

FINANCE COMMITTEE

Tuesday 5 December 2000
(Morning)

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FINANCE COMMITTEE 28th Meeting 2000, Session 1

CONVENER

*Mike Watson (Glasgow Cathcart) (Lab)

DEPUTY CONVENER

*Elaine Thomson (Aberdeen North) (Lab)

COMMITTEE MEMBERS

*Mr David Davidson (North-East Scotland) (Con)

*Rhoda Grant (Highlands and Islands) (Lab)

Mr Adam Ingram (South of Scotland) (SNP)

George Lyon (Argyll and Bute) (LD)

*Mr Kenneth Macintosh (Eastwood) (Lab)

Alex Neil (Central Scotland) (SNP)

*Mr Keith Raffan (Mid Scotland and Fife) (LD)

*Dr Richard Simpson (Ochil) (Lab)

*Andrew Wilson (Central Scotland) (SNP)

*attended

WITNESSES

Andrew Maclaren (Scottish Executive Development Department)

Paul McCartney (Scottish Executive Development Department)

Neil Macdonald (Scottish Executive Development Department)

Sandy McNeil (Office of the Solicitor to the Scottish Executive)

CLERK TO THE COMMITTEE

Callum Thomson

SENIOR ASSISTANT CLERK

Anne Peat

ASSISTANT CLERK

Graeme Elliot

LOCATION

Committee Room 2

Scottish Parliament

Finance Committee

Tuesday 5 December 2000

(Morning)

[THE CONVENER *opened the meeting at 10:01*]

The Convener (Mike Watson): I call this meeting to order. Please switch mobile phones off and set pagers to vibrate. I am delighted to welcome back Keith Raffan. It is good to see him restored to what I hope is full health. We have no apologies for absence today.

I invite the committee to consider whether to take items 3 and 4 on the agenda, on a draft report and a draft letter, in private, in accordance with our normal practice. Is that agreed?

Members *indicated agreement.*

Proposed Contingent Liability

The Convener: Item 2 on the agenda is our first consideration of contingent liability for some time. With us are officials from the transport division of the Scottish Executive development department. It is fair to say that their presence at this meeting signifies some urgency on this matter, as was reflected in the letter from the Minister for Transport, which has been circulated. Should there be any points of clarification or suggested rewording, I hope that it will be possible to deal with that today.

I understand that Mr Maclaren will make an opening statement about this contingent liability, and I invite him to do so now.

Andrew Maclaren (Scottish Executive Development Department): I am in transport division 4 of the development department. I am head of the branch dealing with ports policy, and I am dealing with the northern isles ferries tendering exercise. I will let my colleagues introduce themselves and explain which part of the Executive they come from.

Sandy McNeil (Office of the Solicitor to the Scottish Executive): I am from the office of the solicitor to the Scottish Executive, in the branch that deals specifically with contracts, procurement and competition law issues.

Neil Macdonald (Scottish Executive Development Department): I am from the finance division, with responsibility for transport.

Paul McCartney (Scottish Executive Development Department): I am an economic adviser, advising Andrew Maclaren on transport issues.

Andrew Maclaren: I would like to record my thanks to you, convener, to the committee and to the clerk to the committee for seeing us at short notice. The minister's letter explained the urgency behind this matter. Ideally, we would have liked more time, and I record my apologies that that has not proved possible.

I thought that it would be useful to give a brief overview to provide the background to this issue, and to explain how it has arisen and what factors lie behind it, rather than go into all the detail, which is contained in the paper attached to the minister's letter. If there are any questions on the detail, I will be happy to answer them.

The first policy point is that this exercise stems from the Executive's and partnership agreement's policy to support lifeline ferry services in the Highlands and Islands. That has been the policy of successive Governments as far as the northern isles are concerned. For us, the key issue is that the situation in the northern isles is different from what some of you may be more familiar with on the west coast, with Caledonian MacBrayne.

At present, a private sector operator receives subsidy from the Executive for providing an agreed specification for ferry services. The current five-year block subsidy was won by P&O Scottish Ferries following a competitive tendering exercise, which was concluded in 1997. Accordingly, it won the contract for 1997-2002. For the past two years, we have been involved in the tendering exercise for the next contract, for 2002-07.

