

LOCAL GOVERNMENT AND TRANSPORT COMMITTEE

Tuesday 24 May 2005

Session 2

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CONTENTS

Tuesday 24 May 2005

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FERRY SERVICES (CLYDE AND HEBRIDES)	2611
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LOCAL GOVERNMENT AND TRANSPORT COMMITTEE

18th Meeting 2005, Session 2

CONVENER

*Bristow Muldoon (Livingston) (Lab)

DEPUTY CONVENER

*Bruce Crawford (Mid Scotland and Fife) (SNP)

COMMITTEE MEMBERS

*Fergus Ewing (Inverness East, Nairn and Lochaber) (SNP)

*Dr Sylvia Jackson (Stirling) (Lab)

*Paul Martin (Glasgow Springburn) (Lab)

Michael McMahon (Hamilton North and Bellshill) (Lab)

David Mundell (South of Scotland) (Con)

*Tommy Sheridan (Glasgow) (SSP)

*Margaret Smith (Edinburgh West) (LD)

COMMITTEE SUBSTITUTES

Bill Butler (Glasgow Anniesland) (Lab)

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

Colin Fox (Lothians) (SSP)

Mr Bruce McFee (West of Scotland) (SNP)

John Farquhar Munro (Ross, Skye and Inverness West) (LD)

*attended

THE FOLLOWING GAVE EVIDENCE:

Dr Paul Bennett (University of Edinburgh)

Professor Neil Kay (University of Strathclyde)

CLERK TO THE COMMITTEE

Eugene Windsor

SENIOR ASSISTANT CLERK

Alastair Macfie

ASSISTANT CLERK

Euan Donald

LOCATION

Committee Room 6

Scottish Parliament

Local Government and Transport Committee

Tuesday 24 May 2005

[THE CONVENER opened the meeting at 14:04]

Ferry Services (Clyde and Hebrides)

The Convener (Bristow Muldoon): I open the 18th meeting in 2005 of the Local Government and Transport Committee. I have received apologies from Michael McMahon and I believe that Tommy Sheridan wishes to express his apologies for some future meetings.

Tommy Sheridan (Glasgow) (SSP): I apologise for the fact that I will miss the next five meetings because of the birth of my first child—I am going to take the month of June to learn how to be a father. I am sure that I will be contacting members such as the convener and Paul Martin so that they can give me advice.

The Convener: I speak on behalf of the whole committee when I wish you, your wife Gail and your forthcoming baby all the very best in the next few weeks. I am sure that it will take you a lot longer than a month to learn everything about being a father. Everybody's good thoughts and best wishes are with you.

The only agenda item today is on the tendering of ferry services in the Clyde and Hebrides. I welcome our first witness, Dr Paul Bennett, of the institute of geography at the University of Edinburgh. Before we go to questions and answers, we will give you the opportunity to make some introductory remarks.

Dr Paul Bennett (University of Edinburgh): I will give a brief introduction to the paper, which examines the rationale behind, and the risks of, competitive tendering. The paper started out using Caledonian MacBrayne as a case study, although the CalMac case has since become more central to it, and it uses the 300-plus responses to the first two consultations on competitive tendering as its main source, as well as subsequent discussions. It examines in particular the extent to which the Executive's plans for tendering address the concerns of consultees and reflect the lessons that have been learned from tendering in other sectors.

The paper's main conclusion is that, although few economic or social benefits can be foreseen in tendering, a series of risks comes with it, including risks to service quality, accountability, labour

standards and, in certain circumstances, the very continuation of services. That is not meant as a criticism of the Executive, which has done quite well in designing the tender, given the possibilities. Nevertheless, no matter how good the design of the tender, going down the tendering route gives rise to risks that simply would not arise if one did not go down that route in the first place. That is the overall conclusion.

I have been asked about my legal views on the necessity or otherwise of tendering, but I am not a lawyer and that is not my area of expertise. I make a couple of comments on pages 8 and 9 of my paper on the requirements of the maritime cabotage regulation. The issue is whether the problem is caused by the law or by the Commission's interpretation of the law, particularly in the communication of 2003. The paper questions the appropriateness of the one-size-fits-all policy to competition and state subsidies, as that policy does not pay attention to the local and regional context of services.

The Convener: Thank you for those introductory remarks.

Bruce Crawford (Mid Scotland and Fife) (SNP): Thank you, Dr Bennett, for coming along and giving evidence. You said that the Executive designed the tender process quite well, but your paper asks fundamental questions about what the process is about. Is it about efficiency gains, innovation or improved services? I hear what you are saying generally, but will you say more about why, in your view, tensions exist between those areas? Will you also expand on what I thought was your implied criticism of the tender process not being able to deliver an improved service? Is the issue more about where we are now and how we can protect what we have got, rather than asking the islanders how they can get better delivery of services in the future?

Dr Bennett: I certainly agree that there are unlikely to be any benefits coming from the tender process. If you have read my paper, you will know that I found it difficult to come up with reasons to support the tendering process on the basis of the Clyde and Hebrides case. To write the section on the potential advantages of tendering, I had to look to examples of tenders in other sectors and the theory about tendering. It is telling that almost the only justification for tendering has been that it is necessary in order to comply with European law. I do not denigrate that as a reason, because, if it is the case—which I dispute—it is not unimportant. Nevertheless, it does not sell the case for tendering in terms of the economic and social benefits that might accrue. It is telling that neither the Executive nor the Commission has been able to come up with positive reasons why tendering is beneficial.

