements in terms of bigger vessels and appropriate infrastructure for the Northern Isles services.
- 4.34 With in-house delivery these constraints could mean that, even though shown to be necessary and appropriate, investment in new vessels and infrastructure cannot happen with sufficient urgency.
- 4.35 Under a tendering procurement policy a service contract could be structured in terms of length and conditions of contract to enable private investment to be made into vessels and perhaps harbour infrastructure.

Democratic Accountability

- 4.36 An in-house policy could be said to be more democratically accountable to users of services.
- 4.37 This may give more influence over how the services operate in terms of local employment, use of local suppliers, influence over service changes, etc.

Summary

- 4.38 The procurement policy of tendering Northern Isles Ferry Services has served Shetland well in terms of improvements in service quality whilst also reducing the subsidy required for the service.
- 4.39 Although some aspects of an in-house policy could provide some additional positive opportunities, these opportunities are equally possible within a tendering policy. The key is flexible management of the contract as well as ensuring the relationship between Scottish Government/ Transport Scotland and local service users and public sector agencies is structured and managed well.
- 4.40 On balance, there is evidence that tendering of Northern Isles Ferry Services has led to service quality improvements and at the same time reductions in subsidy requirements (inclusive of the profit element sought by the operator).
- 4.41 These points support a position being taken by the Council that a ferries procurement policy based on a tendering approach promotes efficiency and good service delivery and would give the highest confidence of value for money and hence a greater likelihood of releasing funds to invest in necessary service improvements.

| 5.0 Exempt and/or Confidential Information: | | |
|--|--|--|
| 5.1 | None. | |
| 6.0 Implications : | | |
| 6.1 Service Users, Patients and Communities: | The detail of any future Ferries Procurement Policy could have impacts on the economy and communities of Shetland. Therefore it is important that the Council contribute fully to the process of policy development. | |
| 6.2 Human Resources and Organisational Development: | There are no implications immediately arising from this report. | |
| 6.3 Equality, Diversity and Human Rights: | There are no implications immediately arising from this report. | |
| 6.4 Legal: | There are no implications immediately arising from this report. | |
| 6.5 Finance: | There are no direct financial implications arising immediately from this report. | |
| 6.6 Assets and Property: | There are no implications immediately arising from this report. | |
| 6.7 ICT and New Technologies: | There are no implications immediately arising from this report. | |
| 6.8 Environmental: | There are no implications immediately arising from this report. | |
| 6.9 Risk Management: | Failure to take the opportunity to provide a response to the Minister for Transport and Islands' letter could result in poorly informed policy development and potentially damaging impacts on Shetland's economic and social wellbeing. This risk is mitigated by considering and providing an appropriate response to Scottish Government. | |
| 6.10 Policy and Delegated Authority: | The terms of this report would normally require consideration by the Policy and Resources Committee in terms of section 2.2(2) of the Council's Scheme of Administration and Delegations. However due to the timescale for responding, the Leader agreed that the matter be referred directly to the Council for determination. | |
| 6.11 Previously Considered by: | None. | |

Contact Details:

Michael Craigie, Executive Manager Transport Planning,
Michael.Craigie@shetland.gov.uk 26 February 2018
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Appendices:

- Appendix 1 – Letter from Minister for Transport and Islands
- Appendix 2 – Scottish Government Ferry Services Procurement Policy Review – Interim Report – Emerging Findings 20 December 2017

Background Documents: None



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Cecil Smith
Leader of Shetland Islands Council
Town Hall
Lerwick
Shetland
ZE1 0HB

31 January

Dear Cecil

FERRY PROCUREMENT POLICY REVIEW: FURTHER ENGAGEMENT WITH NORTHERN ISLES COMMUNITIES

You will be aware that I published an [interim report](#) on 20 December 2017, setting out the emerging findings from the ongoing policy review on the future procurement of the Scottish Government's lifeline ferry services. I also set out implications for each of the Scottish Government's three ferry service contracts.

I made clear in the report that arrangements are in hand to extend the current Northern Isles ferry service contract by eighteen months, until October 2019. I also made clear that a decision on the future approach to the procurement of these services will be taken in the spring of 2018.

The interim report indicated that previous engagement with Orkney and Shetland did not reach a conclusive view. Therefore, before reaching a final decision about our future approach to the procurement of the Northern Isles ferry services, I am keen to build a deeper understanding of local community and stakeholder views.

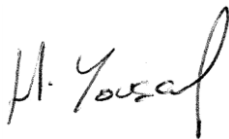
I would, therefore, be grateful if you could write to me with your views by the 28 February 2018. If helpful, I would also be happy to meet with you in Edinburgh to discuss your views. Please contact my diary secretary Catriona Kennedy at TransportMinister@gov.scot to make arrangements.

I should also mention that I intend visiting both Orkney and Shetland in the near future to meet with and hear the views of local stakeholders, including local authorities and transport partnerships, local business and tourism interests, relevant community groups, and the staff and crew from the operator of the current services.



I look forward to receiving your views on this important issue. I am writing in similar terms to local stakeholders listed in the Annex to this letter.

Best wishes

A handwritten signature in black ink, appearing to read 'H. Yousaf', with a stylized, flowing script.

HUMZA YOUSAF

FERRY PROCUREMENT POLICY REVIEW: FURTHER ENGAGEMENT WITH NORTHERN ISLES COMMUNITIES

LOCAL STAKEHOLDERS

Local Authority/Regional Transport Partnerships/Community Groups

Orkney Islands Council
 Shetland Islands Council
 HITRANS
 ZEtTRANS
 Orkney Community Councils Democratic Services
 Association of Shetland Community Councils

Economy/Business/Tourism Groups

National Farmers Union Scotland
 Lerwick Port Authority
 Scrabster Port Authority
 Aberdeen Harbour Board
 Stewart Building Group (Transport, haulage and sea food sector)
 Visit Scotland (Visit Shetland)
 Orkney Tourism Group
 Chamber of Commerce



**TRANSPORT
SCOTLAND**

CÒMHDHAIL ALBA

Scottish Government Ferry Services Procurement Policy Review

Interim Report - Emerging Findings
20 December 2017

Ministerial Foreword



As Minister for Transport and the Islands, one of my responsibilities is to ensure the provision of safe, efficient and reliable ferry services to the island and remote rural communities which rely on them for their economic, social and cultural sustainability. It is a responsibility that I, and this Government, take very seriously. That is why, in my statement to Parliament on 2 February 2017, I announced a policy review on the future approach to the procurement of our three contracted ferry services: the Clyde and Hebrides, Northern Isles and Gourock-Dunoon. The main focus of the review being to determine whether it would be possible to make direct awards to an in-house operator in the future, potentially removing the need for competitive tendering procedures.

In order to consider the possibility of making direct awards to an in-house operator in the future, it is first necessary to establish whether such awards would be capable of satisfying the strict conditions set by European, United Kingdom and Scottish legislation, including the Teckal exemption and the State aid rules. This interim report outlines key emerging findings to date in relation to our future ability to meet those requirements and signposts the way ahead for each of the three ferry services.

The question in hand raises a number of complex legal, policy and financial issues, with a significant amount of detailed investigation and analysis still to be carried out: we need to establish a clear case for making direct awards that would satisfy the Teckal exemption and the State aid rules; follow up on the initial views of local communities; and engage with the European Commission on the final approach we intend to take in relation to the future procurement of the ferry services. We will work closely with key stakeholders on all these issues, with a view to publishing a further progress report in the Spring of 2018.

This government is fully committed to providing the best ferry services possible to our island and remote rural communities, whilst ensuring value for money to taxpayers. This report, and the approach outlined for each of the three ferry service contracts, demonstrates our on-going commitment to the ferry services and the communities which rely on them.

Humza Yousaf MSP

Minister for Transport and the Islands



MV LOCH SHIRA

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1 INTRODUCTION



MV LOCH FYNE

1. The question of whether the Scottish Government may lawfully award ferry service contracts to an in-house operator without first having put the contract out to a competitive tendering procedure has been the subject of sustained public debate over many years. The position of the Scottish Government, and previous administrations, has been that tendering is required in order to comply with Article 4 of the Maritime Cabotage Regulation¹ and to ensure compliance with State aid law. That position was generally vindicated by the European Commission in its decision of 28 October 2009 on the State aid No C 16/2008 implemented by the UK: subsidies to CalMac and NorthLink for maritime transport services in Scotland.²

2. The question was raised again in 2015, when the National Union of Rail and Maritime Transport Workers examined the position further. The Union considered that Regulation (EC) No 1370/2007 (“the Passenger Transport Regulation”) and the Teckal doctrine, which is applicable in the context of EU procurement rules, present the possibility of providing public service contracts through an in-house operator, without the need to put the services out to public tender.

3. Following representation from, and discussion with, the National Union of Rail and Maritime Transport Workers, Derek Mackay MSP, then Minister for Transport and Islands, wrote jointly with the Union to the European Commissioner for Transport on 1 April 2016. The letter (Annex A) sought clarity on whether, as a matter of EU Law, the Scottish Ministers may be exempted from the requirement to proceed with a competitive tender for ferry services through the application of the Teckal exemption, and whether such an arrangement would raise State aid implications. The letter referred specifically to the tendering of the Clyde and Hebrides ferry services, but, in principle, it applied equally to the Northern Isles and Gourock-Dunoon ferry services.

4. The Commissioner’s reply of 22 September 2016 (Annex B) stated:

“..... whereas the Commission can provide some general guidance and advice, it cannot offer legal certainty through its opinions: only the European Courts can provide authentic interpretation of EU law”.

This accords with the Scottish Government’s understanding that only the courts can definitively determine the law and its application to particular factual situations. In the case of the current question, the critical issues have not been tested in court.

5. A note prepared by Commission Services and annexed to the Commissioner’s reply of 22 September, expressed the view that:

“Even though the Cabotage Regulation does not explicitly refer to the direct award of public service contracts, the case law on an in-house operator should be applicable in cases on maritime cabotage as well.”

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31992R3577&from=EN>

² http://ec.europa.eu/competition/state_aid/cases/225288/225288_1151646_138_1.pdf

6. The note also referenced that the use of a public procurement procedure may have consequences for compliance with European Union State aid rules, drawing particular attention to the Commission Decision C-16/2008 of 28 October 2009. That decision assessed whether ferries services across Scotland constituted State aid by reference to the four “Altmark” conditions. The note concluded that the fourth Altmark condition can be considered to be met where the undertaking is chosen via a public procurement procedure.

7. In consideration of the potential implications of the European Transport Commissioner’s letter of 22 September, and the prevailing legal framework, the Minister for Transport and the Islands, Humza Yousaf MSP, made a statement to the Scottish Parliament on 2 February 2017.

8. The Minister announced that a policy review would be undertaken to identify and consider in detail the legal, policy and financial implications relevant to the procurement of ferry services, including the possible application of the Teckal exemption. The on-going tender for the next Gourock-Dunoon ferry service contract was paused and the current contract extended by nine months, with further consideration to be given to the implications for the Northern Isles ferry services.

9. Whilst not prejudging the outcome of the review, the Minister announced that:

“.....should the review conclude that it would be possible to apply the Teckal exemption and meet State aid rules, the Government would be minded to provide ferry services through an in-house operator, taking account of the communities that they serve. That would be subject to wider policy and value-for money implications and the views of affected communities”.

10. As noted in the terms of reference for the policy review (Annex C), the primary purpose of the review is to ensure the continued provision of safe, efficient and reliable ferry services that meet the needs of island and remote rural communities. In so doing, it is essential that the future procurement of ferry services provides value for money to the taxpayer.

11. On 20 July 2017, the Minister informed the Scottish Parliament that the policy review would most likely have to be extended beyond its initial timeline of Autumn 2017. This was necessitated by the requirement for further consideration to be given to the application of the State aid rules, specifically the four Altmark criteria.

12. Since the Minister’s announcement of 20 July, Audit Scotland has published its report on Transport Scotland’s ferry services³. The report confirms that the ferry services are performing well and underlines the Scottish Government’s commitment to the ferry networks and the vital services they perform for island and remote communities. The report’s findings will help shape the future approach to the procurement of ferry services,

³ <http://www.audit-scotland.gov.uk/report/transport-scotlands-ferry-services>

including the provision of services which meet the needs of users and provide value for money to the taxpayer.

13. This interim report on the future approach to the procurement of ferry services describes the legal, policy and financial implications that have been considered to date. It outlines emerging findings and the actions that will be taken in the short to medium term in order to ensure the continued provision of safe, efficient and reliable ferry services to the island and rural communities which rely on them.

2 EXECUTIVE SUMMARY



MV LOCHINVAR

This Executive Summary provides an overview of the emerging findings to date. More detailed analysis is provided in Sections 3 to 7.