My colleagues will agree that the process has been lengthy and, at times, difficult. We are now nearing the end point, following the announcement in October of a preferred bidder. That is a company called NorthLink Orkney and Shetland Ferries Ltd, a joint venture involving Caledonian MacBrayne and the Royal Bank of Scotland. We have reached a conclusion with the preferred bidder, and a draft contract was laid before the Parliament last week.

Shortly after this meeting, we will be going to this morning's meeting of the Subordinate Legislation Committee. The Minister for Transport will be attending the Transport and the Environment Committee next Tuesday. That is the policy context and the current position with regard to the contract. That should be useful background for the exercise that we are considering this morning.

The key point about the competitive tendering process is that the rules relating to subsidies for ferries are set under European Community

regulations and guidelines. That was the starting point for the issue that led to the contingent liability, as referred to in the paper that members have before them. In 2002, new and strict safety requirements will come into force, under what is known as the Stockholm agreement. It became clear that new ferries were required from 2002, and the question was how to deal with a situation in which there is a five-year contract, in which new ferries are required—the bidders have produced bids with three ferries—and in which the estimated total costs of providing the ferries are between £80 million and £100 million.

In considering the contingent liability, the central question is how to persuade the potential bidders to consider a five-year contract and make such a significant investment. We considered various options throughout the tendering process. The approach that we came up with in producing the tender and the draft terms and conditions is what we have labelled a transfer of assets clause. That means that, at the end of the five-year contract period, the vessels will be transferred to a new operator, following a subsequent tendering exercise. In the next tender, starting in 2007, we will tender for the operation of the new vessels in place.

The advantage of that for the bidders is that they would not be left with the vessels, after having invested heavily in them, if they lost the next contract. It was made clear to us by the bidders concerned that, if they did not have any comfort on that point, they would not be in a position to make a bid. Furthermore, we had to make arrangements whereby, if the bidders did not make the investments and lost the next contract, we were clear about the price at which the vessels would be transferred.

On the Executive's part, that seemed the best way of getting round the problem of the five-year contract. We had extensive discussions with the European Commission to extend the contract to at least 10 years, but we were not successful. The Commission stated firmly that the normal period for such contracts was five years, and we were unable to persuade it to take a different line.

From our point of view, the transfer of assets clause met the bidders' concerns. They were telling us that they would not be in a position to make a bid if the problem was not solved. It also allowed us a certain stability in the contract arrangements, whereby vessels that are specifically designed for the northern isles—a very particular route, across difficult and dangerous North sea waters—are known and are secure for the foreseeable future.

We thought that that was a reasonable way to proceed, and we are confident in our discussions with the bidders and with experts within the

Executive that there is a good chance that the arrangements will work. As far as the contingent liability is concerned, despite that optimism and our feeling that, even if the arrangements did not work, they contained safeguards whereby we would be able to try to find another operator or take on leases if need be, we still had to determine what would happen if those arrangements did not work or if, for some reason and against our expectation, problems arose.

The paper that has been circulated is dominated by the problems rather than by our risk evaluation that those problems would not arise. It focuses on what the problems would be and on what would then happen. For example, the arrangement would fall into difficulty if ministers or the Executive decided at a future date that they did not want to subsidise ferry services to the northern isles. Our assessment was that that was unlikely. The present subsidy is £11 million per year. We could not envisage a situation for the foreseeable future in which ministers would not want to subsidise those services.

In the paper, we highlighted the possibility that no bidder emerges: either the existing operator is successful but decides not to go ahead, or no bidders come forward. Our assessment on that was that there would be sufficient interest on the part of the current operator and of any future bidders to take on the contract. However, in theory, it is a risk. There could also be technical problems with the terms and conditions of the contract at the later stage. If that was the case, we might not be able to secure an interested bidder. The assessment that we have expressed in the paper deals with what would happen if all those problems arose.

We have built into the draft contract provisions whereby, even if such problems arose, the Executive would be able either to intervene to try to find another operator or, as an option not an obligation, the Executive could take on the lease to the vessels as an interim measure. We have built further safeguards into the contract against those possibilities arising.