Tendering poses a series of difficult questions. Do we allow a new operator to take over both the operation and the ownership of the assets, thereby running the risk of not being able to sustain investment over time? Alternatively, do we, as the Executive has suggested, split the company in two and retain the assets and the investment in public hands? That is a difficult choice to make. Neither of the options that the Executive could have gone for is good. There is a bad option and a less bad option. The only good option is not going down the tendering route in the first place so as to avoid such questions.

Bruce Crawford: Goodness—on the basis of that answer I could ask hundreds of questions, but I will try to restrict myself, convener.

Dr Bennett, you said that you dispute the need to tender in order to comply with European Union rules. Although I note that you said that you are not necessarily an expert on the law, will you expand on what you meant? If we are going to have an operator of last resort—the vessel-owning company—and a company other than Caledonian MacBrayne wins the contract but does not want to use the existing ships, what might the Executive do with those ships, given that they would have to be parked somewhere for a considerable time in case they were needed to be drawn back into use? How might the Executive deal with their upkeep? That was my concern about the vesco process.

Dr Bennett: Can I deal with that last point first?

Bruce Crawford: Sure.

Dr Bennett: The vesco is not an operator of last resort but the owner of the assets.

Bruce Crawford: Okay. Sorry. You are right about the terminology.

Dr Bennett: It is intended to be the owner of the assets. If the tendering goes ahead, the operating company will be required to use the ships.

On your first point about the legal aspects of tendering, the matter simply comes down to the observation that the cabotage regulation specifies that member states should conclude public service contracts

“on a non-discriminatory basis in respect of all Community shipowners.”

It is simply a question of how we ensure that non-discriminatory basis. The Commission has said that in principle it thinks that tendering is the best way of doing so, but that does not necessarily close off every other avenue.

Last year, there was a lot of discussion about the implications of the Altmark court case. When the Executive reached its conclusion on the matter—last June, I think—it said that the Altmark

case referred to the general state-aid rules, whereas shipping in the Western Isles is covered by the separate maritime cabotage regulation and the Altmark judgment cannot be used to get round the regulation. I agree that that is the case, but that is different from saying that Altmark cannot be used to interpret the requirements of the cabotage regulation.

It is not possible simply to escape the requirements of the cabotage regulation. However, we should consider what Altmark demands; it sets a series of conditions to ensure that subsidy is transparent and that there is no overcompensation and therefore no financial advantage. That approach seems to be entirely to do with ensuring non-discrimination.

14:15

Bruce Crawford: You suggest that there are other avenues through which non-discrimination might be demonstrated. Can you tell us more?

Dr Bennett: That might be done by coming up with a transparent method of proving that there is no overcompensation, which is one of the conditions in the Altmark judgment. Neil Kay proposed a mechanism that would go beyond the requirements of Altmark by establishing a non-profit operation, which would more than cover the bases.

A case in which the Commission threatened to withdraw subsidy from Trasméditerranéa—or Tramed—in Spain was brought to my attention as evidence that the Executive should go for tendering. The case is interesting because, after a tender that the Commission ruled was inadequate, there was a three-year gap before the services were retendered. The question then arose whether Tramed should pay back the subsidy that it had received during those three years, because it was not possible to rely on the tender to demonstrate that there had been no overcompensation. The Spanish Government employed an expert to assess whether there had been overcompensation and persuaded the Commission to authorise the subsidy for the three years.

The Tramed case differed from the situation that the Altmark conditions assume, because the issue of overcompensation was addressed after the subsidy had been given, whereas the Altmark conditions require that to happen before any compensation is given. However, the case demonstrates that there are alternative ways of calculating whether there has been overcompensation that do not require us to go down the tendering road. In the Tramed case, the question did not arise in the long term, because Spain had already signalled its commitment to go down the tendering road, but Tramed offers a

practical example of a case in which it was proved that there had been no overcompensation.

Bruce Crawford: I could ask many more questions, but I should let my colleagues in. I will come in again later, if the convener does not mind.

The Convener: No problem.

Dr Bennett, you said that you found it difficult to demonstrate the potential benefits of competitive tendering, particularly in relation to community interests in the islands. In your paper, you quote a respondent to the Scottish Executive's consultation who said that it was important that any savings from a tendering exercise should be reinvested in additional service provision or lower fares. You go on to say:

"The Scottish Executive will be the immediate beneficiary of any subsidy reduction".

Would it be possible for the Executive to give a commitment to reinvest savings in lower fares or improved services to the islands?

Dr Bennett: First, there is no guarantee that the tendering exercise would result in savings to the Executive. If there were savings and the political will existed to reinvest the money in lower fares, in theory that could happen at the next tender. The most recent documents from the Executive contain a new provision whereby change might be able to be negotiated during a contract—that is untested, but the provision means that a contract could be improved.

The Convener: I have many questions of my own but, like Bruce Crawford, I will allow other colleagues to come in.

Mr David Davidson (North East Scotland) (Con): I think that we are all in the same boat: there are a thousand questions flying around in my brain.