Legal Framework

- A Teckal compliant award under the procurement regime would be compatible with the Maritime Cabotage Regulation, subject to meeting the strict functions, control and private capital participation tests of the Teckal doctrine.
- A Scottish Minister owned company, as currently constituted, would meet the requirements of the Teckal functions and private capital participation tests.
- Further consideration is required on the governance of a Scottish Minister owned company, as currently constituted, in order to ensure full compliance with the Teckal control test.
- The provision of ferry services, whether undertaken “in house” or not, is an economic activity for the purposes of the State aid rules.
- In order to satisfy the State aid rules, it will be necessary to demonstrate full compliance with the four Altmark criteria.
- The fourth Altmark criterion is particularly challenging. It can be satisfied by means of a public procurement procedure, as highlighted in the European Commission’s letter of 22 September 2016. An alternative would be to undertake detailed benchmarking against typical, well-run and adequately equipped undertakings in the ferry sector.

Stakeholder Engagement

- Local communities and stakeholders in the area currently served by CalMac Ferries Limited in fulfillment of the Clyde and Hebrides ferry services contract expressed a general preference for a direct award to an in-house operator for those services.
- There was a general preference for a direct award to an in-house operator for the Gourock-Dunoon town-centre ferry service. If this cannot include provision for the transport of vehicles, the general preference from the local community was that the service should be tendered to allow the possibility of a vehicle-carrying service being returned to the route.
- Shetland communities and stakeholders adopted a more neutral stance on whether the Northern Isles services should be awarded to an in-house operator or tendered, with many expressing a preference for tendering. In Orkney, the community and stakeholders expressed a clear preference for tendering.
- Further engagement with the local community and stakeholders will be undertaken to inform the final decision on the future approach to the procurement of the Northern Isles and in due course the Clyde and Hebrides ferry services, if required.

Value for Money

- There is some evidence that tendering can present different creative and innovative service solutions. Any direct award to an in-house company would need to include mechanisms to deliver similar levels of continuous innovation and service delivery improvement.
- A direct award to an in-house operator, in full compliance with the Teckal doctrine and the State aid rules, is capable of providing similar levels of efficiency and service delivery to that which might otherwise be obtained from tendering.
- A direct award to an in-house operator would avoid the high costs of tendering, allowing savings from the tendering process and operator returns to be reinvested in public services.
- A direct award would also allow longer-term investment planning.

Future Operating Models for Ferry Companies Owned by the Scottish Ministers

- The immediate focus is on the changes required to the current corporate company framework for David MacBrayne Limited and its operating companies in order to satisfy the Teckal control test.
- Further consideration can be given to alternative operating models, such as the creation of a new public sector body, or transfer to an Agency of the Scottish Government, once the immediate question of changes required to the current corporate company framework to satisfy the Teckal control test has been addressed.
- The costs of any significant restructuring of current company structures, including potential tax liabilities, will have to be assessed against value for money. Further specialist analysis on potential tax implications will inform the costs associated with required changes to the current operating model and any future alternative models.

Implications for Ferry Services

Clyde and Hebrides

- The Clyde and Hebrides ferry services are already provided by a wholly state-owned operator until 2024.
- There is no immediate time pressure in which to consider the full implications of Teckal and the State aid rules in relation to the future approach to be taken to the procurement of the Clyde and Hebrides ferry services.
- We will build a case for making a direct award to an in-house operator for the Clyde and Hebrides services in line with the requirements of Teckal and the State aid rules, particularly the four Altmark criteria.
- A decision on the future approach to procuring the Clyde and Hebrides ferry services will be taken ahead of the current contract ending in 2024.

Northern Isles

- Arrangements are in hand to extend the term of the current Northern Isles ferry services contract until October 2019.
- A decision on whether to make a direct award or continue tendering the Northern Isles ferry services will be taken in the Spring of 2018.
- The decision to be taken in the Spring of 2018 will consider progress made on the further analysis of the Teckal exemption and the State aid rules. It will also take account of local community views and the remaining timeline in which to complete a competitive tender, should that be required.

Gourock-Dunoon

- The current Gourock-Dunoon ferry service contract will be extended to December 2018.
- A direct award for the Gourock-Dunoon service, assuming that such an award could be achieved by reference to the Teckal doctrine and the Altmark criteria, could only be applied to the transport of foot passengers under the terms of the public service obligation.
- Tendering the Gourock-Dunoon ferry service could potentially realise the return of a vehicle-carrying service on the town-centre route.
- The currently paused tender exercise for the Gourock-Dunoon ferry service will therefore be restarted as soon as practicably possible.

3 LEGAL FRAMEWORK



MV ISLE OF LEWIS

1. The Scottish Ministers are required to make decisions on the procurement of ferry services within the context of the prevailing legal framework. That framework is substantially based on European law, and consists of:

- the public procurement regime;
- the Maritime Cabotage Regulation;
- the State aid regime; and
- the Passenger Transport Regulation.

2. The detailed process and timeline for the United Kingdom's withdrawal from the European Union (Brexit) has yet to be determined. Until such time as the outcome of that process is known, it cannot be discounted that the future legal framework may continue to reflect many aspects of the current legislative requirements relevant to the procurement of ferry services.

Public Procurement Regime and Maritime Cabotage

3. In-house awards under the public procurement regime are compliant with the Treaty principle of non-discrimination. The non-discrimination principle is reflected in Article 4 of the Maritime Cabotage Regulation. That being the case, there is no incompatibility between in-house awards and maritime cabotage. A Teckal compliant award under the procurement regime would therefore be compatible with Article 4 of the Maritime Cabotage Regulation.

4. An in-house award under the Teckal doctrine⁴ would require strict compliance with the following tests:

(a) the contracting authority exercises over that person control similar to that which it exercises over its own departments [the control test];

(b) the person carries out more than 80% of its activities in the performance of tasks entrusted to it by the authority or by other persons controlled by that authority [the functions test]; and

(c) no other person has direct private capital participation.

5. A company wholly owned by the Scottish Ministers, as currently constituted, would meet the Teckal functions test and the requirement for no direct private capital participation. However, although the Scottish Ministers would be the sole shareholders of such a company, this does not necessarily extend to the definition of exercising control similar to that exercised over their own departments, as required by the Teckal control test. Further consideration is required to be given to the governance and structure of the company framework before the Scottish Ministers, as the contracting authority, could be deemed to have satisfied the full requirements of the Teckal control test. It is considered that this could be achieved by a relatively limited review of the company's governance arrangements, including Scottish Government representation on the company's Board, with very little or no impact on employees.

⁴ First articulated in Case C-107/98 *Teckal Srl v AGAC*

The State Aid Regime

6. The State aid rules pursue different aims from the procurement regime, although the two are related. It is, therefore, necessary to consider the State aid rules when assessing the possibility of a direct award to an in-house company - even if the in-house company is Teckal compliant. This is clear from the note attached to the Commission's letter of 22 September 2016, as referred to in the Introductory section of this report and set out in Annex B.

7. The State aid rules flow directly from Article 107 of the Treaty on the Functioning of the European Union, which states:

“Save as otherwise provided in the Treaties, 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 internal market.”

8. It is established law that the State aid rules apply to an economic activity, even if it is integrated into the State administration, and even when the public authorities funding the activity and the public undertaking performing it are, legally, one and the same. It is also clear that the provision of ferry services is an economic activity for the purposes of the State aid rules and it makes no difference whether this activity is undertaken “in house” or not.

9. In order to satisfy the State aid rules, consideration has been given to the application of the Altmark criteria, the 2007 Passenger Transport Regulation and Services of General Economic Interest.

Altmark

10. The European Court of Justice has laid down that there is considered to be no provision of State aid, and therefore the State aid rules would not apply, in the event that an award to an in-house company satisfied all four Altmark criteria⁵:

- first, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined;
- secondly, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings;
- thirdly, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations;

⁵ First articulated in Case C-280/00 *Altmark*

- fourthly, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure, the level of compensation to be given must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately equipped so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

11. Compliance with the fourth Altmark criterion requires evidence as to the basis for determining the level of compensation in accordance with the criteria. The fourth criterion can be satisfied by a public procurement procedure, as highlighted in the European Commission's letter of 22 September 2016. An alternative approach would be to undertake detailed benchmarking against typical, well-run and adequately equipped undertakings in the ferry sector. If all four Altmark criteria are satisfied, then State aid does not exist. Whilst there is no legal requirement to notify the European Commission in the absence of any State aid, the Commission's previous interest in Scottish ferries, particularly its 2009 Decision, means that it would, in practice, be appropriate to engage with the Commission concerning any proposals aimed at satisfying the Altmark criteria.

Passenger Transport Regulation

12. The Passenger Transport Regulation does not apply to the transport of freight or commercial vehicles. The substantial freight and commercial vehicle components of both the Clyde and Hebrides and Northern Isles services effectively rule out any application of that Regulation as a means of satisfying the State aid rules.

Services of General Economic Interest

13. Another approach which might satisfy the State aid rules would be to seek the European Commission's approval of the aid scheme as Services of General Economic Interest.

14. The rules on Services of General Economic Interest can be used to provide operating aid for the day-to-day running of ferry services where there is recognition that the services would not otherwise be provided by the market. The rules are sufficiently broad to allow Member States to meet their objectives, provided that the relevant compatibility criteria (including genuine need for the service and compliance with sector-specific legislation) are met.

15. Any proposal for an aid scheme would require a substantial evidence base and a full analysis of the services on a route-by-route basis, and the market more generally, in order to establish that any such scheme did not adversely affect the internal market. It cannot be assumed that a scheme would be approved, particularly in light of the Commission Services' comments during their meeting with Transport Scotland officials on 28 April 2017 (Annex D).

Application of Legal Framework

16. It is clear that in order to secure a direct award to an in-house company for ferry services on the Clyde and Hebrides and Northern Isles network of routes, it will be necessary to demonstrate full compliance with the requirements of the Teckal doctrine and the State aid rules for the immediate and foreseeable future. This will require further detailed consideration of the Teckal control test and benchmarking of a wholly-owned Scottish Minister company against typical, well run and adequately equipped undertakings in the ferry sector, as specifically required by the fourth Altmark criterion.

4 STAKEHOLDER ENGAGEMENT



MV HROSSEY AND MV HJALTLAND

1. The Minister for Transport and the Islands announced on 2 February 2017 that the procurement policy review would:

“... liaise closely with key stakeholders including the European Commission, ferry operating companies, local communities and, of course, the trade unions.”

This section summarises the engagement that has taken place to date with each of the key stakeholder groups covered by the Minister’s announcement.

European Commission Services

2. Transport Scotland met with European Commission Services in Brussels on 28 April 2017. A note of the meeting is attached at Annex D.
3. The meeting covered the possible application of the Teckal exemption and the State aid rules to the future provision of the Scottish Government’s three contracted ferry services. European Commission Services confirmed the view expressed in their note attached to the Transport Commissioner’s letter of 22 September 2016 that the Teckal exemption should be capable of being applied to the Maritime Cabotage Regulation. They also expanded on the specific measures that the Scottish Ministers would have to take in order to make a direct award to an in-house company that was fully compliant with the requirements of the Teckal doctrine and the State aid rules.
4. Transport Scotland will continue to engage with European Commission Services as the policy review progresses, most notably on the requirement to satisfy the State aid rules through the application of the Altmark criteria.

Ferry Operating Companies

5. Transport Scotland met with representatives of the ferry operating companies delivering the public service contracts for the Clyde and Hebrides, Gourock-Dunoon and the Northern Isles ferry services. The meetings covered general discussion on the purpose and progress of the policy review. Other meetings involved discussions with Argyll Ferries Limited about an extension to the Gourock to Dunoon ferry services contract, and with Serco NorthLink Ferries Limited about an extension to the Northern Isles ferry services contract.
6. Transport Scotland also engaged with private sector operators providing commercial ferry services on routes similar to those supported by the Scottish Government (i.e. Western Ferries (Clyde) Limited and Pentland Ferries Limited). Discussions covered the purpose and progress of the policy review.

Local Communities

7. Transport Scotland undertook a series of initial engagement events with representatives from local community, ferry user groups, business and tourism stakeholders during the months of May and June 2017. Meetings took place in Lerwick, Kirkwall, Stornoway, Benbecula, Oban and Glasgow. Transport Scotland published information about the events on its website, extending a general invitation to community groups or local stakeholders who may not have been captured by the initial invitation.

8. The meetings provided an opportunity for those in attendance to discuss and express views on the future approach to be taken to the procurement of ferry services.

9. Each meeting addressed two questions:

- The key considerations that would support in-house operation or competitive tendering of the ferry services in future from a local community perspective?
- If Teckal and State aid rules can be satisfied, should the Scottish Ministers make a direct award to an in-house operator, or continue to tender the services?