We have assessed the problems carefully and, in our paper, we have produced detailed calculations about how it would work. In this case, NorthLink Orkney and Shetland Ferries is leasing the vessels, so the arrangements are quite complicated and, in the worst scenario, would involve a contingent liability that would have to provide for the termination values of the lease to be met. The termination value for that eventuality is noted in the paper. In that worst scenario, where there was no service, the costs would be netted off by the receipts gained from the vessels. The paper contains different calculations and circumstances for how that would be done. We can go over those

in detail if members wish. We wanted to draw that contingent liability to the committee's attention, and that is the subject of the main part of the paper.

10:15

A second area emerged in the negotiations following the tendering exercise. I mentioned the transferring of vessels at the end of the contract, but an issue also arises about the transfer of staff at the end of the contract. The problem relates to the Transfer of Undertakings (Protection of Employment) Regulations 1981. All the bidders assumed that TUPE would apply at the end of the next five-year contract. We agreed that that was a reasonable assumption. However, it is a complex area, involving quite detailed regulations. The bidders' concern was the risk, however small, that TUPE would not apply despite their assessment.

One difficulty, which I hope we can avoid in future, was that in trying to make an assessment of the risk, the bidding companies did not have full access to the current operator's information about staff costs and terms and conditions. The operator was unwilling to give that information because it thought that that might prejudice its position in the bidding competition. The current contract includes a condition that the new operator will have to make such information available to all bidders next time round.

One approach that we considered was to ask the bidders to assess the costs of such a problem arising and to build those costs into the subsidy bid, and we would then pay subsidy against the potential risk. However, the problem might not arise and our concern was that that was probably not the best value for money option, as we and the bidders assessed the risk as low. If unexpected costs arise under TUPE at the end of the contract, the contract provides for grant assistance. Our judgment is that that is unlikely to happen, but we have provided for that contingent liability. We wanted to draw that to the attention of the committee.

The Convener: Thank you. I understand that there is a correction to table 1 of the paper. I understand that the figure for the hand-back rental should be £53 million rather than £50 million, so the potential liability would increase to £23 million. What is the reason for that increase?

Andrew Maclaren: It was an error in processing the document, for which I apologise.

The Convener: I have one or two points on which I would like clarification. Paragraph 9 refers to the conditions agreed with NorthLink and says that

"the vessels involved are being leased from the Royal Bank of Scotland".

Is there a contractual relationship with the Royal Bank of Scotland? If, for the sake of argument, NorthLink did not get the later contract, the obvious thing for whoever got it would be to lease the vessels from the Royal Bank of Scotland. Would there be a relationship between the Executive and the bank in those circumstances?

Andrew Maclaren: Yes. It will be a tripartite agreement. The Royal Bank of Scotland is leasing through Lombard, which is owned by the bank. The contract agreements include a grant agreement between the Executive and NorthLink, setting out our obligation to pay subsidy and NorthLink's obligation to provide the services.

The Convener: I see now that paragraph 11 contains a reference to

"The Tripartite Agreement between NorthLink, the lessor and the Scottish Ministers".

The final bullet point on page 3 refers to the circumstances that might arise if

"the proposed operator for a further subsidised ferry service was unacceptable to the lessor of the vessels."

Yet paragraph 11 refers to

"the right to require the lessor to enter a new lease with an incoming operator".

That seems contradictory: either the lessor does or does not have the right to say that it does not want that company to lease its vehicles. Which is it?

Andrew Maclaren: The lessor would have a facility to make sure that the lessee was acceptable. The contract provides that the lessor will have a say in whether it accepts a new lessee. We have tried to ensure that the procedures in the next tendering exercise take that into account at the earliest possible stage. The lessor would want to have the chance to look at any new company that was being considered and we felt that that was necessary. However, during our own process of due diligence and assessment of the bidders we would ensure that the lessor was doing the same exercise and that any problems could be sorted out at an early stage.

The Convener: But ministers would have the last word?

Andrew Maclaren: Yes.

The Convener: I have a further point on the second part of the contingent liability, but I suggest that we deal with the two parts separately. I invite members to raise points on the first part, but remind them that we are talking not about the policy but only about the indemnity.

Mr David Davidson (North-East Scotland) (Con): I am puzzled that the Executive has only now come to the committee, because the risk

evaluation process has obviously been going on for a long time. Although the figures you have given us are informed guesses—I appreciate that they are informed—the exercise seems to be very last minute. Should that convey to us that there was some difficulty in getting the contracts signed?