Dr Bennett, although you declared that you are not a lawyer, you seem to have a fair knowledge of the arrangements. In the conclusion of your written submission, on page 27, you state:

"European State Aid policy encourages competitive tendering in order to improve competition, competitiveness and cohesion."

In the same paragraph, however, you go on to say:

"Competition is restricted to service-cost".

Further on, you state:

"Cheaper fares and higher quality services might make local economies more competitive, but neither fares nor quality are dimensions of competition in the tender ... it is difficult to see how it will enhance cohesion."

That is basically where the EU is coming from and it seems to be the gist of your paper, as well as of the other paper that we have received. Have you

come up with any ideas as to how that approach applies to a real competition situation? You said to Bruce Crawford that you could envisage renegotiations mid-term during a tender to allow reinvestment or changes. Presumably, in true competitive tendering, all the risks are anticipated in advance and there is a level playing field involving those who are tendering and those who are awarding the contract. Do you have any thoughts about why the model that is being put forward has been selected, given that it flies in the face of the position that I have just described?

Dr Bennett: If tendering is required, the tender must be awarded on a lowest-cost basis. That is potentially a spur towards greater efficiency, but there is no guarantee, even if there is greater efficiency—and I have doubts about whether there will be—that it will benefit service users. The only costs that will be saved are those relating to the subsidy.

Mr Davidson: If we look at the matter from the perspective of the Executive considering lifeline services and possible improvements to them—and given that the Executive has to abide by European rules—how can it achieve what it wants and still keep within those European rules without adopting this particular model?

Dr Bennett: Sorry—could you rephrase that?

Mr Davidson: The Executive wants to maintain lifeline services. That is the whole purpose of the exercise. Presumably, it wants to improve those services and there is great demand from the people on the islands for all sorts of other things to help the economy, to provide better access to health services and so on. Given that the Executive is bound by the European rules, is there any other model that it could have come up with that would have dealt with everything, or that would have allowed us to tick all the boxes for the purposes of the Executive, the EU and communities? Is there any other way of doing things as far as you can see?

Dr Bennett: One should distinguish the way in which services are specified from the way in which they are implemented. Regardless of whether the Executive goes down the tendering route, the option is open to it, if it has the political will and the money, to improve the service specification. The biggest demand is for increasing the frequency of services, after which is the desire to reduce costs. It may be possible for those factors to be specified in a public service obligation. There is then the question whether to go to tender or not. The Executive needs to be satisfied that it is not overcompensating the operator for fulfilling those public service obligations, whatever they happen to be.

Tendering is one way of trying to prove that there is no overcompensation, but there are other ways of doing that. If each route can be accounted for transparently and if the costs and income for each route can be benchmarked against the costs demanded by a typical operator, such as in the Altmark case, that can prove that there has been no overcompensation. That is a separate issue from improving the services, which is a matter for the service specification. The Executive can put public service obligations on CalMac or whatever company is the operator whether or not it chooses to go to tender, but it has to prove that it is not overcompensating for the improved PSOs.

Mr Davidson: You are hinting that each route should be subject to a separate set of documents and cost criteria, although I did not see that proposal detailed in your submission. If the boats are rented from the vesco—or whatever we call it—at a set price, where are the variance opportunities to allow for cost benefit?

Dr Bennett: Do you mean for a company to lower its bid or to improve its profit once it has the services?

Mr Davidson: The latter.

Dr Bennett: The evidence from other tenders is that the most obvious way of making cost savings is by trying to renegotiate the labour force's terms and conditions and even, potentially, employing lower-cost labour. That has happened on almost every other ferry service throughout the United Kingdom. The labour force will bear the brunt of cost savings. The more qualitative dimensions, which cannot be specified in a contract, might also suffer. By and large, however, the contract deals comprehensively with service quality, although it cannot cover every base. The costs of labour and labour efficiencies provide the potential for savings. The most recent consultation documents pretty much acknowledged that there were limits to the protection that the Executive could afford to give.

Dr Sylvia Jackson (Stirling) (Lab): Before I ask my main question, I will follow up on that important point. You are saying that, if we opt for tendering based on the lowest cost, it is most likely that the labour costs would make the difference between a lower-cost tender and a higher-cost one. To follow the logic of that, would there not then be a greater likelihood that a company with workers from outwith the UK would be able to submit a lower-cost tender?

Dr Bennett: The Executive has said that the Transfer of Undertakings (Protection of Employment) Regulations will apply or that, if they do not apply, it will recoup the costs, so the concern is more what would happen if a company bids a bit optimistically and finds that it has

economic pressures after the tender has been accepted. TUPE does not protect the workforce indefinitely; it transfers rights and obligations at the moment of transfer but, under a six-year contract, there is ample time for terms and conditions to be renegotiated. Even though the redundancy liabilities would transfer to the new operator, it is possible that the company could replace workers and make cost savings in a six-year period, even if it had to make a redundancy payment. That is the most extreme example but, even if things did not go that far, there would still be time to renegotiate terms and conditions, numbers of employees and working hours.

There is ample evidence of that from other tenders. There was an example in the Norwegian press last week. Although Norway is not part of the EU, it complies with the cabotage regulation as part of the European Economic Area. One of the companies that operate the Norwegian coastal voyage service was reported as considering replacing its workers with overseas workers because it was running into financial difficulty.