The views expressed are summarised as follows:

Clyde and Hebrides Ferry Services

10. Although some personal preference was expressed for continuing to tender, there was, by and large, a general preference for making a direct award to an in-house operator for the Clyde and Hebrides ferry services. There was clear affection for and close community affinity with the Caledonian MacBrayne brand, with many stakeholders concerned about the loss of cultural identity should the contract be awarded to a private-sector operator.

11. Other reasons in support of a direct award to an in-house operator for the Clyde and Hebrides ferry services included the benefits to be obtained from a longer term view on future investment in services and vessels, and the positive impact this could have on the future economic development of the islands and prospects for local employment.

12. Whilst expressing a general preference for a direct award to an in-house operator for the Clyde and Hebrides ferry services, there was strong recognition that the 2016 tender had brought about innovation and a number of proposed service improvements. The communities and stakeholders taking part in the events were clear that any direct award to an in-house operator must ensure that the benefits obtained from the 2016 tender are retained and further developed in line with local community and business needs. Any in-house award would therefore have to allow for much higher levels of direct local community and stakeholder involvement in decisions taken about future service delivery, including improved communications and more detailed publication of operational performance levels.

Gourock - Dunoon Ferry Services

13. There was a general preference for a direct award to an in-house operator for the Gourock-Dunoon ferry service. Should it not be possible to include a vehicle-carrying service in any direct award to an in-house operator, the community's preference would switch to tendering in order to maximise the possibility of the market providing a subsidised passenger service, with a vehicle carrying element provided at the operator's commercial risk.

Northern Isles Ferry Services

14. For the Northern Isles routes, there was strong recognition in both Shetland and Orkney of the benefits obtained from past tenders.

15. The general view from Shetland was that Transport Scotland should focus more on the communities' key issues and concerns in relation to the level of services to be delivered and the vessels to be made available to deliver those services, rather than the question of tendering or not.

16. Shetland Islands Council and the Regional Transport Partnership (ZetTrans) emphasised the importance that any approach to the provision of ferry services in future has to be efficient and provide a responsive transport solution that meets the economic and social outcomes necessary to ensure sustainable island communities. They considered that the approach to be taken needs to have the greatest capacity to provide investment in infrastructure and vessels necessary to enable economic growth and equality of access to opportunities for the islands.

17. There was some recognition that a direct award to an in-house operator may provide greater capacity to develop and implement long-term planning and delivery of service and infrastructure improvements, incorporating relevant components of Local Outcomes Improvement Plans into national plans. It was equally recognised that, under continuing public funding pressures, tendering may realise opportunities to secure private sector investment in infrastructure dependent on the structure and length of contracts, in particular private investment in additional or new vessels. These opportunities may be more limited in the event of an in-house delivery scenario.

18. A number of key stakeholders in Shetland were concerned that a direct award to an in-house operator may not be as "fleet of foot" and innovative as a tendered model. Currently, a wide range of service statistics is available which service users (particularly seafood and aquaculture sectors) find worthwhile, informative and of benefit to their business operations. This was considered to be a major benefit that had been obtained from the last tender.

19. There was clear majority support for tendering in Orkney, reflecting the many benefits which the island community considers have been obtained from the current contract. In line with the views expressed across the Clyde and Hebrides, it was recognised that, in the event of a direct award to an in-house operator in future, clear provisions must be made for local decision making. This would ensure that service delivery and operational performance levels meet the needs of local communities and stakeholders, and support the future economic development of the islands.

Further Community and Stakeholder Engagement

20. Previous engagement involved meetings with a range of community stakeholders to obtain a general view on the respective communities' preference for a direct award or whether the services should continue to be tendered. Further engagement will be undertaken across the Northern Isles, and in due course the Clyde and Hebrides, if required, to allow the Scottish Ministers to develop a better understanding of the respective communities' preferences on the future approach to be taken to the procurement of the ferry services.

Trade Unions

21. Transport Scotland officials met with representatives from the STUC and the four trade unions (Nautilus, RMT, Unite and TSSA) with an interest in the ferry services. The Minister for Transport and the Islands also held discussions with representatives from the unions.

22. The STUC prepared a joint-union policy position on the requirement to tender ferry services. The policy position paper is set out in Annex E and summarised as follows:

- the trade unions remain firmly in favour of public ownership and operation of lifeline public ferry services, supported by public investment, as the model to deliver long-term economic and social benefits to workers, passengers, communities and taxpayers;
- the two key Teckal tests centre on the control and functions of the public body being considered for exemption. The analysis of whether CalMac falls within the control and function test clearly concludes that it does;
 - a tightly specified tender process, in which the Scottish Government negotiates in private with all bidders, encourages bids that are based on reducing pay or other terms and conditions of ferry staff. This runs contrary to Fair Work objectives and potential community benefit;
- recent evidence suggests a continuing high level of public support for direct delivery of services and for public ownership more generally;
- it is not possible to base decisions about ferry contracts on assumptions, in particular that EU Regulations and State Aid Guidance will not apply in future or that similar rules will not replace them;
- whilst Brexit alone cannot be used to argue for non-tendered public provision, neither should it be used to argue against it;
- the Scottish Government can make clear, whatever statutory framework emerges as a consequence of Brexit, that it is committed to democratically owned and publicly operated ferry services.

23. The community and stakeholder views gathered to date, and those to be gathered from any future engagement activity, will feed into the overall consideration of the legal, policy and financial implications relevant to the future approach to be taken to the procurement of ferry services. This will ensure that the views of communities and stakeholders are taken into account before the Scottish Government reaches a final decision on the best way to procure the Clyde and Hebrides and Northern Isles services in the future, be that a direct award to an in-house company or a competitive procurement procedure.

5 VALUE FOR MONEY



MV LOCH SEAFORTH

1. Audit Scotland's Report: Transport Scotland's Ferry Services⁶ published on 19 October 2017 confirms that ferry services are performing well. The report also underlines the Scottish Government's commitment to its ferry network and the vital services they perform for island and remote communities. Audit Scotland also reported total annual spending of £209.7 million on ferries for the financial year 2016-2017: £168.7 million of which was attributed to annual subsidies paid to ferry operators, with £41.0 million attributed to capital expenditure. These substantial levels of public funding make it increasingly important that the future approach to the procurement of ferry services, be that a direct award to an in-house operator or a competitive tendering procedure, provides value for money to the taxpayer.

2. The following paragraphs cover some of the issues associated with the question of direct awards to an in-house operator or continued tendering in the context of providing value for money.

Benefits of Tendering

3. The view that opening services to competition increases efficiency is generally supported by the 2016 Clyde and Hebrides tender. The new contract was estimated at £996 million, based on the continuation of the previous contract on the same terms. The successful tender came in at £868, some £128 million lower than the estimated £996 million. The new contract had to be updated prior to commencement to take account of such issues as the impact of planned changes to timetables, the final roll-out of Road Equivalent Tariff and increased pension contributions imposed by the CalMac Pension Fund Trustees. This added a further £107 million to the winning tender bid of £868 million, bringing the final tendered cost of the new contract to £975 million.

4. The successful bidder for the 2016 Clyde and Hebrides tender made 350 service improvement commitments. These commitments will realise wider benefits through the delivery of better quality services over the full term of the contract.

5. It is also important to recognise that a direct award to an in-house operator is also capable of delivering similar levels of operational efficiency, innovation and service improvement to those which might otherwise be obtained from tendering. Section 3 Legal Framework established that a direct award to an in-house company would have to satisfy the State aid rules. This would be achieved through the successful application of the four Altmark criteria, the fourth criterion of which requires the operator to be a typical, well-run and adequately equipped undertaking. In meeting the Altmark criteria, any in-house company would, by definition, have to demonstrate operational efficiency levels equivalent to those which would be provided under ideal market conditions.

Costs of Tendering

6. As well as the potential benefits of tendering, it should be recognised that tendering multi-million-pound ferry service contracts is a highly complicated and expensive procedure. Tendering requires highly qualified and experienced resources to develop complex procurement, legal and financial processes and documents. Resources are also required to assess bidders' submissions and undertake significant levels of legal and financial due

⁶ <http://www.audit-scotland.gov.uk/report/transport-scotlands-ferry-services>

diligence leading to the award of contract and the commencement of the new services. Tendering also requires support from specialist consultants on the development of detailed financial modelling and technical specifications for the provision and use of vessels and harbour infrastructure. All this incurs high levels of costs to be paid for by the public purse.

7. The Scottish Government has previously published information on the costs of tendering ferry services since 1999⁷, estimated to fall in the region of some £4 million. The £4 million figure includes the estimated £1.1 million incurred on the tendering of the 2016-2024 contract for the Clyde and Hebrides ferry services. These cost estimates may not have captured every single cost associated with tendering, such as the cost of senior officials, specialist officials and Ministers, nor a proportion of the overheads which the Scottish Government accrues generally. It is, therefore, possible that the total costs of tendering past ferry contracts may be slightly higher than those previously published.

8. In addition to those costs directly attributable to the tendering process, an estimated £13.2⁸ million was also incurred on the restructuring of Caledonian MacBrayne into a separate services company (David MacBrayne Ltd) and an asset-owning company (Caledonian Maritime Assets Ltd), £11 million of which related to tax liabilities. Similar costs are unlikely to be incurred again, subject to no further significant company reorganisation. The particular issue of potential tax liabilities arising from any future restructuring of the existing public-sector company structures is addressed further under Section 6 – Future Operating Models for Companies Owned by the Scottish Ministers.

9. Added to the Scottish Government's costs are those incurred by bidders. These can also amount to substantial sums, depending on the nature of the contract being tendered and the amount of resources a bidder applies to the competition. In the case of a publicly-owned bidder, such costs are attributable to the public purse.

10. In addition to the high costs of tendering, all the ferry service contracts let by the Scottish Government, including the recent contract to CalMac Ferries Limited for operating the Clyde and Hebrides ferry services, provide for an allowable operator's return (essentially a fixed profit level). The contracts operate to a capped subsidy payment level, with a claw-back mechanism that recovers excess payments made in the event that the subsidy required to cover the costs of operating the services is lower than the capped subsidy level in any one year. The contracts therefore ensure that operating companies cannot profit excessively from Scottish Government ferry contracts. Nonetheless, in the case of private sector operators, any profit derived from the allowable operator's return can generally be considered to have been lost to the public purse.

11. In summary, tendering has the potential to deliver efficiency savings and good outcomes for consumers, but it can incur high costs. It is, however, possible for a direct award to an in-house operator to provide levels of operational efficiency and service delivery commensurate with the general ferry market.

⁷ Parliamentary Question S5W-00678

⁸ Parliamentary Question S2W-31530

6 FUTURE OPERATING MODELS FOR COMPANIES OWNED BY THE SCOTTISH MINISTERS



MV HAMNAVOE

1. Major organisational and structural changes are not required in order to address the immediate question about the possibility of making a direct award to an in-house operator in future. Significant changes at this point in time would only serve to raise further legal, financial and tax complications, and unnecessarily extend the timeline for the review. For these reasons, the review has initially focused on the changes required to the existing corporate company framework owned by the Scottish Ministers in order to satisfy the immediate requirements of Teckal (i.e. the control test) and the State aid rules (i.e. Altmark).

Existing Corporate Company Framework

2. The benefits of utilising the existing corporate company framework are summarised as:

- utilising existing company structures is likely to be far less complicated from a legal, accounting and tax perspective;
- any changes required to comply with the Teckal control test could be achieved by a relatively limited review of governance arrangements for the David MacBrayne group of companies, including Scottish Government representation on the company's Board, which could be achieved with very little or no direct impact on employees;
- the existing corporate company framework does not necessarily preclude the establishment of subsidiary commercial companies to bid for contracts on the open market in future - subject to continued compliance with the Teckal functions test, which allows for 20% of the company's activity to be conducted outwith that delivered with the parent authority (i.e. the Scottish Ministers).

Possible Future Structures

3. Once the immediate question of Teckal and State aid compliance has been addressed in terms of the limited changes required to the existing corporate company framework, consideration can be given to any future organisational restructuring which might improve service delivery and provide better value for money for the taxpayer. Any future restructuring would, of course, still be required to satisfy the full requirements of the Teckal doctrine and the State aid rules.

Agency of the Scottish Government

4. Any transfer of assets and business interests to an Agency of the Scottish Government sometime in the future would satisfy the requirements of the Teckal doctrine. Executive Agencies are an integral part of the Scottish Government and staffed by civil servants, including the Chief Executive who is directly accountable to Ministers. Agencies operate under a Framework Document approved by Ministers, which may be reviewed, amended or revoked at any time. This has the advantage that they can normally be set up by administrative action without the need for legislation. Although an Agency structure could satisfy the requirements of the Teckal doctrine, the economic

nature of the ferry services to be performed would not remove the need for State Aid compliance in relation to the funding of those services.