Andrew Maclaren: I suggest that it does not. I accept that we have come to the committee quite late—we want to avoid that in future. We were looking at the transfer of assets clause, which led to this position, late last year and in the early part of this year. We knew then that it involved a contingent liability but we were not in a position to come to the committee with anything approximating the final figures, as we did not know which bidder would be chosen. Negotiations on the details with the bidder and its lawyers continued until last week, shortly before we arranged to come to the committee. Certainly, the issue of a contingent liability did not suddenly pop up—it was clear in the terms and conditions offered to the bidders that a transfer of assets arrangement would be available. The questions were over the mechanics and the figures involved. That is why the submission was late.

Mr Davidson: To follow on from what the convener asked about the relationship between the three parties, did the Executive participate in the negotiation between the tenderer and the Royal Bank of Scotland on the pricing of the lease?

Andrew Maclaren: No. When we issued the tenders, we did not know how the bidders would finance the provision; in two cases we knew that they intended to lease but we did not participate in the negotiations over the leases.

Mr Davidson: I do not know if you are able to answer this, but what discussions were held about risk sharing between the Executive and the Royal Bank of Scotland? If, after five years, the current operator does not tender and there is nobody on the horizon, it will come down to there being two parties to the lease. I am not arguing about exit strategies, as we would want the lifeline service to continue, but what discussions were there about risk sharing in such an eventuality? That would make a difference to your valuations.

Andrew Maclaren: We included in the tender document details of our assessment of where the risks in key areas of the contract fell, so we made our position clear. In negotiations at the post-tender stage, the issue of risk sharing was raised and one of the calculations has an adjustment that reflects risk sharing between the lessor and the Executive if termination happens in certain circumstances. My colleagues could explain that further.

There were discussions that led to variations in the calculation for dealing with termination values reflecting different shares of risk. The key circumstance in which it arises is if the Executive gives early notice of an unusual decision to stop subsidising the service. In that case, because we would have given notice, we argued for a different share of the risk, which is shown in the calculations in table 1 on page 4. The figures given are for termination payments where there is two years' notice, so the hand-back rental is the amended figure of £53 million.

Less the deductions shown, that gives a potential liability of £23 million. The termination value of the rentals is reduced but the bank would take a larger share of the proceeds, so it comes out as the same potential net liability as it would if the Executive took the full hand-back rental and full sales value of the vessels. However, that calculation reflects a different share of the risk between the Executive and the bank.

Dr Richard Simpson (Ochil) (Lab): I would like to consider other possible scenarios. The Estonia disaster is of course significant for current ferry contracts, but what would happen if another disaster were to show that even current ferry design is unsafe and that either substantial modifications were required or the vessels would have to be declared unsafe and replaced? Secondly, what happens if NorthLink goes bankrupt or if it decides to terminate the contract?

Andrew Maclaren: On safety, it is built into the contract that if there is any change in regulatory requirements, that is a material change in circumstances and the arrangements for the grant take that into account.

Dr Simpson: I know that it is unlikely that the vessels would be declared of no use—as it is likely that they could be modified—but if they were, would the contingent liability go up considerably?

Andrew Maclaren: It would depend on the circumstances. One issue is what would happen about continuing to provide the services if the vessels had to be taken out of service. If the vessels could not be used, the termination clauses in the contract would apply, as would the termination values in the paper. That would be an extreme case and an unusual set of circumstances. If there were costs in meeting new regulatory requirements, which is more likely, those would be taken into account and the subsidy would be adjusted accordingly.

Dr Simpson: I want to press you slightly further on that. If those ships were declared of no use—the most extreme possibility—who holds the contingent liability? Does it revert to the Royal Bank of Scotland, or does NorthLink or the Executive have it? If we take your example, at the

end of two years, the pessimistic forecast of vessel sale proceeds is £62 million. However, if the vessels were found to have a design fault—which could not reasonably have been established and therefore was not due to the negligence of the builder—who would hold the contingent liability for the ships?

10:30

Andrew Maclaren: The contingent liability would mean that the contract would have to be terminated. The termination arrangements set out in the contract would then apply.