Dr Jackson: Are there any other examples?

Dr Bennett: I have not studied tendering examples in enough depth. However, if you go round ferry services on the coast of the UK—including services between Scotland and Northern Ireland—you will notice that many of the crew have been replaced by workers from overseas, including from elsewhere in the EU.

14:30

Dr Jackson: Can I ask the question that I was going to ask—

The Convener: I just want to ask a supplementary on that point. I understand your point about the protection that TUPE provides the workforce and the fact that any company that comes in could try to renegotiate terms. What has been the degree of unionisation in the companies that you mentioned? Obviously, CalMac has a high degree of unionisation. If a new company intended significantly to alter staff conditions or to reduce staff numbers, there could be industrial action, which itself would cause the successful tenderer financial problems.

Dr Bennett: That represents another disincentive to an operator. However, three years ago, in order to save costs, P&O replaced most of the non-officer staff on its routes between Portsmouth and France, which are about to be discontinued, with Portuguese workers. Although those ships were heavily unionised, the measure went through without that much industrial action. That said, I take your point that considerable industrial action would result if such a strategy were adopted.

The Convener: I am sorry for interrupting your question, Dr Jackson.

Dr Jackson: That is fine. You raised an important point.

On page 9 of your paper, you say that the 1992 cabotage regulation

“was designed to create a mechanism whereby states could legitimately subsidise essential ferry services, without falling foul of state aid law. What has now become clear is that such subsidies were never state aid in the first place”.

Will you expand on that comment?

Dr Bennett: It is important to remember that the regulation was intended to bring shipping—in this case, coastal shipping—in line with major elements of the treaty of Rome. Most of the regulation centres on the freedom to provide services but, with article 4, the Commission is basically saying that, although it has removed legal barriers to operators from other countries operating ferry services in another member state, it does not want countries to get round that by imposing public service obligations on everyone, which makes routes unprofitable, and then subsidising only their own operators.

However, the Altmark case shows that PSOs can still be imposed and operators compensated, as long as they are not overcompensated to the point at which such funding becomes a state aid. After all, a state aid provides more than necessary compensation to something that provides a public service. If that is not the case, such funding escapes classification as a state aid.

Margaret Smith (Edinburgh West) (LD): Colleagues have already asked several of my questions. What might be the consequences if the Executive does not put the routes out to competitive tendering? On page 9 or 10 of your paper, you say that the Commission rejects outright only a small number of state-aid cases, although it might decide to change the aid or some other action might be taken. The suggestion is that there might be another way forward than outright refusal. Will you expand on that point?

Dr Bennett: The Commission rejects only 1 or 2 per cent of cases and most do not reach that stage. There is a risk, in the medium term, if the Commission remains unhappy with what we are doing. If its interpretation of the cabotage regulation differed from what the Scottish Executive did, there would be the risk of legal proceedings against the Executive. That is why it is important to get a negotiated solution. The arguments could be tested in court, but that would be a lengthy and expensive process.

Margaret Smith: You said that 1 per cent of cases have been rejected by the Commission. Do you know what happened in those situations? Did

they all end up in court or was a solution eventually found?

Dr Bennett: I do not know. The information comes from European law textbooks; I do not know the detail of the cases. Some cases will go to court, whereas others will be rejected by the Commission and renegotiated without legal proceedings being initiated.

Bruce Crawford: My question relates to Margaret Smith's questions. We have the maritime cabotage regulation and underneath that we have EU guidance notes. A guidance note was issued in 1992 and a new guidance note on the need to tender or not, on the basis that Margaret Smith described, was issued in 2004. What is your understanding of the new 2004 guidance note? From your evidence and from what Margaret Smith has said, I understand that that guidance does not require that tendering take place.

Dr Bennett: The notes that you mention are Community guidelines on state aid to maritime transport. They do not deal solely with the cabotage regulation; they also deal with other situations in the maritime industry. It is true that, although the 1997 guidelines referred to tendering—they allowed exceptions in certain circumstances—tendering is not mentioned in the 2004 guidelines. However, a couple of months before the new guidelines were written, the Commission produced not guidelines but a communication on its interpretation of the cabotage rule. That communication of December 2003 went into considerable detail and states that, in principle, tendering is the best way to ensure non-discrimination. It also makes an exception, for the first time, for routes that carry fewer than 100,000 passengers a year; however, that would by no means cover all CalMac services. That communication is just the Commission's interpretation of the law.

Interestingly, there is also a new Commission directive—which, if it is approved, should be signed before the end of July—on services of general interest, which deals with the implications of Altmark across the Community's activities. It, too, uses the figure of 100,000 passengers. It states that if a route has fewer than 100,000 passengers a year, the Altmark conditions will be allowed to apply, whereas if the figure is higher than that, the route will come under the cabotage regulation. However, again, it does not clarify what the cabotage regulation actually says. That is further evidence that the Commission was dealing with arguments about whether people could get round the regulation by referring to Altmark, but did not consider whether one could interpret what the regulation says using Altmark.

The Commission has also promised to develop a framework for larger-scale services in other

sectors, but it wants to exclude cabotage from that new framework.

Bruce Crawford: In other words, it is as clear as mud.

Dr Jackson: Can I ask for clarification of the date that you mentioned? You mentioned July, but which year did you mean?