5. In addition to considering whether funding arrangements under an Agency model would comply with the State aid rules, there are a number of legal, employment and financial implications that could arise from the transfer of business activities and assets, including:

- tonnage tax in relation to the transfer of any vessels;
- Land and Building Transaction Tax /Stamp duty in relation to the transfer of heritable property;
- corporation tax in relation to any capital gain in relation to the transfer of assets;
- off-shore crewing exemption from National Insurance contributions, which will require HMRC approval;
- recovery of VAT, subject to HMRC regulation;
- funding arrangements and potential accounting and cash-flow implications for the Scottish Government;
- third party arrangements in relation to Solent Gateway Limited, a joint-venture company set up by David MacBrayne Limited, and any future contracts;
- payment and transfer of pension liabilities;
- TUPE transfer of staff, including harmonisation of pensions, pay, terms and conditions and contracts of employment.

6. Further detailed specialist advice will be sought to ascertain the full impact of these legal, employment and financial implications, be these incurred through changes to the current corporate company framework or future operating models. This analysis will be considered as part of the overall value for money that future operating models might provide to taxpayers.

New Statutory Public Body

7. A new public body would most likely be classed as an Executive Non Departmental Public Body with trading capability, subject to Office for National Statistics classification. It would take on responsibility for the provision of the ferry services (and any other transport services defined by Scottish Ministers). It would also receive grant funding from Scottish Ministers, supplemented by fare revenue, and be answerable to the Scottish Parliament through the Scottish Ministers.

8. A new statutory public body would mirror many of the benefits associated with the existing company framework. It would, however, provide a platform for more statutory regulation and public accountability in terms of the body's operational activities and performance.

9. The creation of a new statutory public body would, however, raise many of the same legal, employment, accounting and tax implications associated with the transfer of the current companies' business interests and assets to an Agency of the Scottish Government. It would also add further complexities in relation to the Scottish Government's ability to satisfy the Teckal doctrine and the State aid rules.

10. The corporate company framework structure, or transfer to an Agency of the Scottish Government, could be classed as an in-house operation under the terms of the Teckal doctrine. However, this would not necessarily be the case for a new statutory public body operating at arms-length from the Scottish Ministers. Under such arrangements, the Scottish Ministers may not be able to demonstrate compliance with the Teckal control test, which requires control similar to that exercised over their own departments.

11. The establishment of a new public body, funded by the Scottish Ministers, would also require careful consideration of the State aid rules. It is likely that the public body's functions would be classed as the delivery of economic services (even where stepping in to address market failure). As the delivery of economic services is not the usual domain of government, more detailed consideration would have to be given on whether the funding provided by the Scottish Ministers constituted State aid.

7 IMPLICATIONS FOR THE FERRY SERVICES



MV ARGYLL FLYER

1. The Scottish Ministers' priority is the provision and continuity of safe, efficient and reliable ferry services to the island communities and businesses which rely on them. In delivering that outcome, they must ensure that the organisation and funding of the ferry services complies with the relevant legislative framework.

2. It will take time to undertake the necessary analysis to ensure that the Scottish Government could comply with the relevant legislative framework, particularly its ability to satisfy the full requirements of the Teckal doctrine and the State aid rules (i.e. Altmark). This analysis and associated timelines have implications for each of the three contracted ferry services.

Clyde and Hebrides

A case will be built for making a direct award to an in-house operator which meets the full requirements of Teckal and the State aid rules, particularly the four Altmark criteria. A decision on the future approach to procuring these services will be taken in advance of the current contract ending in September 2024.

3. The joint approach to the European Commission on 1 April 2016 sought clarity on the legal requirement to tender the Clyde and Hebrides services. The approach stemmed from concerns raised by the National Union of Rail and Maritime Transport Worker's and some opposition parties that tendering could lead to the 2016-2024 public service contract being awarded to a private-sector operator. These concerns have since been overtaken by events. Following completion of the 2016 tender, the contract was awarded to CalMac Ferries Limited. The contract guarantees that the ferry services will be provided by a public-sector (in-house) operator for the remaining duration of the eight-year contract, until the end of September 2024.

4. As the Clyde and Hebrides ferry services will be provided by a public-sector operator until the end of September 2024, there is no immediate requirement to reach a final decision on whether to continue tendering the services, or make a direct award to an in-house operator. The services are already provided by a state-owned company and will be for the best part of another seven years from the date of publishing this report. Doing anything outwith the terms of the current contract at this stage, and certainly before ascertaining that a direct award would satisfy the full requirements of the Teckal doctrine and the State aid rules, could potentially render the Scottish Government open to legal challenge or a complaint to the European Commission, either of which could risk the provision of the ferry services in their current form.

5. The remaining seven-year duration of the current contract provides more than sufficient time for further detailed analysis of the existing corporate company framework and governance arrangements (as required by the Teckal control test), and detailed benchmarking against standard industry ferry practice to demonstrate that the in-house operator is a typical, well run and efficient undertaking, (as required by the fourth Altmark criterion). Completion of this analysis will then be used to inform the Scottish Government's case on the possibility of making a direct award to an in-house operator, ahead of the current contract ending in 2024.

6. If further analysis shows that it would be possible to make a direct award to an in-house operator, in full compliance the Teckal doctrine and the State aid rules (i.e. Altmark), the Scottish Government need not necessarily notify the European Commission about such an award. However, as previously stated under Section 3 Legal Framework, the

Commission's 2009 decision on the application of State aid to Scottish public ferry services means that it would be appropriate to notify the European Commission and seek its views on the suitability or otherwise of such an award.

7. The timeline afforded to complete the full analysis required to build a case for a potential direct award to an in-house operator for the Clyde and Hebrides ferry services does not however extend to the Northern Isles and Gourock to Dunoon contracts.

Northern Isles

A decision on the future approach to procuring the Northern Isles ferry services needs to be taken by spring 2018, taking account of progress on further analysis of the Teckal exemption and the State aid rules, and further engagement with local communities.

8. Arrangements are in hand to extend the term of the current Northern Isles ferry services contract with Serco NorthLink Ferries Limited to the end of October 2019, with limited scope for any further extension period beyond this date.

9. Unlike the Clyde and Hebrides, the remaining term of the extended Northern Isles contract places constraints on the time available to reach a decision on whether it would be possible to make a direct award to an in-house operator.

10. Tendering the Northern Isles ferry services would be a highly technical, complex and time consuming procedure, requiring extensive legal and financial due diligence by both contracting authority and bidders. A tendering exercise of this nature would normally take at least 18 months to complete: from initial advertisement, to preparation of tender documents and submission of bidders' proposals, to the award of contract, and finally the transition to a fully operational service. It might be possible to complete a tender exercise within a shorter timescale, but this could impact on the quality of the tender, the proposals submitted by the bidders and the final service solution.

11. The current time constraints means that a decision on whether to make a direct award, in full compliance with Teckal and the State aid rules, or to tender the Northern Isles services will have to be taken by the Spring of 2018. This would allow for the required 18-month timeline to complete the full tendering procedure, should that be required. To inform this decision, as well as considering the progress made on the possibility of satisfying both the Teckal doctrine and the State aid rules, the Scottish Government will follow up on its earlier engagement with local communities and stakeholders across the Northern Isles to build a better understanding of local views on

the future approach to be taken to the procurement of the Northern Isles ferry services.

Gourock-Dunoon

A direct award allowing for the transport of vehicles on a commercial basis is not considered a deliverable option in light of the limited scope of the public service obligation. Consequently, the currently paused tender for the Gourock-Dunoon ferry service will be restarted as soon as practicable to allow for the possibility of a commercially viable vehicle service being reintroduced as part of the next public service contract.

12. The Gourock-Dunoon contract was due to expire in June 2017. The contract was subsequently extended by nine months to March 2018, and will now be extended by a further nine months until December 2018.

13. A direct award for the Gourock-Dunoon ferry service under the State aid rules, assuming that such an award could be achieved through the successful application of the Teckal doctrine and the Altmark criteria, could only be applied to the transport of foot passengers under the terms of the public service obligation. A direct award allowing for the transport of vehicles is therefore not considered to be a deliverable option. Alternatively, tendering provides an approach which may realise the Scottish Ministers' long-standing policy position and the local community's aspirations for the return of a vehicle service to the town-centre route. This requires the currently paused tender to be restarted as soon as practicable.

ANNEXES



MV HELLAR

ANNEX A

Minister for Transport and Islands

Derek Mackay

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Commissioner Violeta Bulc
European Commissioner for Transport

By email to Violeta.bulc@ec.europa.eu

1 April 2016

Dear Commissioner

Council Regulation (EEC) No. 3577/92 (the Maritime Cabotage Regulation) Re- tendering of Public Service Contract for the Clyde and Hebrides Ferry Services: Request for the Commission's Views

I am writing to seek the Commission's view on the legal requirement to tender the Clyde and Hebrides ferry services. The people of Scotland expect Scottish Ministers to safeguard lifeline ferry services to ensure island communities are connected to Scottish, UK and European markets, in order to take full advantage of tourism, business and employment opportunities. The tendering of lifeline ferry services has been the subject of frequent scrutiny by the Scottish Parliament. In the course of a Scottish Parliament debate in November 2015, I agreed to meet with David Stewart MSP and the National Union of Rail, Maritime and Transport Workers (RMT) to discuss the union's recent QC's legal opinion on the need to tender the Clyde and Hebrides ferry services.

We are undertaking a tendering exercise with a view to the award of a fresh public service contract to operate a number of ferry services, collectively known as the Clyde and Hebrides ferry services. The services are currently operated by CalMac Ferries Limited ("CFL") pursuant to a public service contract entered into following a tendering exercise initiated in 2006. That exercise proceeded on the basis that the proposed contract fell within Article 4(1) of the Maritime Cabotage Regulation. The services operated by CFL were among those considered, in the context of State aid, in the Commission Decision C-16/08 of 28 October 2009 ("the 2009 Decision").

CFL is ultimately wholly owned by the Scottish Ministers. The question has arisen whether, in the particular circumstances, the operation of the Clyde and Hebrides ferry services through CFL could fall to be treated, as a matter of EU law, as exempted from the requirement to invite public tenders on the same basis as the familiar Teckal exemption to EU public procurement rules.

I would be grateful if you would be able to clarify whether, as a matter of EU law, the Scottish Ministers may be exempted from the requirement to proceed with a competitive tender on the basis of the Teckal exemption which would allow the Clyde and Hebrides ferry services to be operated through an in-house provider without competition and whether or not such an arrangement would raise State aid implications.

I attach a supporting paper, jointly prepared with the RMT setting out the issues which I invite you to consider. Your views on whether the Teckal exemption is capable, in principle, of applying to a competent authority's securing the provision of public passenger transport services to which the Maritime Cabotage Regulation applies and whether such provision by a competent authority itself or an in-house company on a subsidised basis would raise State aid implications would be especially welcome.

The Scottish Ministers are currently engaged in the Clyde and Hebrides tender process. It would be extremely helpful to all concerned to have your earliest reply or an offer to discuss with both myself and RMT representatives.

Kind regards

DEREK MACKAY

Copied to:

[The Rt Hon Patrick McLoughlin MP](#), Secretary of State for Transport, UK Government
Mr Ivan Rogers, [Permanent Representative of the United Kingdom to the European Union](#)
Mick Cash, RMT General Secretary

Council Regulation (EEC) No. 3577/92 (the Maritime Cabotage Regulation) Re- tendering of Public Service Contract for the Clyde and Hebrides Ferry Services: Request for the Commission's Views

1. Joint paper, prepared by Scottish Government and the National Union of Rail, Maritime and Transport Workers (RMT)

Teckal Discussions

2. Discussions about the application of the Teckal exemption have taken place between the Scottish Ministers and the National Union of Railway, Maritime and Transport Workers ("RMT"). As a starting point, and before any application of Teckal, article 4(1) of the Maritime Cabotage Regulation imposes, through the reference in its second indent to the principle of non-discrimination, an implied obligation to conduct a public tendering (or equivalent) exercise among EU shipowners before awarding a public service contract to a shipping company. In the 2014 interpretative communication COM (2014) 232 ("the Maritime Cabotage Guidance") this principle is referred to in sections 5.3 and 5.4. At paragraph 5.4.1 it is clearly stated that where a public service contract is concluded applicable procurement rules must be respected. That obligation arises independently of the Treaty rules on State Aid.