Dr Simpson: If the ships have a design fault and are worth only £30 million, the liability would increase by another £30 million.

Andrew Maclaren: I understand that that is what would happen in those circumstances. We would try to maximise the receipts from any disposal in such an extreme situation. The rules that are mentioned are specific to the north of the North sea. However, I take your point. In such extreme situations, the pessimistic receipts assumptions that we have built in might be different.

Dr Simpson: We must recognise that when we approve the contingent liability. We are dealing with real situations—although I hope that the situation that I suggest is unreal. However, there have been two major ferry disasters in the last 15 years, requiring substantial redesign and the removal of certain types of ferry from operation for safety reasons. When we approve the liabilities, we must say that they may stretch further.

My second question was on the situation that would arise should NorthLink go bankrupt.

Andrew Maclaren: The termination arrangements set out in the paper would apply. If ministers decided not to subsidise at the end of the five years, the termination values and arrangements would apply at the end of that period. If NorthLink went bankrupt, the termination process would apply from that point. In those circumstances, we would have the option, built into the arrangements with the lessor, to find another operator or to take on the lease ourselves. We feel that it is reasonable to build in such a safeguard.

Dr Simpson: In effect, you would not have to act as the renegotiator of the lease, but would be able to take on the lease or transfer it to another operator.

Andrew Maclaren: Correct. We have built into the contract that the terms of the lease in all those situations would be the terms passed on to a new operator.

Neil Macdonald: I would like to comment on the scenario in which the ships proved to be unusable and unsaleable. We have assumed that we would be able to sell the ships and we are setting the projected sale proceeds against the hand-back rentals, which we would have to pay in the extreme circumstances that we have outlined in the paper. If regulations changed and it was known that the ships would become obsolete after two years or so, we could serve notice. If we did so, the Royal Bank of Scotland would carry a degree of risk and the risk would be shared. The bank assumes residual value risk in respect of 40 per cent of the initial cost. If we were unable to give notice, the Executive would bear that risk. In normal circumstances we assume that the ships would have a resale value.

Dr Simpson: Thank you. That was very helpful.

Andrew Wilson (Central Scotland) (SNP): I have a general question on the contingent liability process. Do you have a relationship with the finance division of the Scottish Executive when discussing the undertaking of contingent liability? Does the finance division have a relationship with the UK Treasury?

Andrew Maclaren: The answer to your first question is yes. Neil Macdonald is from the finance division. His senior colleagues and the accountancy services unit, which is part of the finance department, are also involved in the project. We do not have a relationship with the Treasury, although we are aware of the guidance that the Treasury has produced on Government accounting and contingency liabilities. There are also various bits of guidance that relate to private finance initiatives. The project is not a PFI, but we would look to Treasury guidance as a starting point, as a matter of principle.

Andrew Wilson: Does the Treasury place a limit on the contingent liabilities that the Executive can undertake? Is there an overall amount? We have a liability of £23 million here; what would be the upper limit?

Neil Macdonald: I am not aware of any upper limit as such. As Mr Maclaren has indicated, we take account of Treasury guidelines, although we are not bound to follow them.

The Convener: That is interesting.

Rhoda Grant (Highlands and Islands) (Lab): You said that it was written into the contract that anyone to whom the Royal Bank of Scotland leased the vessels would be subject to the same terms as NorthLink is. Is that correct?

Andrew Maclaren: Yes.

Rhoda Grant: My other question is on TUPE. If it is written into the contract that NorthLink must reveal details of salaries and conditions, why is

that a contingent liability? Any new contractor would have to take account of those salaries and conditions in its tender.

Andrew Maclaren: We felt that it was sensible to write that liability into the contract to allow the details of the contract at that time to take into account the fact that the new operators will have access to the information involved. That has not been possible in this contract, which is why we are offering protection against the unlikely event of the problem arising into this contract. Whether that protection is built into the contract after that remains to be seen—it would depend on the circumstances at the time and on our assessment at the time of how TUPE applies.

The Convener: We have strayed into the second part of the contingent liability. Are there any more questions on the first part?

Mr Kenneth Macintosh (Eastwood) (Lab): If NorthLink does not have its contract renewed, does the Executive have any say in the negotiations on the transfer of the lease?