Dr Bennett: Sorry, this is a draft directive—

Dr Jackson: So, it is this July.

Dr Bennett: The directive will be signed this July if it is approved. It is not clear what stage the directive is at, but the aim, initially, was to have it approved before the end of July.

Bruce Crawford: So, we now have guidance, the regulation and another layer—notes—that try to explain the cabotage regulation. We have layer upon layer of different argument.

Dr Bennett: Each of those layers carries different weight in law. A communication is the Commission's interpretation of the law, but a directive has more weight.

Bruce Crawford: I understand.

The Convener: Fergus, do you want to ask about this point?

Fergus Ewing (Inverness East, Nairn and Lochaber) (SNP): I want to follow up Margaret Smith's points.

The Convener: I will bring in Tommy Sheridan first, in that case.

Tommy Sheridan: Dr Bennett's paper is informative, detailed and, at points, complicated. We are dealing with a lifeline service for thousands of people and a company that employs more than 1,000 people. Is it your considered opinion that the competitive tendering route that the Executive seemed to be determined to pursue was the most productive route for the public in terms of value for money, given your experience of other examples? Has the Executive done all that it could to avoid competitive tendering or did it set off from the position that it had to have competitive tendering?

Dr Bennett: Obviously, I do not have an insight into everything that has gone on in the Executive. When the proposals were first announced back in 2000 or so, the Executive was quite clear that competitive tendering was required. The debate has moved on since then because of the Altmark ruling. However, I am not privy to information regarding whether other avenues were explored.

Clearly, if the Executive thought that the route that it was taking was the only way to protect lifeline services, that is why it could not see any other possibility. However, I have to say that, if it

were not required by European law, I do not think that it would be economically sensible to have competitive tendering. Jeanette Findlay has done more work on the costs and benefits.

The Committee of the Regions singled out the cabotage regulation as one that had not produced economic benefits in relation to publicly run services to small islands, which is a qualitative definition that the Commission interpreted as meaning services that have 100,000 passengers or fewer a year. However, the criticism that the Committee of the Regions made of the cabotage regulation applies broadly to the CalMac situation.

Tommy Sheridan: On page 8 of your submission, after talking about the four conditions that were attached to the Altmark judgment, you state:

"As long as subsidies are proportionate and transparent, they can escape rules on state aid."

From a layperson's point of view, that seems to be an extremely specific statement. Are you telling us today that that statement could not have been made before the Altmark judgment, when the Executive started the competitive tendering process, which would mean that the Executive could be forgiven for pursuing the competitive tendering route at that point? If so, should the Executive's actions now be guided by your statement, which pertains to the situation that we find ourselves in since the Altmark judgment?

Dr Bennett: It is fair to say that the Altmark case clarified the law, although it did not rewrite it. It has had major implications for a lot of European Union legislation. Technically, it did not change the law, but it has changed the way in which the law is interpreted in quite a few sectors.

You ask whether the Executive should be pursuing a different course now. The Executive went back to the Commission and asked whether the Altmark ruling affected the need to tender the Clyde and Hebrides ferry services and was told that it did not. I was not privy to the negotiations, so I do not know how strongly the case was argued or which arguments were made. The Altmark judgment has a sting in its tail, because it states that if there is a particular regulation, it must be met, even if it is different from the state-aid rules. Therefore, the cabotage regulation must be met, but given that the requirement is that we do so on a non-discriminatory basis, the question boils down to whether we can use the Altmark judgment to interpret what it takes to be non-discriminatory. I argue that we can do that. If we do not overcompensate the operator, we will not discriminate against anybody. If we do not give a profitable opportunity to anybody, we will not discriminate.

14:45

Tommy Sheridan: You made the interesting comment that the original purpose behind the cabotage regulation was to make the situation less, not more, restrictive. However, the irony seems to be that, on this occasion, the cabotage regulation is being used to suggest that the Executive has less room for manoeuvre. Your evidence is that, as long as the public service obligation is clear and transparent, that is a viable legal route for the Executive to use in the matter.

Dr Bennett: It is certainly a legal route that is worth trying, although the Commission may well disagree with that interpretation—it may say that one can still discriminate even if one is not overcompensating. I disagree with that and I do not think that it is a plausible argument, but it is nevertheless one that the Commission might come up with.

Tommy Sheridan: To me, that is the crux of the matter. The Executive tells us that there are enormous consequences of its falling foul of the Commission legally. We need academics such as you to give us a strong backbone. If the Executive ensured that the subsidy to CalMac was proportionate, transparent and therefore legal, in your academic experience and from your reading of previous case law, what would be the chances that the Commission would take legal action against the Executive? We hope that it will not do so but, given that the Executive tells us that it is frightened that the Commission will do so, we need guys such as you to give us a bit of backbone.

Dr Bennett: There are two circumstances in which the European Commission might take legal action. One would be if, after all the negotiations were finished, it was still not happy with any of the proposals that were on the table. However, before we get to that stage, there is a lot of work to do to develop the proposals. For example, we need to add flesh to Neil Kay's proposal and work out a practical proposal under which we can show that there will not be overcompensation.