3. Those procurement rules include the Teckal exemption which is codified under Directive 2014/24/EU and Directive 2014/23/EU at articles 12 and 17 respectively. If the Teckal exemption is capable of applying in principle to services for which public services contracts may be awarded under Article 4(1) of the Maritime Cabotage Regulation, the result would be as follows:

(i) The question whether CFL in fact satisfies the Teckal criteria would be one for further examination by the Scottish Ministers;

(ii) In the event that the Scottish Ministers find the criteria satisfied, it would be open to them to engage CFL to operate the relevant services, following expiry of the existing public service contract, without any obligation under Article 4(1) to invite public tenders (or to undertake an equivalent exercise); and

(iii) The State aid rules might, quite separately point to a public tender exercise, especially having regard to the findings of the Commission's 2009 Decision, but that did not specifically consider whether the delivery of the public service by an in-house company meeting the Teckal test would lead to a conclusion that there was no aid, and, such a question would also fall to be considered.

4. As regards the future operation of the Clyde and Hebrides ferry services, the Scottish Ministers currently hold a political preference for taking advantage of the *Teckal* rule if they conclude that it is lawfully open to them to do so consistently with the Maritime Cabotage Regulation, the State aid rules and any other applicable legal requirements. Accordingly at this stage, the parties (the Scottish Ministers and the RMT) are concerned to resolve the threshold question of whether the Teckal rule is capable of applying in principle to the provision of the relevant services and, if so, whether such a direct award would also raise State aid implications.

5. So far as the parties are aware, the applicability of Teckal to maritime services within Article 4(1) does not appear to have been the subject of any previous judgment of the Court of Justice and nor does it appear to have been addressed in the Maritime Cabotage Guidance.

Legal Argument

6. One view is that the Teckal exemption is in principle capable of applying to services covered by the Maritime Cabotage Regulation. Thus a competent authority wishing to secure the provision of island ferry services, such as the Clyde and Hebrides ferry services, may choose either (i) to procure the operation of those services from the private market (in which case Article 4(1) would plainly oblige it to award a public service contract by means of a transparent procedure such as open public tenders), or (ii) to operate the service itself or through its in-house company.

7. If making the latter choice, the competent authority might utilise vessels and staff owned and employed directly by one of its own departments. Alternatively, it might establish a legally separate entity over which it exerts control similar to that exercised over its own departments, in which case it would be likely to enter into a contract with that entity (which would be likely to amount to a public service contract within the Maritime Cabotage Regulation) specifying the relevant services and establishing funding arrangements.

8. The principle of non-discrimination referred to in the Maritime Cabotage Regulation is a fundamental Treaty principle to ensure the effective operation of the single market. It applies equally to the procurement rules as it does to other measures in relation to competition and it is clear from the Maritime Cabotage Guidance that when awarding a public service contract it is the public procurement rules that are relevant.

9. The Court of Justice has repeatedly made it clear that an authority is free to determine whether or not to perform public tasks itself without being obliged to call on other entities for such matters (see for example Stadt Halle C-26/03 at paragraph 48). In accordance with the Teckal line of authority of the Court of Justice, the provision of services through such an entity is regarded as tantamount to their provision by the authority itself and as such does not infringe the principle of non-discrimination.

10. As that is the same principle that is engaged through the Maritime Cabotage Regulation proponents in favour of the argument may reasonably suggest that nothing in Article 4(1), precludes the competent authority from adopting either of these methods for operating the relevant services, i.e. without the involvement of privately-owned shipowners at all. In other words, in direct parallel with the established procurement rules, the rules in Article 4(1) indicate what is to happen where a Member State enters into a public service contract with, or imposes public services obligations on, a private shipping company. It does not stipulate that the only way in which the State can bring about the operation of the services in question is by entering into such a contract or imposing such obligations. The State may provide the service itself. If it does so, the rules in the second indent of Article 4(1) are simply never engaged.

11. The 2007 Rail Regulation, Regulation (EC) No. 1370/2007 should also be noted. Article 1(1) empowers Member States to apply its provisions to public passenger transport “by inland waterways and, without prejudice to [the Maritime Cabotage Regulation], national sea waters.” By Article 5(2), the 2007 Regulation expressly recognises the power of a competent authority, as an alternative to seeking tenders from the private market, to operate passenger transport services itself or to do so via a separate entity. But, in accordance with Teckal, such an entity must satisfy certain criteria relating to control by the competent authority. The scheme of the 2007 Regulation therefore, in effect, represents a codification of the law as recognised in the Teckal line of authority. It is recognised that there are limits as to the possible application of the 2007 Regulation to the Maritime Cabotage Regulation, for example only extending to passenger transportation. As you will be aware, besides passengers, the operator of the Clyde and Hebrides ferry services also carries cars, vans, large commercial vehicles and freight.

12. It might also be suggested that the 2007 Regulations could not be applied to Maritime Cabotage to extend the application of the Teckal exemption, even to the extent of passenger transportation only. That may be a conclusion reached from considering section 8 of the Maritime Cabotage Guidance. An argument against the application of the exemption may suggest that the absence of a power to extend Article 5(2) of the 2007 Regulations to the provision of services covered by the Maritime Cabotage Regulation would be fatal to the application of Teckal in the latter context.

13. The absence of such provisions, however, cannot give rise to the inference that Member States are prohibited from operating the relevant services themselves rather than procuring them from the private market. The 2007 Regulations were not seeking to amend the Maritime Cabotage regime but merely providing member States with a power to extend the application of the 2007 Regulations to such matters. As the 2007 Regulations were not concerned with a review of the Maritime Cabotage Regulation it is unsurprising that the power was expressed as without prejudice to the Maritime Cabotage regime.

14. The primary object of the Maritime Cabotage Regulation was to define, in the relevant sector, the scope of the Treaty freedom to provide services. It was not an instrument aimed at requiring Member States to privatise, or divest, their own provision of the relevant services (which, in the light of what is now Article 106 of the Treaty of the Functioning of the European Union, would require a clearly stated legislative intent). Given that the Teckal principle is simply an extension (within defined boundaries) of the concept of a Member State providing services itself, nothing in the Maritime Cabotage Regulation is inconsistent with the application of that principle.

15. It should be noted however, that the Maritime Cabotage Regulation pre-dates the 2007 Rail Regulation and indeed the Teckal judgment. It is also therefore not surprising that it contains no express provisions seeking to reflect or codify the conditions on which a competent authority may provide passenger transport services otherwise than through the private market.

16. It should be further noted that this understanding of the law appears to accord with the views expressed by officials of D-G Mobility and Transport during a meeting with Mr. David Stewart MSP during the summer of 2015. The position expressed by officials is summarised in the attached e-mail, sent to Mr. Stewart by Mr. Erdem Erginel, International Relations Officer in the Maritime Transport and Logistics Unit (D.1) on 25 September 2015.

17. Furthermore it is also the case that in its judgment in the ANAV case mentioned in Mr. Erginel's e-mail (see attached) (*Associazione Nazionale Autotrasporto Viaggiatori v. Comune di Bari*, C-410/04, [2006] ECR I-3311), the Court of Justice was not directly concerned with the Maritime Cabotage Regulation but with road transport services by way of service concession which at that time fell outside the scope of the Community Public Procurement Directives. However, the Court recognised the application of the Teckal principle to service concessions outside those Directives (See paragraph 24 of its judgment).

18. It can be observed that like any view now expressed in response to the present communication, that view is not binding on the Commission; and that it will have been expressed without the benefit of a detailed explanation of the competing approaches of the present parties.

State Aid

19. If the Teckal principle applies as above in the context of the maritime cabotage regime it raises the question whether a direct award of a subsidised public service contract to an inhouse company would result in State aid within the notion of aid set out in Article 107 TFEU.

20. That article applies where the recipient of the aid is an undertaking, being an entity engaged in economic activity. Where a public body is itself simply discharging public functions that does not constitute an economic activity with the result that Article 107 does not apply. Where a public body, however, engages in economic activity that body may, itself, fall to be treated as an undertaking. That may be so in a market where other operators would be willing and able to provide services in the market concerned but in this case the very need for a public service contract only arises due to the failure of the market to deliver necessary services without public intervention. An intrinsic element of State aid is that there must be a distortion or threat of distortion of competition. That need not be significant but the likelihood must be more than merely hypothetical.

21. The 2009 Decision reached a conclusion that there was existing State aid in relation to the Clyde and Hebrides ferry service but it was compatible with the common market. The Decision, however, does not appear to have addressed the in-house nature of the provision nor does there appear to be any substantive consideration as to whether or not the service is economic. It appears reasonably clear that without public intervention these lifeline ferry services would not be provided by the market as they would be uneconomic.

22. The 2009 Decision places considerable emphasis upon fulfillment of the Altmark criteria in the context of the effect upon competition without apparently examining whether there was actually a market that might reasonably be considered to be subject to interference and distortion.

23. Those who would advocate a direct award would suggest that delivery of the public service obligation in-house or through an in-house company would not give rise to State aid considerations where the service provider was not active in the market of ferry services beyond the PSO itself (and therefore did not compete in the wider market). In such a case we would merely be providing services that the market was not providing without any interference with the market in relation to other services that operators may wish to provide.

24. We trust that this short exposition of views enables the Commission to provide a preliminary indication of its views on whether, in the these circumstances, the provision of these services via a Teckal entity, where operating costs are funded by public expenditure less fare revenues and the service is not operated for profit, is likely to raise a State aid issue

Conclusion

25. The Scottish Ministers and the RMT invite the Commission to consider this communication and attachments.

Derek Mackay MSP
for Transport & Islands
Scottish Government

Mick Cash Minister
General Secretary
RM

Dear Mr Stewart,

Thank you for your e-mail,

Further to our meeting of last month, I looked into the EU rules and regulations concerning tendering. I would like to take this opportunity to share with you my conclusions.

You will remember that during our meeting you had inquired about the possibility of not having a tender procedure in relation to ferry services connecting the Scottish islands.

At the outset, I would like to note that we recognize the importance of the maritime transport connections for residents of the Scottish islands. The EU rules in particular, the Cabotage Regulation (3577/1992), contain a balanced set of rules. On the one hand they liberalise cabotage services to improve the quality of services provided to European citizens through increased competition between operators. On the other hand, they provide for special rules which aim to ensure territorial continuity of the Member States' islands.

In the view of the European Commission a transparent and non-discriminatory tender for public services is the best way to ensure that the citizens receive the best possible services in terms of quality and price at the lowest cost for the tax payer. Consequently, we strongly advocate the widest possible use of open and transparent tendering procedures when public authorities entrust companies with a public service obligation.

Regarding the possibility of the direct award of a public service contract (i.e. without a tendering procedure), this is, in principle accepted by the European Court of Justice (case C-420/04 ANAV), in the case of 'in-house' service, if certain conditions are met cumulatively.

- The public authority awarding the contract must wholly own the share capital of the company to which the contract is being awarded;
- The public authority exercised a control over that company that is comparable to the control exercised over its own departments;
- The company carries out the essential part of its activities with the controlling authority.

The Cabotage Regulation does not explicitly foresee the modalities of the provision of the public service in-house, but the case-law should be applicable to maritime cabotage. As specified by the Court (also in the cases C-107/98 Teckal; C-29/04 Commission v Austria), as this is a derogation from the general principles of the Treaty, the existence of the above mentioned conditions has to be strictly interpreted and the burden of proof as regards the fulfillment of these conditions lies with the Member State invoking the derogation.

I hope you will find the above to be useful.

Yours sincerely

Erdem Erginel,

International Relations Officer European Commission
Directorate-General for Mobility and Transport
Maritime Transport and Logistics Unit (0.1)
B-1049 Brussels Office: DM28 3/98

ANNEX B

VIOLETA BULC
Member of the European Commission

Brussels, 22.09.2016
NvP Ares (2016) 5502257

Mr Humza YOUSAF
Minister for Transport and Islands
5 Atlantic Quay,
150 Broomielaw Glasgow G2 8LU SCOTLAND

Dear Minister

I am writing to you further to the letter of Mr. Mackay, who wrote to me in his capacity as Minister for Transport and Islands in the Scottish Government, on 1st April 2016.

In his letter, Mr. Mackay requested the Commission's view on the legal requirement to tender the Clyde and Hebrides ferry services. I understand that - after the above-mentioned letter was sent – the tender for the Clyde and Hebrides ferry services has been awarded to CalMac Ferries Limited (CFL). However, the Scottish Government EU Office in Brussels has indicated to my services that a reply to the letter of Mr. Mackay would nevertheless be useful, as similar cases regarding ferry services to Scottish islands might emerge in the future.

In his letter, Mr. Mackay wrote:

I would be grateful if you would be able to clarify whether, as a matter of EU law, the Scottish Ministers may be exempted from the requirement to proceed with a competitive tender on the basis of the Teckal exemption which would allow the Clyde and Hebrides ferry services to be operated through an in-house provider without competition and whether or not such an arrangement would raise State aid implications.