Andrew Maclaren: We wanted bidders to be bidding in a position of clarity and certainty and in that respect the answer is yes. The values in the lease would be those that we would offer for the next tendering round. In that sense we have a say. However, in entering into the agreement, we are signing up to the current leasing arrangement. In future, that information would be made available to all the next tenderers. We would then be in a position to gainsay that or change it. That is clear in the contract.

Mr Macintosh: NorthLink does not own the vessels, but it owns the lease. Am I right in saying that, at the end of the contract, if NorthLink wants to sell the lease on, you could veto that?

Andrew Maclaren: That is correct.

Mr Macintosh: Do you have any say in a situation where NorthLink decides that it would be in a better financial position if it were to cancel the lease entirely—because of the money that the Executive would pay—despite the fact that it might be offered a good deal on the sale of the lease?

Neil Macdonald: There is a tripartite agreement involving the Executive, NorthLink and the Royal Bank of Scotland. That protects the Executive's interests. NorthLink cannot act unilaterally and take away the ships. In effect, the lease will be assigned to any new operator on basically the same terms. The bank cannot change the terms of the lease. We have the right to ensure that the ships are transferred to any new operator at the end of the five years.

Paul McCartney: If NorthLink does not win a second contract, it will have no control over the lease. The Royal Bank of Scotland would

terminate the lease and NorthLink would not be able to sell the lease on to anyone else.

The Convener: That is a one-off agreement and applies only to the contracts for 2002 and 2007. Do you intend to write that into future contracts from 2012 onwards?

Paul McCartney: We have a lease agreement and the Royal Bank of Scotland has the ships for 15 years. There are two contract periods.

Andrew Maclaren: Neil Macdonald's point is key. The tripartite agreement obliges the lessor to make the vessels available for the next contract as part of the deal. That is the essence of the tripartite agreement. We had the same concern as Mr Macintosh and part of the reason that we wanted to establish a tripartite agreement was to address that point. We wanted to ensure that we had a say in the transfer of the lease at the end.

Mr Macintosh: Am I right in saying that, if NorthLink wanted to sell the vessels on to somebody else—nothing to do with the North sea—it could not do it?

Andrew Maclaren: That is correct.

Mr Macintosh: If a body wanted to take over the service from NorthLink and made an offer, could NorthLink reject that offer?

Andrew Maclaren: That point came up earlier. In that scenario, the lessor has a right to assess the party to whom the lease is being assigned. If they said no, there would be an issue and we would have to sort it out. As I said earlier, we would engage the lessor in the process that we go through with the bidders—we have not worked out the details and it has not been written into the contract. That is what we would do to ensure that there was not a problem.

Mr Macintosh: That relates to the Royal Bank of Scotland, but I am asking about NorthLink. Can NorthLink veto the sale of the lease?

Andrew Maclaren: No.

Mr Macintosh: If P&O came in and wanted to take on the lease, could NorthLink veto that?

Andrew Maclaren: No.

Neil Macdonald: It is worth pointing out that NorthLink will not have anything to sell at the end of the five years. The tripartite agreement ensures that, after five years, if NorthLink fails to win the next contract, the incoming operator will effectively step into NorthLink's shoes as far as the lease is concerned. NorthLink does not stand to gain at the end of five years.

Mr Macintosh: Are you saying that NorthLink does not own the lease and that the Executive owns the lease with the Royal Bank of Scotland?

The Convener: The lease would be taken for five years, would it not?

Mr Macintosh: What about the option at the end of it? Does NorthLink not own the lease? Does the contract not give NorthLink the right to sell the lease at the end?

Neil Macdonald: The lease is between the bank and NorthLink. However, the tripartite agreement ensures that, at the end of five years, if NorthLink fails to win the next subsidy award, the incoming operator will have the right to step into NorthLink's shoes. At that point, NorthLink will not receive any payment. It would not be selling its interest.

Mr Macintosh: Under paragraph 10 there are four bullet points on different circumstances that might arise. Surely the most obvious situation would be where a new operator has its own vessels. What would happen if a new company, which owned vessels that were perfectly capable of providing the service and so did not need the vessels that are currently in use, were to take over the lease?