The other circumstance would be if, after we had done all that work and the Commission was happy with it, another ship-owner complained about the situation. In that case, the issue might be considered again but, if the Commission was happy with the proposals, the chances are that the complaint would not be upheld. However, negotiation is required to get the Commission to accept the proposals. If the Commission is not happy with them, there is a chance that legal proceedings might take place. In theory, there is a threat that services may have to cease immediately, but that is not at all likely in practice, although there is a potential legal risk if we do something with which the Commission is not happy.

Fergus Ewing: Would it be fair to say that the Executive's approach of saying that we must ask the European Commission's permission for the policy that we pursue in relation to the provision of lifeline ferry services for the islands is akin to inviting the Celtic manager to referee an old firm game in that it involves a misconception of roles? Do you agree that it is the responsibility of the Scottish Executive to propose a scheme? The European Commission's role really comes in after consultation, to assess whether that scheme complies with the legal framework.

Dr Bennett: I agree that it is the European Commission's role to give guidance and the Commission is clear that it would prefer the competitive tendering route to be taken. It stated in its 2003 communication that it believes that competitive tendering is, in principle, the best way to ensure non-discrimination. If the Executive wants to argue something different, it is incumbent on the Executive to come up with an alternative proposal. That is not to say that the Commission should not be involved in giving guidance but, if it prefers tendering, there is no reason to assume that it will come up with an alternative proposal for us.

Fergus Ewing: To put it another way, if we ask the Commission, "Do we have to go out to tender?" the Commission will not say, "No, you don't." It will not do the Executive's job for it. We cannot really expect the Commission to say tendering is not necessary.

Dr Bennett: No. If you want to do something other than tender, it is for us or for the Executive to come up with an alternative proposal. It helps to have guidance from the Commission while doing that, but—

Fergus Ewing: When I applied the football manager analogy to the Commission, in the interests of balance I should have said that it would be a bit like expecting the Commission to be the Celtic or Rangers manager, rather than attributing any particular bias to the Commission. It is not the Commission's role to come up with a scheme; it is the role of the Executive, after consultation with the Commission.

Dr Bennett: I think so.

Fergus Ewing: Secondly—perhaps this is to play devil's advocate with your conclusions, but in a way that is, I hope, helpful to the argument—there seems to be an undercurrent that the aim of EU law in requiring competitive tendering is to secure the cheapest option—cheapest is best. That is perhaps implicit, if not explicit, in your conclusions. That is not a criticism of those conclusions per se. Am I right in saying that EU law permits two types of criteria governing the decision that must be taken in public procurement

contracts? Those are set out in article 30 of 93/37/EEC.

The first criterion is lowest price—cheapest—but the second criterion is the most economically advantageous tender, which need not be the cheapest. As we know well, situated as we are in this building, the construction managers Bovis did not put in the cheapest bid. If we were to apply that to CalMac, would it be possible for CalMac—if tendering goes ahead—to put in a bid that is accepted by the Executive, although it is not the cheapest, on the basis that the Executive could stipulate criteria, as it would be required to do under the tender process, which I am told applies to transport? It could stipulate criteria other than price; for example—in order of preference—quality, continuity and reliability. All those criteria could justify the Executive's appointing CalMac, even if it did not put in the lowest bid. Is that a fair summation of one scenario?

Dr Bennett: The advice from the Commission and what has been stated by the Executive are that it is possible to assess a tender only on the lowest-cost basis, and it is for the Executive to specify dimensions such as quality. Once that has been set, assessment of the bids can be done only on the lowest-cost basis.

If there were alternatives to that, it would be worth exploring them because a more rounded best-value approach rather than one that is based only on lowest cost may have potential benefits, but that seems to be contrary to the statements that have been made by both the Commission and the Executive in this case, in which it is for the Executive to specify the quality and form of public service obligations. If such an approach were possible, there would at least be some service-quality benefits to tendering. However, that would not remove some of the other reservations about tendering. There are reservations related to accountability and investment, the labour force and the operator of last resort—even under that circumstance it could not be guaranteed that CalMac would win the tender. If we go down the tendering route, we cannot artificially set up a system that would make CalMac the winner.

Fergus Ewing: I understand that. I hope that we will have the chance to take evidence from the minister, civil servants and perhaps others from the EU later on. After all, this is an EU process: European Commission input to this Parliament is, perhaps, overdue, but in that way we could find out what it is saying.

I think that I am right in saying that even if lowest price is the only criterion, there is still a fallback provision in the service specification documents to the effect that there exists the power to reject a bid if it is felt to be artificially low.

Dr Bennett: That is right. That power exists if the bid is thought to be unrealistic in terms of meeting public service obligations. Bids must be realistic.

Fergus Ewing: So that power exists. The tender's being economically advantageous as an alternative criterion could be another route. I mention that not because I am advocating tendering—I am not—but to point out that if there is tendering and if it is possible for CalMac to be appointed, even if it does not put in the lowest price, all that would have happened is that we would have undergone a hugely expensive process just to maintain the status quo.

Dr Bennett: That is a possible scenario.