Before replying to this question, let me first observe that whereas the Commission can provide some general guidance and advice, it cannot offer legal certainty through its opinions: only the European Courts can provide authentic interpretation of EU law. Moreover, the legal analysis of a case can vary considerably depending on specific circumstances and concrete details.

I would also like to underline that the Commission recognises the importance of the maritime transport connections for the residents of Scottish islands. We are aware of the significance of ferry services for the social, cultural and economic well-being of the communities of the Scottish islands. We also appreciate the commitment of the Scottish Government to deliver sustainable maritime links to the islands, while acknowledging the financial challenges this may entail.

I have attached to this letter a note prepared by my services, analysing the legal situation, very much hoping it provides you with the desired clarity.

Remaining with best wishes for your start in this office,

Yours faithfully,

VIOLETA BULC
Address: European Commission – B-1049 Brussels, Belgium

Note on Council Regulation No. 3577/92

EU legislation on maritime transport, specifically the Council Regulation No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States (“the Cabotage Regulation”),¹ ensures that all EU operators can offer their services without unjustified restrictions, so that users can profit from wide choices and affordable prices. It also recognises that there are situations in which the market does not adequately respond to citizens’ needs and it allows State intervention to guarantee public service links, participating in regular services to, from and between islands. In such cases, EU rules require that the attribution of public service is done on a non-discriminatory basis in respect of all Union shipowners and in an open and transparent way.

It is well established that EU Public Procurement Directives apply if contracting authorities enter into public contracts; that is, contracts for pecuniary interest concluded in writing with a third party and having as their object the execution of works, the supply of products or the provision of services within the meaning of the Directives.

In the *Teckal*-case,² the Court interpreted this rule in a functional manner. It laid down two cumulative criteria for the exemption from EU public procurement rules of a relationship between a contracting authority and another legal person. According to the Court, such a relationship falls outside the scope of EU public procurement law if:

- 1) the contracting authority exercises over the legal person concerned a **control which is similar to that which it exercises over its own departments**; and, at the same time,
- 2) that legal person **carries out the essential part of its activities with the controlling contracting authority or authorities**.³

Indeed, the Court considers that if both conditions are met, the agreement between the parties constitutes an in-house administrative arrangement, and it is therefore not a public contract with an external provider. The existing case-law excludes the participation, even as a minority, of a private undertaking in the capital of an in-house operator. Therefore it applies only to fully-owned public companies.

In the subsequent judgment in the case of *ANAV*,⁴ the European Court of Justice reiterated the legal possibility for a public authority to award a public service contract directly, provided that certain conditions are met:

[T]he principles of equal treatment, non-discrimination on grounds of nationality and transparency do not preclude national legislation which allows a public authority to award a contract for the provision of public service directly to a company of which it wholly owns the share capital, **provided that** the public authority exercises over that company control comparable to that exercised

¹ Official Journal L364, 12/12/1992 P.7-10

² C-107/98

³ Ibid, para.50

⁴ C-410/04

over its own departments and that that company carries out the essential part of its activities with the controlling authority.⁵

Even through the Cabotage Regulation does not explicitly refer to the direct award of public service contracts, the case law on the in-house operator should be applicable in cases on maritime cabotage as well. Our view is that, since this is a derogation from the general principles of the Treaty, the existence of the above mentioned conditions has to be strictly interpreted and the burden of proof as regards the fulfilment of these conditions lies with the Member State invoking the derogation.

It should also be noted that the use of a public procurement may have consequences for compliance with EU State aid rules. In particular, I would invite you to examine the Commission Decision C-16/08 of 28 October 2009⁷ that you refer to in your letter, which assessed whether ferries services across Scotland constituted State aid by reference to the four “Altmark” conditions (see point 166). The fourth Altmark condition can be considered to be met where the undertaking is shown via a public procurement procedure.

⁵ Ibid, para.33

ANNEX C

FERRY SERVICES PROCUREMENT POLICY REVIEW TERMS OF REFERENCE

Purpose

The Policy Review will examine the future approach to the procurement of the Scottish Government's lifeline ferry services, in accordance with European and domestic legislation.

The Policy Review's primary purpose is to ensure the continued provision of safe, efficient and effective ferry services that meet the needs of island and remote rural communities and which provide value for money to the taxpayer.

Remit

The Policy Review will identify and consider in detail the legal, policy and financial implications relevant to the procurement of ferry services, including:

- the possible application of the Teckal exemption
- the requirement to ensure compliance with State aid rules, and
- all other legal, policy and financial implications relevant to the procurement of ferry services in future

The review will examine alternative models to the current organisational structures and governance of David MacBrayne Ltd and Caledonian Maritime Assets Ltd. within the context of meeting the conditions of Teckal and State aid rules.

The review will produce a report on the sustainable provision of ferry services in future. It will be made available to Parliament and be published on Transport Scotland's website.

Structure and Process

The Minister for Transport and the Islands will oversee the review which will be conducted by officials with the relevant expertise from across Transport Scotland and Scottish Government, including:

- Transport Scotland Ferries Unit
- Transport Scotland Analytical Services
- Transport Scotland Finance
- Scottish Government Finance
- Scottish Government Legal Directorate
- Scottish Government European Union Office
- Scottish Government State aid Unit

- Scottish Government Procurement and Commercial Directorate

The review will be structured around three workstreams:

- Legal – including such elements as consideration of the Teckal exemption, the Maritime Cabotage Regulation and State aid rules
- Policy – including such elements as operational implications, consideration of future operating models, key stakeholder engagement and implications of Brexit
- Financial – including such elements as consideration of costs, benefits and value for money associated with procurement of ferry services in future

Stakeholder Engagement

The review will engage closely with stakeholders through a series of key stakeholder reference groups and bi-lateral meetings, including:

- Regional Transport Partnership Ferry User Groups involving local authority, community, business and tourism stakeholders
- Constituency MSP and Transport Spokespersons
- Trade Unions
- European Commission
- Existing Public Service Contract Operating Companies

Provisional Timeline

The requirement to consider complex and detailed legal, policy and financial information means that the outcome of the review cannot be prejudged. Emerging findings could influence both the direction and timeline of the review.

A provisional timeline is presented for information purposes only at this early stage in the review process and may be subject to amendment as the review progresses.

| Key Milestones | Provisional Timeline |
|---|------------------------|
| Key Stakeholder engagement | February – June 2017 |
| Consideration of legal, policy and financial implications | February – August 2017 |
| Publication of Report | Autumn 2017 |

ANNEX D

Meeting with European Commission on Scottish Ferries Procurement Review

DG MOVE, Rue de Mot 28, room S36

Friday 28 April 15:00

Meeting Note

Transport Scotland began the meeting by thanking the Commission services for taking the time to meet and by giving an overview of the importance of ferries to Scotland, including the scale of the coastline, number (93) of inhabited islands with a population of around 100,000 served by over 30 vessels at a cost of £200 million per annum, making Scotland's ferry services a unique part of the transport system in the UK and possibly one of the largest subsidised ferry services in Europe. He also illustrated the lifeline nature of services in Scotland for the economies of the island communities that they serve. As a result these issues have had a significant profile at both political and operational level.

Nearly all political parties in Scotland have indicated they have an ideological preference for these services not to have to be tendered. However, all parties when in Government have agreed, based on the legal requirement that public service contracts shall be attributed on non-discriminatory basis in respect of all Community shipowners, that these services would be opened up to competition and so, since devolution in 1999, this has been the approach that has been taken by successive Governments.

Last year the Scottish government approached the Commission with a question on whether the Teckal exemption could be applied to the maritime transport services. The Commission replied that, although the Cabotage Regulation does not foresee a possibility of an in-house operator, there is no explicit rule that would forbid the application of this option to maritime cabotage. However, since this is a derogation from the basic principles of the Treaty, the Teckal conditions have to be interpreted strictly. The Commission also stressed that its opinion has no binding effect and that only the European Court is competent to provide authentic interpretation of EU law.

Following the clarification from the Commission, the current Minister for Transport has commissioned a review of ferry procurement in Scotland to determine the optimum approach to the provision of ferry services in Scotland. The review will be conducted without prejudice to ideological preference and will be rooted in evidence based consideration of the following policy, financial and legal questions;

1. Whether the Teckal exemption is capable of being applied to the provision of ferry services;
2. Whether it is possible to apply the exemption and to still fulfill State Aid and EU Procurement requirements;
3. Whether and how value for money for the public purse will be ensured if providing ferry services without a tender on the open market; and,
4. The wishes of the communities to whom these services are so vital.

The Commission services thanked the Scottish Government for the discussion paper in advance of the meeting and indicated their understanding of the sensitivity of the issues at stake. They indicated that there are several aspects to the issue including: the justification for imposing public service obligations or concluding public service contracts; the mode of the attribution of a public service contract to a provider; and the definition of a proper amount of compensation for the service. The point of departure is the principle that the market should be open to all operators without restrictions, which is a fundamental concept in the Maritime Cabotage Regulation. The public service has to be clearly defined and can be introduced only if the public authorities can demonstrate that the public service need (or part of it) cannot be met by the private operators. Providing a robust market study and evidence supporting the scope of the public service is particularly important on routes where currently there are private operators.

In addition to the principles of the Maritime Cabotage Regulation, the procedure for entrustment of the public service has to comply with public procurement rules. Recourse to a public tender process provides a simple solution to the questions of non-discrimination in the attribution of the service and of determination of appropriate compensation.

The discussion moved on to evidence of public services and requirement for subsidy, clarification of ownership models and control and whether there are other, similar examples to Scotland.

Transport Scotland indicated, in relation to the evidence base for public subsidy, that it has been very clear from recent tenders in Scotland that the required services would not have been provided without the subsidy being available. The most recent tender attracted 2 bids, one from our “in-house” operating company and one from the private sector, which would not have happened without public subsidy being available.

On State Aid issues the Commission services noted that the rules on Services of General Economic Interest (SGEI) can be used to provide operating aid for the day to day running of ferry services, where there is a recognition that these services would not otherwise be provided, and drew attention to the fact that the 2012 SGEI package also applies to maritime transport. The rules are sufficiently broad to allow Member States to meet their objectives, provided that the relevant compatibility criteria (including genuine need for the service and compliance with sector-specific legislation) are met. Alternatively, Member States can set up their compensation in compliance with the four conditions set out in Altmark, in which case the compensation is not considered State aid. However, there are challenging conditions to be met in relation to Altmark, which imposes strict conditions aimed *inter alia* at limiting the compensation granted to the costs which an efficient provider would incur in performing those obligations.

A competitive tender is the best way to ensure that (subject to all other conditions being met) the subsidy provided is not State aid, as there is no advantage to the winning company which it would not gain in the normal market. It was also made clear that this was much more straightforward than being able to meet the second option set out in the fourth Altmark criterion, which states that where there is no tender

process, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with the necessary means, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

The challenge in applying the benchmarking provision under the fourth Altmark criterion is how to prove that the undertaking against which you are benchmarking is “efficient”. The burden of proof is high and efficiency is difficult to prove in a vacuum. On this basis, most people choose to run a tender in order to ensure that the service is provided at the least cost to the community. It should also be noted that under the SGEI rules there is no restriction on the provider making a reasonable profit in return for the provision of the services in question. The Commission services reiterated that Member States always have the right to notify an aid measure for legal certainty and are welcome to approach the Commission services informally to get a first indication of whether a planned measure is compliant with the relevant rules.

Transport Scotland indicated that requirements for benchmarking and whether that is a realistic avenue to pursue would be considered, as well as whether the recent tender that had been run could serve as a useful starting point for benchmarking, alongside a wider range of critical questions including whether it is possible to apply Teckal in respect of in-house operating company? Transport Scotland indicated that, so far as the two control and function tests applicable to Teckal go the Scottish Government is confident that the functions test is met, however there is less clarity about whether the control test is met in respect of the current structures and what changes might be necessary to the company to meet the control test. Transport Scotland outlined the public ownership arrangements that exist in Scotland and offered to send further details on this to the Commission services, and invited the Commission services to give their views on the application of Teckal and relevant case law.

The Commission services explained that the Teckal exemption requires the fulfilment of three conditions, initially set by the case-law and now codified in the new public procurement Directives. Firstly, the public (controlling) authority needs to have a control over the controlled enterprise similar to that it has over its own departments; 80% of the activity of the controlled entity must be carried out on the basis of an entrustment by the controlling authority; no direct private capital participation in the controlled entity is permitted.

Concerning the “similar control” condition, the Commission colleagues were very keen to have further detail on the current structures and what potential structures to meet the control function might look like. The Court of Justice has not provided precise indications on the exact elements which constitute similar control. In order to get a full picture of whether the control condition is fulfilled it is therefore important to take into consideration all potentially relevant circumstances. In principle, as indicated in the Directives, similar control exists where the controlling authority has decisive influence over the strategic objectives and significant decisions of the organisation. Some of the most relevant elements that are usually looked at are how and by whom the decision-making bodies of the controlled entity are appointed, what are their powers, whether the public authority has control over the appointees as well as to what extent that

enables the public authority to control the entity. In general, details on the corporate structure and the link between decision making bodies and Government would help in assessing the situation.