Andrew Maclaren: Despite the fact that we are dealing with bespoke vessels on particular routes with very specialised harbour needs and constraints, in theory it is possible that there might be such a bidder. However, the Executive would be offering to subsidise the operation of the existing vessels rather than to take on anyone else with new vessels, such as you have described.

10:45

Mr Macintosh: Plenty of vessels that operate in the Baltic and to the north of Russia could perform the operation. The vessels that you are talking about might be bespoke, but they are not the only ones that can do the job. A company with its own vessels might bid for and win the contract. What would then happen to the existing vessels and the lease with the Royal Bank of Scotland? You would be left with two redundant vessels. Would you be obliged to pay the full £90 million and sell them on at that stage?

Andrew Maclaren: Are you talking about a situation in which we had put out the next tender on the basis of the transfer of assets but had not accepted bids for it and had accepted a bid from somebody else with a different proposition?

Mr Macintosh: Yes. When the next tender goes out in five years' time, will part of the tender require the new company to take on the two vessels?

Andrew Maclaren: Yes. That is what the Executive would be offering.

Mr Keith Raffan (Mid Scotland and Fife) (LD): If the contracts are not finalised by 15 December,

you will return to us, as these figures will have to change. The minister's covering letter says that a contract must be finalised with the Finnish yard by 15 December so that intervention funding can be applied for to keep the costs down. Therefore, all the figures might change.

Andrew Maclaren: If we do not meet the target dates, that will happen.

Mr Raffan: You are working to a very tight timetable. I have a query relating to contingent liability, which you might be able to answer. When in 2002 do the new safety standards become operational?

Andrew Maclaren: The complication is that there is a range of safety standards. The key one that I talked about in relation to the Stockholm agreement will come into force on 1 October 2002. The existing vessels of P&O Ferries can ply the routes until 30 September 2002.

Mr Raffan: You will provide that flexibility, through negotiation with the existing operator. The question is whether the vessels are going to be ready. Are two being constructed at the Finnish yard and one at Fergusons?

Andrew Maclaren: NorthLink has issued letters of intent for two vessels from the Finnish yard and one from Fergusons.

Mr Raffan: Letters of intent, yes—but have the blooming things been designed yet?

Andrew Maclaren: Yes. The company is finalising its contractual agreements with the yards, concerning the timetable that you are talking about.

Mr Raffan: Can the vessels be built by the summer of 2002?

Andrew Maclaren: Yes.

Mr Raffan: Are you convinced of that?

Andrew Maclaren: Yes.

Mr Raffan: You will be in a mess if they are not ready by 1 October 2002.

Andrew Maclaren: Yes. That explains the urgency with which we have pursued the issue.

Mr Raffan: I would be sweating, if I were you. You are leaving things to the last minute.

The Convener: Let it be noted, for the record, that Mr Maclaren is not noticeably sweating.

Andrew Maclaren: Thank you, convener.

Mr Raffan: Maybe you should be. Perhaps this is the calmness of the Executive.

The last time I was in Shetland, the provision of inter-island ferries was an issue, particularly the construction of bigger vessels to transport the

bigger lorries that are now allowed on the islands.

Andrew Maclaren: Indeed.

Mr Raffan: I presume that you will have to enter into similar negotiations with regard to those inter-island ferries and that you will return to us for contingent liability on those vessels as well. Will you try not to do that at the last minute, as you said that in future you would not? Inter-island ferries are an on-going concern in Shetland, and we do not want to be in this position again. I am sure that you do not, either.

Andrew Maclaren: I accept your general point about the urgency that is necessary, but the subsidies in Shetland are provided by Shetland Council and I am in the fortunate position of not having to come to you for those. The situation is the same in Orkney: the inter-island ferry services in Orkney are subsidised by the council. Following receipt of the Government's consultation paper in April, the council has been asked to consider the matter.

Mr Raffan: I realise that the council provides the subsidies, but it gets that money from the Executive.

Andrew Maclaren: We have a joint interest in the way that the subsidies are allocated.

Mr Raffan: Not just a joint interest, but a joint involvement.

Andrew Maclaren: That is a fair point.