Fergus Ewing: I want to ask about a matter that you have touched on and to which Margaret Smith alluded: the consequences of breaking the rules, with particular reference to Trasmed. I understand that Trasmed was, like CalMac, a state-owned ferry company, which provided lifeline ferry services to the Spanish island communities. It failed to consult the Commission on its particular arrangements. You were good enough to correspond with me back in January to explain some of the background in that case. Following the Executive's defeat in December on tendering, I lodged a series of questions to Nicol Stephen, the Minister for Transport. One of them, S2W-13269, asked about what costs would be incurred as the result of any failure to tender the Clyde and Hebrides ferry services. In his answer, Nicol Stephen painted a very bleak picture of the dire consequences that would ensue all round. I will put to you parts of the answer. I will inevitably have to read from the answer selectively because it is quite long. He stated:

"When the Commission began the investigation"

into Trasmed,

"it required the Spanish authorities to suspend payment of state aid to Trasmed until the Commission's examination of the case had been concluded."

That was in 1998. The answer continues:

"The case took three years to complete at which time the Commission found that the tender process had been flawed and breached the non-discrimination principle."—[*Official Report, Written Answers*, 28 January 2005; S2W-13269.]

Can you tell the committee whether the aid was suspended?

Dr Bennett: Aid was not suspended, although all that is in the answer is true. The Commission initially said that it wanted the aid to be suspended, but there is a provision—in the cabotage regulation itself, I think—for emergency funding of services. The Spanish Government's argument was that if it suspended aid, the services would stop, so it had to keep providing it. The

Commission relented and allowed Spain to continue the funding.

There was then the question how to prove that the funding was not overcompensatory, which is a matter that I dealt with earlier. Spain employed someone because it could not rely on the tender, which was flawed. Spain had to employ an expert to come in and calculate whether, relative to a benchmark, overcompensation was a factor.

15:00

Fergus Ewing: Right. So, as the Minister for Transport told Parliament, the Commission required aid to be suspended. In fact, it was not suspended because Spain said that it could not do so

“for practical and legal reasons”.

Is that correct?

Dr Bennett: The Commission issued a requirement that Spain should suspend aid.

Fergus Ewing: Yes, but, in practice, the aid was not suspended.

Dr Bennett: No, not to my understanding. The aid had to continue.

Fergus Ewing: That is the point that I am trying to draw out. Following the investigation,

“Spain was obliged by the Commission to terminate the existing contract with Trasmed, to suspend any payment of aid and to comply with the Cabotage Regulation”.

Was any aid reclaimed?

Dr Bennett: Not to my knowledge.

Fergus Ewing: Nothing was paid back by Trasmed or the Spanish Government. Is that right?

Dr Bennett: There was a court case about the matter; I think that it was in 2001. In order to avoid the aid being reclaimed, Spain had to prove that there was no overcompensation, which it did.

Fergus Ewing: Right. The point that I am making is that, although the minister painted the bleak picture that aid was required to be suspended and that Spain broke the rules, what happened was that neither Spain nor Trasmed paid back a penny piece. Nobody paid back anything—there was no penalty, sanction or consequence.

Why did the Scottish Executive, which says that it wants to avoid tendering, paint such a black picture, which—as it turns out—is a severe misrepresentation of what happened? Spain waived the rules and yet the Scottish Executive seems to worship the rules. According to the Commission, there was a clear case of breach of the law: Spain was found guilty, but it did not have

to pay back anything. Nobody suffered: there were no consequences, no loss of ferry services and no loss of subsidy.

The threats that the Executive has issued seem to be its only justification for going along with tendering. However, as far as the Trasmed precedent illustrates, those threats now appear to be empty threats.

Dr Bennett: There is a difficulty there. It is true that, in the Trasmed case, Spain did not have to refund the payments. However, the difference is that the Spanish Government was committed to going down the tendering road. Three years later, it issued a renewed tender. The case does not show that a country can ignore ad infinitum what the Commission tells it to do. That said, the case shows that, in practice, the Commission is unlikely—certainly, in the short term—to demand complete and sudden cessation of services. For all sorts of reasons, it would be mad to do so. There are provisions in the cabotage regulation that allow the emergency aid to continue, at least temporarily. Nevertheless, that does not mean that a country can ignore ad infinitum what the Commission tells it to do. At some point, it will have to come to an agreement with the Commission.

The Convener: I have two points to raise that follow on from Fergus Ewing’s line of questioning. The CalMac situation is not similar to the Trasmed situation. As I understand it, Trasmed went through a tendering process that was deemed to be flawed. I understand that we have not gone through a tendering situation yet. Is that correct? I also understand that the ultimate outcome of the Trasmed case is that the service is now tendered. Is that the case?

Dr Bennett: Yes. Both those points are correct. The problem with the initial tendering process was that the Spanish Government gave 16 days in which companies had to compile tenders, which was not long enough, for obvious reasons. That is why the process was initially flawed. Spain was already committed to going down the tendering route. It ran one exercise that was incorrect, and then ran another three years later. In the legal proceedings that I have seen, the debate about whether or not the Government had to tender did not actually arise; it was a case of whether or not it should tender properly. The reason that I raised the issue was not to do with complying with European laws or with what the consequences might be; I raised it simply as a practical example of a case in which compensation has been shown not to be overcompensation in a shipping cabotage situation, albeit for a limited period of time. That practical example might inform this case.

Mr Davidson: If the Executive is, as it appears to be, so concerned about being open and transparent in its tendering process, and if the vesco will simply become a leasing company, why did not the Executive go for an open tender so that people could simply choose where they might lease a vessel from? I appreciate that they are quite specialist vessels, and it might be that somebody would want to lease some of them. However, why, in your view, did the Government not go for a completely open tendering system, given that, in theory, it is going to set up a separate company, in which it will own the shares, to lease vessels?