Transport Scotland sought clarity on the question of whether Teckal was applicable to the Maritime Cabotage Regulation. Until the recent letter from the Commission, this had not been an avenue that had been explored as it had never, in the Scottish Government's previous interpretation of the guidance, been applicable to the Maritime Cabotage Regulation.

The Commission services responded by saying that the guidance excludes a direct award of a contract to a private operator. An in-house operator which fulfils all the necessary conditions of ownership, control and function is not considered an external provider, but an integral part of an administrative structure of a public authority. Such an internal provider is entrusted to deliver services to the competent public authority(ies). Such entrustment could be arranged without a public tender.

The Commission services informed that to date there are no known examples of in-house operators in the maritime transport sector. The Commission services noted that, whilst this option might appear attractive, the public authority is not released from the obligation to demonstrate that there is a real need for a public service on each route considered and that this need cannot be fulfilled by the market. This would mean that the scope of operations of the in-house operator and the elements that actually require state funding would have to be precisely defined. The Commission services also recalled that, in particular on routes with current or potential private operators, the performance of public service maritime operation by an in-house provider could be subject to a complaint.

The Commission services sought clarity on whether all services currently awarded would be bundled. Scottish officials explained that the bundling of services has been the case with the Clyde and Hebridean Ferry Services which includes a number of routes ranging from 120 metre vessels serving Stornoway and Ullapool to 30 metre vessel undertaking 15 minute journeys. The bundling of services, as is common practice, was to make the services more attractive to potential commercial suppliers and to minimise the amount of subsidy that might be required to support the full breadth of services. Bundling also allowed for operational flexibility and redeployment of vessels when necessary.

From the Commission services' perspective, the important elements are understanding whether there are routes within the bundle that are profitable. The arguments in favour of bundling have to be weighed against the services provided and that can become problematic if you are bundling profitable and non-profitable services. There is a need to look at the full scope of activities including conducting a market study on what would be considered a public service need and the capacity of the market to meet those needs in the absence of public intervention. State Aid would also require the same questions to be asked and answered. Under the rules on Services of General Economic Interest bundling is not necessarily a problem, provided that there is clear evidence to support the need to have a bundle. However, it must always be kept in mind that relevant sector-specific rules must also be complied with.

Transport Scotland responded that the [Ferries plan for Scotland](#) contained much of the information that may need to be provided, having undertaken a needs based assessment of each of the routes which was then used as the basis for specification of services. Experience in Scotland has been that no private operators have wanted to enter these routes, or that the private sector would step in if there was no public service available.

Transport Scotland thanked the Commission services for their helpful clarifications and outlined the further work underway, including finalising legal advice on Teckal and State Aid issues, in advance of final recommendations. Officials expressed a desire to keep a dialogue with the Commission going during this period and invited Commission officials to Scotland where they would be able to see and hear first-hand from communities some of the challenges and issues pertinent to the review. Officials also indicated that the Minister would be keen to both write and to visit Brussels for a meeting at some point in the future.

STUC first stage response to Scottish Government Ferries Review

11 July 2017

Introduction

The STUC and our affiliated trade unions with membership in the maritime sector have long held the view that the tendering of ferry services is detrimental to local economies and to workers as well as posing potential long term risk to the maintenance of effective lifeline services. Moreover, it has been our strong view that the EU regulations under which successive Scottish Governments have tendered contracts for these services are not in the long term interests of either passenger services or workers' terms and conditions of employment on lifeline ferries.

Since 2005, successive Scottish administrations have taken a view that they have no option but to tender these contracts, in order to comply with EU law and to avoid any potential for legal action to be pursued against it by private operators.

In February 2017, the Scottish Government announced that the European Commission had accepted the Scottish Government and RMT's joint case for considering an exemption under Teckal case law for public contracts for Scottish ferry services from re-tendering requirements in EU Maritime Cabotage Regulation 3577/92. This joint position was based on the legal advice RMT received in November 2015.

In this context, we strongly welcome the Scottish Government and the current Transport Minister's proactive pursuit of the legal means to permanently provide Scottish ferry services through an in-house operator. The transport minister has stated that should the government conclude that it is possible to apply the Teckal exemption and satisfy State aid rules then "(it) would be minded to provide ferry services through an in-house operator, taking account of the communities they serve."

By pausing the current tendering exercises for the next contracts for Gourock-Dunoon and Northern Isles ferry services, the minister has signalled serious intent. This is positive news. Trade unions, backed up by over a decade of high quality academic research and legal opinion, are confident that the case for an in-house operator is strong. Moreover a number of major developments over the past two years have added significant weight to that case. This paper examines the new developments as well as relying on previous academic research which remains relevant today.

Ferries Review process

The Scottish Government Ferries Review identifies three main streams of inquiry:

- Legal – including consideration of the Teckal exemption, the Maritime Cabotage Regulation and State aid rules
- Policy – including operational implications, consideration of future operating models, key stakeholder engagement and implications of Brexit
- Financial – including consideration of costs, benefits and value for money associated with future procurement of ferry services, vessels and infrastructure enhancement.

The STUC and ferries unions has no difficulty with the suggested lines of inquiry provided that in stream three (Financial) it is understood that the benefits to be

assessed include the wider economic and social benefits of stable and reliable employment and services, underpinned by the Scottish Government's Fair Work objectives. The trade union view remains firmly in favour of public ownership and operation of lifeline public ferry services, supported by public investment as the model to deliver those long term economic and social benefits to workers, passengers, communities and taxpayers.

Legal advice

As stated earlier, the key recent development is the legal advice obtained by the RMT which prompted the Scottish Government to review its existing legal advice on the necessity for public contracts for Scottish ferry to be subject to the requirements in EU Maritime Cabotage Regulation 3577/92 for regular commercial competition for these public contracts.

The STUC recognises that the Government will take its own legal advice on this and other aspects of the issue. It is unfortunate that by general (though not absolute) convention, we will not be in a position to analyse this advice during the course of the Ferry Review.

Given the complexity of EU law and the history of ferry contract tendering in Scotland, there is every possibility that the legal advice whichever way it leans will contain a number of caveats. Legal advice to government however at all levels is notoriously risk averse. It is therefore regrettable that the general public, whose taxes are spent on transport provision and whose name the final policy decision will be taken, will not have the opportunity to assess all of the factors which will ultimately contribute to the final decision.

Audit Scotland and the current Clyde and Hebrides Service

The STUC and affiliated ferry unions are confident that the Audit Scotland report into ferry services, due out in the Autumn will back the assertion made by Jeanette Findlay and Dania Thomasⁱ that the foundation on which the case for public ownership is built is the

‘... largely undisputed proposition that the existing service in the Clyde and Hebrides – the largest of the bundled routes - is a well-run, efficient and cost-effective service provided by the public-sector operator, CalMac (Findlay, J, 2005, 2010, 2016).’

The fact that the Clyde & Hebrides (CHFS) contract, the largest of the three public ferry contracts is operated by a publicly owned and highly successful company, providing a range of socio-economic benefits is the cornerstone of our position. Had the CalMac bid not been successful in securing the 2016-24 CHFS contract, Scotland's publicly owned ferry operator, with a long history of quality provision for island communities would have effectively ended in Scotland, with only the joint operation of a Ministry of Defence contract in Southampton the sum total of its maritime activity. As Prof. Neil Kay has argued, the public sector is only ever one unsuccessful tender away from oblivion and the introduction of a private monopoly: *‘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.

With clearly defined capital costs, specified service levels and effective state regulation, the essential competitive advantage of one provider over another can only be gained by cutting labour costs. Whilst this does not translate to cutting jobs, Jeanette Findlay's argument captures this fundamental problem: 'vessels, timetable and staffing are largely pre-determined and any cost-saving could only come in terms of a deterioration in the terms and conditions of on and off-shore CalMac employees.' This applies to all three public sector ferry contracts.

Thus a tightly specified tender process, in which the Scottish Government negotiates in private with all bidders, encourages bids that are based on reducing pay or other terms and conditions of ferry staff. As argued later, this runs contrary to Fair Work objectives and potential community benefit.

It is of course possible and desirable to secure terms and conditions for staff and collective bargaining rights for trade unions in all public contracts for ferry services. However, if the purpose of any tendering process is to seek best value, it is entirely reasonable that Government should choose not to embark on a costly tendering process in the first place. This is particularly the case if the long-term consequence of tendering is the loss of the public sector operator (including the operator of last resort role) and the creation of a private sector monopoly.

New developments

Putting aside past disagreements between various governments and trade unions about the interpretation of EU law and regulation, it is freely admitted that a number of significant developments – legal and political have taken place since the Scottish Government's decision to re-start the tender process for the 2016-24 CHFS contract. Of major significance is the legal advice obtained by the RMT and the view from the European Commission that the Teckal exemption is a valid line of legal argument. This is dealt with later.

There are also three other factors which have emerged. This paper does not argue that any of these of themselves are a silver bullet for the case for public provision without tender. However, taken together they constitute very important context for a decision which is not just technical but political in nature. These are; the emergence of a clearly defined Fair Work agenda, the clear and increasing public support for public ownership and the referendum decision to leave the EU.

Fair Work

The Fair Work Framework, fully supported by the Scottish Government was published in 2016. It states that:

Our vision is that, by 2025, people in Scotland will have a world-leading working life where fair work drives success, wellbeing and prosperity for individuals, businesses, organisations and society.

The Fair Work Framework states that fair work is delivered through five pillars, security, respect, opportunity, fulfilment and effective voice. Of particular importance relating to ferry service provision are the pillars of security and effective voice. *Security* includes security of employment and pay. Given the importance of a public sector ferry operator to the provision of lifeline passenger services, workers and local communities have a major stake in ensuring that workers are confident in the knowledge that their jobs are guaranteed and that the terms and conditions of employment will not be subject to detriment. Given the view articulated earlier that tendered contract awards based on 'best price' encourage a downward pressure on such terms and conditions, the case for publicly owned provision without tender is strong.

The Fair Work Framework, in a reflection of wider Scottish Government policy, identifies payment of the Scottish Living Wage as a key element of workers' job security.

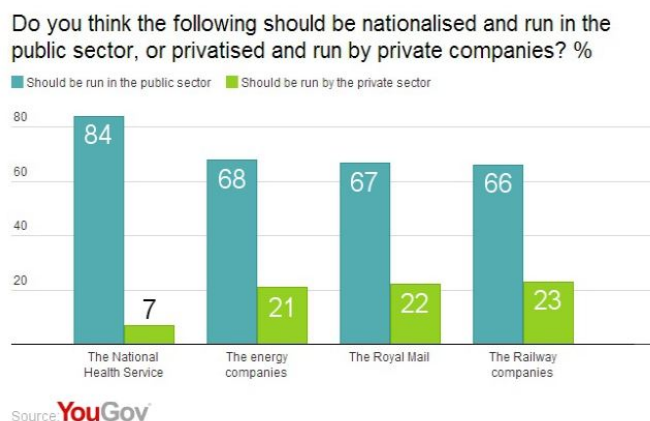
The STUC and the Scottish Government have a differing view about whether the Scottish Living Wage can be delivered through the current procurement regulations. The current position is that the Scottish Government and the agencies it most closely influences (NDPBs, NHS Scotland etc.) pay the Scottish Living Wage as a matter of government policy. Most recently, the Scottish Government's decision to re-negotiate the charter for two Seatruck vessels that form part of the current public contract with Serco for Northern Isles ferry services has seen the National Living Wage being paid to seafarers who were previously earning a basic rate below the National Minimum Wage.

Whilst we share the Scottish Government's view of the Living Wage as important progress in public procurement, there can be no doubting the STUC and ferries union position in supporting the collectively bargained rate of pay and terms of condition of employment, particularly for seafarers in the Scottish ferry industry. It is essential that public funds do not go towards poverty wages and it is equally important for existing public contracts, such as those in the ferry industry are not undermined by the Living Wage.

Clearly the most effective way of delivering this in the ferry industry – particularly given the Government's reluctance to mandate payment through procurement – is through direct government employment. The STUC and ferry unions' position here chimes with another key Fair Work strand - employee voice, through which the Government approves collective bargaining agreements with recognised trade unions. Whilst there are many private sector companies which recognise unions, coverage is far more widespread in the public sector and trade union membership amongst Scottish ferry workers is particularly strong. The same cannot be said of private sector employers, particularly in the shipping industry. Once again, ending re-tendering and securing public sector delivery for the long term is the most effective way to guarantee basic trade union rights are observed and respected.