Mr Davidson: Let us return to the issue of the cost to the Executive—which is what we are talking about this morning—considering the risks that are involved. You said that Europe suggested that you should not have a contract of longer than five years, yet you said that the Royal Bank of Scotland is considering an operating period of at least 15 years. If that period is divided into five-year contracts, the costs will ultimately be greater to both the operator and the Scottish Executive. The kind of vessel that we are discussing does not depreciate in value so rapidly. Would there have been any advantage to the Executive if you had asked for longer contracts?

Andrew Maclaren: I am not sure that I can answer that. You are right about not having a 15-year lease. The Royal Bank of Scotland is therefore taking the residual value risk at the end of the 15 years. You would be right if we had evidence to show that the vessels had depreciated over a shorter time than one would normally expect, but I have seen no evidence to suggest that that would be the case.

The alternative approach, of not having the contingent liability arrangement, would be much more costly if a bidder was willing to come forward and the vessels had depreciated over a much

shorter period, as there would be no comfort concerning what would happen at the end of the contract. According to our assessment, therefore, there was more risk of the need for an expensive subsidy if the contingent liability agreement was not in place.

On your specific question, I am not sure whether there is any evidence to suggest that a longer contract would have produced a cheaper subsidy.

Mr Davidson: In industrial applications, the shorter the lease is, the more expensive the subsidy is, as the bank takes more risk and passes the cost of that on—to the tenderer, in this case.

Nevertheless, I am concerned about the fact that Europe is talking about a five-year maximum lease. What is the European connection? I do not understand why Europe is involved in what seems to be an internal matter.

Paul McCartney: The European Commission believes that generating competition more frequently will generate efficiency and cost savings. Generating competition for the lease every five years will produce efficiency savings for the Executive: that is the Commission's belief.

Mr Davidson: Yet you are offering the lease on at the same rate. Where is the competition in that?

Paul McCartney: There may be competition in the costs of operating the vessels, not necessarily in the lease bids.

Andrew Maclaren: Or in the level of fares and demand.

Mr Davidson: So, the benefit could come back to the Executive in the form of reduced subsidy if you thought that the operation was more profitable.

Andrew Maclaren: Possibly, yes.

Mr Davidson: Is that in the contract?

Andrew Maclaren: Yes, that is in the contract.

Dr Simpson: Are there break clauses in the 15-year lease?

Paul McCartney: Yes, at the five-year point.

Dr Simpson: If there were a shortage of shipping after five years, the asset value would go up. Who will benefit from that—the Executive, the lessor or NorthLink? Sorry—I understand that NorthLink would not benefit.

Andrew Maclaren: We would benefit if the asset value increased, as the leases would be built into the subsidy at a lower rate than the asset value. In the worst scenario, which we have described in our submission, we would benefit because the resale value would be higher than the

figures that are quoted in that document. Is that right, Neil?

Neil Macdonald: That is basically correct. When the ships are sold, the bank will get its costs and any surplus will return to the Executive. If the ships were sold for more than we might have expected, the surplus would return to the Executive.

Andrew Wilson: What happens if the money that you recoup is less than the costs? What happens if the ship does not have a market value because it is bespoke?

Paul McCartney: As Neil Macdonald said, that will depend on whether we are given two years' notice. If we can give two years' notice, the risk of that outcome will be shared between us and the Royal Bank of Scotland.

The Convener: I have a final question on the second contingent liability and the TUPE regulations. Paragraph 16 of your submission mentions the possibility that the TUPE regulations might not apply. Can Mr McNeil, who is the legal expert here, say under what circumstances the TUPE regulations would not apply?

Sandy McNeil: The TUPE regulations either apply or do not apply as a matter of law. In the five years between now and the next contract, case law might be introduced to ensure that the TUPE regulations do not apply. Alternatively, changes in the regulations may ensure that the TUPE regulations do not apply.

The TUPE regulations are a product of the case law that surrounds them. Increasingly, the courts are doing their best to ensure that those regulations apply. However, one decision—or a follow-on of three decisions—may change that in the next five years. We do not know what the courts will do.

The Convener: As things stand, that would be unlikely.

Sandy McNeil: As things stand, we expect that the TUPE regulations will apply.

The Convener: Thank you very much for your evidence and for answering our questions. The committee must now consider the contingent liability and approve the terms of the memorandum that was sent to us. Is the committee agreed to do that?

Members *indicated agreement.*

The Convener: We now go into private session.

10:56

Meeting continued in private until 12:43.

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