Public support for democratic ownership

Recent evidence suggests a continuing high level of public support for direct delivery of services and for public ownership more generally.



Public ownership and delivery in transport is a highly popular policy as reflected in the views of the Scottish public on Abellio Scotrail and the current Scottish Government's thinking on developing a public sector bid (UK legislation currently precludes full nationalisation). Indeed, the most recent stage reached in these discussions specifically raises the prospect of using CalMac Ferries to launch a public sector bid for ScotRail. We would simply point out at this stage that we would be in an invidious position if we were to argue for an end to tendering of Scottish ferry contracts at the same time as the Scottish Government was using the public sector ferry operator to legitimise the equally flawed and inherently pro-private rail franchising process.

Support for public ownership and operation of ferry services was high during the CHFS tender process, which ultimately resulted in CalMac being awarded the contract. We also believe that public ownership and the direction of public investment in Scottish ferry services needs to be effectively applied to the vessels and harbour and ports infrastructure. On vessels, we need to move away from the complicated and expensive charter arrangements we still see on the Northern Isles contract and there is also a strong case to be made for Caledonian Maritime Assets Ltd procuring additional tonnage to deploy in the event of vessel breakdown or other incidents on any of the three public ferry contracts. The diversity of the vessel profile, particularly on the CHFS network might make this difficult but it is by no means impossible. We look forward to getting into the detail of this aspect of the Ferry Review with Transport Scotland and other Government officials.

Clearly, the widespread support for public ownership does not itself make legal the case for exempting Scottish ferry contracts from competitive tendering. But this high level of public support provides important political context to the Scottish Government's Ferry Review.

Brexit

The UK Parliament's Article 50 vote suggests that on the balance of probabilities Scotland will exit the EU. However, the terms of Brexit and its impact on procurement law and the stipulations of any new trade agreements are hard to predict. As Findlay makes clear (Fraser of Allander Institute Economic Commentary, March 2017) EU regulations are likely to apply in the UK for at least two years and probably longer.

The STUC accepts that it is not possible to base decisions on ferry contracts on assumptions, in particular that EU Regulations and State Aid Guidance will not apply in the future or that similar rules will not replace them.

However, it is equally the case that in a complex and changing landscape, and with potentially competing views on the legality of specific actions, it is far from certain that legal action from the EC or private sector ferry companies would be taken against the Scottish Government in the event of David MacBrayne operating a public ferry contract that had not been subject to the competitive tendering process.

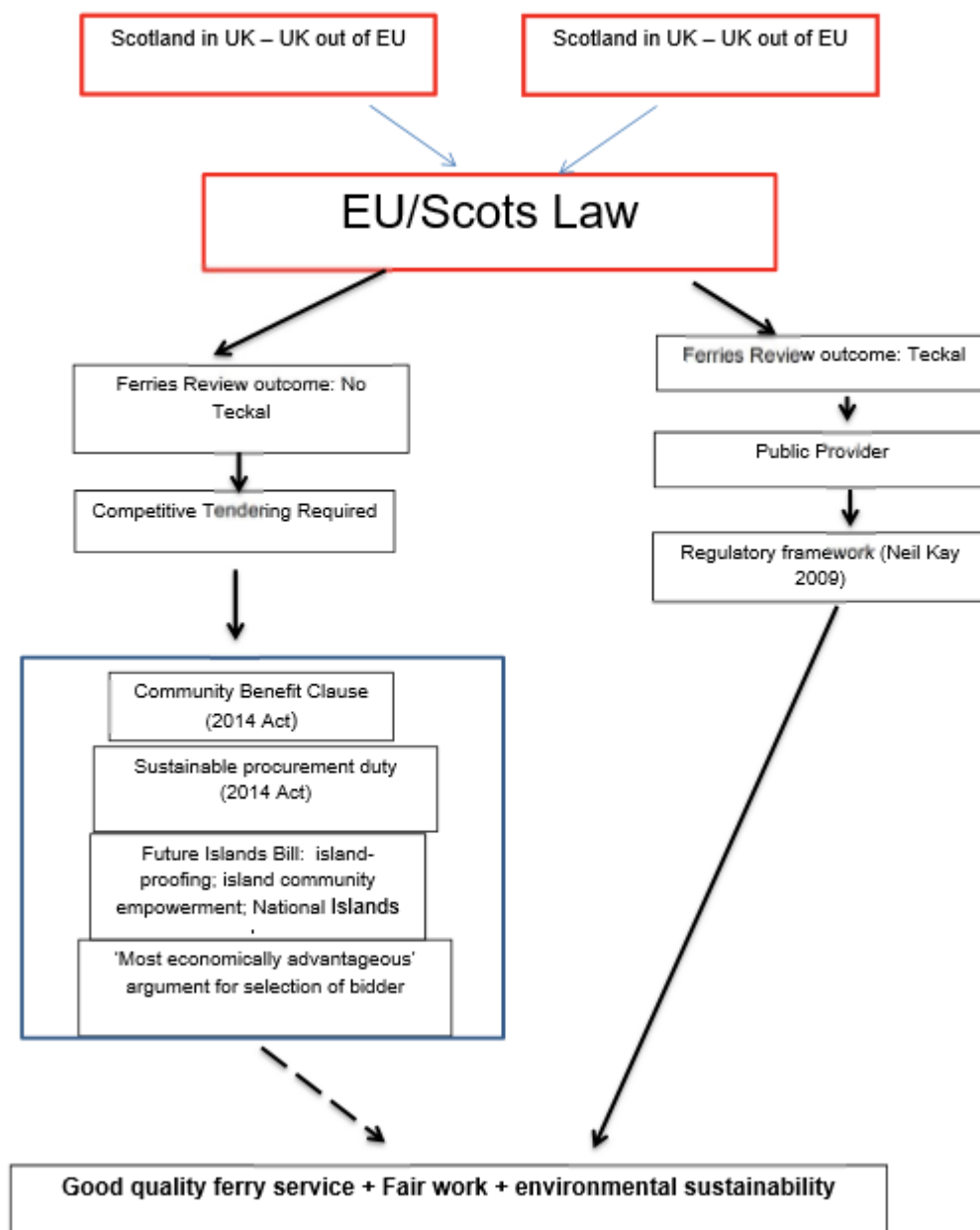
Findlay (Fraser of Allander bulletin March 2017) outlines two potential paths in relation to tendering. Each recognises that EU and Scots law will continue to be the determining framework guiding the review. Whilst the situation might change for future contracts, the key determining factor in relation to the two most imminent contracts (Gourock-Dunoon and Northern Isles) is whether a Teckal exemption can be applied.

The STUC is strongly of the view that, whilst Brexit alone cannot be used to argue for non-tendered public provision, neither should it be used to argue against it. If it is judged that a Teckal criteria exemption can be applied to these contracts, Brexit will not matter. Indeed, it can be argued that it would reduce the chance of any private corporation legal action or negative EC reaction.

The ferry unions and STUC are clear in our view that the application of Teckal to the Northern Isles contract (NIFS) would see the operation returned to the public sector operator, David MacBrayne from Serco NorthLink who hold the existing contract. The Scottish Government is likely to extend the existing Serco NorthLink contract in light of the Ferry Review, so if Teckal is found to apply, this return to the public sector operator would be completed in late 2018.

For the record, in the event that Teckal is not found to apply, STUC and the ferry unions will mount a concerted 'Nationalise NorthLink' campaign during any re-started tender process for the next NIFS contract. Similarly, we will also mount a campaign for the Gourock-Dunoon contract to be awarded to the incumbent operator, CalMac subsidiary Argyll Ferries and for the restoration of freight services as part of that contract.

Fraser of Allander Institute Economic Commentary, March 2017



The 1992 Regulation and State Aid

Prior to the development of Teckal case, the view of Government appeared to be that the effect of the 1992 Regulation required Member States to create a competitive market – essentially to tender services.

The STUC has never accepted this position and much of that view is supported by the RMT legal advice. Whilst the RMT legal advice is in the context of the tender for the

Clyde and Hebrides contract, a great deal of the content of the opinion is relevant to the provision of services for other routes. This is particularly the case with the control test under the Teckal exemption criteria as discussed later.

As stated in the RMT legal advice *“nothing in the 1992 Regulation requires Member States to create that kind of competitive “market”. As in the case of the closely analogous 2007 Rail Member State are perfectly entitled to perform the service themselves without recourse to commercial operators. The obligations of non-discrimination and transparency designed to ensure competitive conditions in the award process (rather than in a wider commercial market) only apply where the authorities choose to go to the market to procure the service.”*

The RMT legal advice recognises that the 1992 Regulation is a liberalising measure and unambiguously rejects the view that it prevents states providing services through its own public authorities

“ ... the question is whether [the 1992 Regulation] goes further, acting as a divestment measure prohibiting a State from carrying on activities falling within Article 4 through its own public authorities. It seems to me impossible to read the Regulation in that way. The rules in Article 4(1) indicate what is to happen where a Member State enters into a public service contract with, or imposes public services obligations on, a shipping company. It does not stipulate that the only way in which the State can bring about the operation of the services in question is by entering into such a contract or imposing such obligations. The State may, in other words, simply provide the service itself. If it does so, the rules in the second indent of Article 4(1) are simply never engaged.”

A similar view is taken in relation to other state aid rules.

Thus the central question is whether Teckal applies.

“In my view, however, the Teckal exemption is capable of applying to the operation of services governed by the 1992 Regulation. On the information available to me, the relationship of the operating company (CalMac Ferries Limited) with the Scottish Ministers, and the nature of its activities, satisfy the control test. On the available information about the relevant activities, the functional test also appears to be satisfied.

“On that basis, that neither the 1992 Regulation nor the State aid rules oblige the Scottish Ministers to hold a competitive tendering exercise before awarding that company a public service contract for the Clyde Hebrides services.”

The Teckal exemption

The clear conclusion of the RMT legal advice is that in principle there is no impediment to the application of the exemption to maritime passenger services. This is a general conclusion which can be applied to all public contracts for ferry services in Scotland.

“... I have no difficulty in concluding that the Teckal exemption is in principle capable of applying to maritime passenger services falling within the 1992 Regulation.”

The two key Teckal tests centre on the control and function of the public body being considered for exemption. The analysis of whether CalMac falls within the control and function test clearly concludes that it does.

In relation to the control test, the argument is laid out in paragraphs 50-57 of the legal advice and it is unambiguous in its conclusion that it does.

Whilst recognising that the function test is somewhat more complicated given that the application relates to service concessions, the advice concludes:

There were formerly some speculative comments in the CJEU's Caselaw as to whether Teckal could apply at all to service concessions. Any such doubt is resolved by the 2014 round of legislation: see in particular Article 17 of the Service Concession Directive. That provision, when it comes into force in Scotland, will prescribe slightly different criteria according to the particular nature of the concession arrangement in question, and where it does impose a functional test it is not in quite the same terms as the judge developed version of that test: see e.g. Article 17(4)(c): "the participating contracting authorities or contracting entities perform on the open market less than 20 % of the activities concerned by the cooperation".

Organisational Structure and Governance

The advice was accepted in broad terms by the Scottish Government and the European Commission, making it clear that a Teckal criteria exemption is feasible. It is also recognised that the organisational and governance structure of public service operators must be carefully designed in order to comply.

We support the aim of the Ferries Review to examine alternative models to the current organisational structures and governance of David MacBrayne Ltd and Caledonian Maritime Assets Ltd. within the context of meeting the conditions of Teckal and State aid rules. In fact, this is a necessity if the function test of the Teckal exemption is to be satisfied.

The STUC and our affiliated trade unions with membership in the maritime sector look forward to engaging further with the Scottish Government on this, as well as providing input on the design of an appropriate regulatory regime, including that applied to David MacBrayne's involvement in the international ferry market.

Conclusion

There is now a very clear opportunity for progress to be made in achieving publicly owned and operated ferry services, free for the long term from the inhibiting and distorting demands created by competitive tendering. In so doing, the Scottish Government would be guaranteeing a positive future for the communities served by lifeline ferries and those who work in the service. Since the point in 2015 when the RMT secured the legal advice referred to in this paper, the Scottish Government, European Commission and trade unions have moved much closer to a consensus on the potential for in house provision without tendering. The STUC has welcomed the

positive attitude adopted by the transport minister and is optimistic that this positive approach will be matched by Transport Scotland officials and the Government's legal advisers in developing a viable path to public provision.

Aside from the important purpose of designing a governance and regulatory regime which will match the requirements of Teckal exemption, the government can point to the central importance of delivering on fair work and community objectives. It can make clear that whatever statutory framework emerges as a consequence of Brexit, that it is committed to democratically owned and publicly operated ferry services.

End of STUC first stage response to Scottish Government Ferries Review



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