Dr Bennett: There were various reasons. One reason was that it was thought that, under European law, when the routes were bundled together, there would be quite a large tender. If it was going to be the responsibility of the operator to come in and provide vessels, that could be seen as a barrier to entry, because you have to be quite a big operator to provide 30-odd ships. If the requirement is simply to lease the ships, that opens up the tender to more competition.

The second reason is the investment reason. If the tenders are only six years long, there is no real incentive for companies to invest in new vessels, because they do not know whether they will win the tender again at the end of that six-year period or whether any new operator will take over those vessels. Those problems can be solved with contractual solutions, but they raise questions about whether investment can be maintained. There were some good reasons for going down the route of splitting the ownership of the assets from the operating company, but it is obviously not a perfect solution because it raises big questions about who is responsible for what.

As you can imagine, those are not novel questions; they arise in chartering situations all the time. Nevertheless, they are questions that will arise. When something goes wrong with the ship's engine, is it the responsibility of the owner of the ship, because the engine is inadequate, or is it the responsibility of the charterer of the ship, because they have not maintained it properly? Such disputes will arise, and that raises questions about accountability and about the fact that the operator's experience could play less of a role in determining the future direction of the investment.

Mr Davidson: Railway companies lease rolling stock, which tends to go with the tender. Lots of vehicles are rented rather than owned as far as transport in general is concerned—company cars, for example. On openness, where is the competition in the part of the tender that stipulates that vessels must be leased from the vesco, or whatever the new leasing company is going to be called?

Dr Bennett: As far as I understand the tender, there is nothing to prevent the new operators from bringing in ships in addition to those provided by the vesco, should they want to.

The analogy with the railways is correct, but the companies that have invested most in new rolling stock tend to be those that have longer franchises. Companies such as Virgin Trains have very long franchises and have an incentive to invest. In this situation, however, the maximum length of tender stipulated by the Commission is six years. It is that length of tender that reduces the incentive to invest, so it makes sense to split ownership of the assets from the operating company.

Mr Davidson: Is there anything that you know of in European regulations or notes—whatever you want to call them—that would interfere with the leasing arrangements for those vessels if they have to be leased by an operator? I presume that someone outside the UK could lease out vessels that might do the same job at a more competitive rate.

Dr Bennett: As far as I know, the Commission has not objected to an obligation to lease the vessels from the vesco being part of the tender.

Bruce Crawford: Many of the CalMac vessels are very large and expensive and need a long in-commission period when they are new. Are the tendering process and the arrangements that have been agreed by the Executive robust enough for a proper discussion to take place between the vesco and the operator, whether it is CalMac or someone else, about a replacement programme? Is the process robust enough to allow agreement of a change in leasing arrangements?

Dr Bennett: Responsibility for new investment will lie with the publicly owned vesco. At the very least, the vesco will be able to slot in new ships when the tenders are renewed every six years. However, in the latest version of the draft tender document, provision is made for the Executive to negotiate with the operator to introduce new ships or change service frequency during the six-year period. The Executive intends to do that on a no-win, no-lose basis for the operator—there would be no financial gain or penalty for the operator. That could solve the problem, but I do not know how it will work in practice.

Bruce Crawford: If the Executive was trying to secure additional efficiency by finding a back-door method of reducing the level of subsidy, it could introduce new ships and come to a leasing arrangement that was more prohibitive for the operator than was the case previously. It is that area of potential future dispute that gives me some cause for concern. However, it might be that the process is robust enough. That is the assurance that I am looking for.

Dr Bennett: In any negotiation, there are opportunities for opportunism, if you like, for the Executive and the operating company. If a larger ship starts to operate on a service, it will carry more passengers, which will bring in more revenue, but it might also cost more. It is not clear whether a new ship would need an increase or decrease in subsidy should it be introduced during the six-year contract. That would have to be negotiated.

Bruce Crawford: On the flip-side, if I was operating a large vessel that I thought was not the right vessel to do the job, I might bring in additional vessels that were more suited to the route, although that might not be the vesco's view. Therefore, I could argue that the cost of leasing the vesco machinery should be less.

15:15

Dr Bennett: I am not sure whether provision has been made for such a scenario. As I understand it, once the tender process starts, the operating company is committed to leasing the existing ships. There are scenarios in which it might argue that it could do that more cheaply by using this or that vessel; however, it is not clear whether there is an obligation on the Executive or on the vesco to respond to such arguments.

Bruce Crawford: Thank you. I will ask the minister about that when he is here.

The Convener: That brings us to the end of our questioning. I thank Dr Paul Bennett for his participation in today's session.

Let us move on to our second witness. I welcome Professor Neil Kay, who has been active on the proposed tendering of the Clyde and Hebrides ferry services for several years. Some of us have met him before and have read many of the papers that he has written on the subject. You are very welcome to the committee this afternoon, Neil. You have an opportunity to make some introductory remarks to the committee, after which we will move to questions and answers.

Professor Neil Kay (University of Strathclyde): I endorse what Paul Bennett said. His coverage of a complicated area that involves many different aspects of law, economics and politics was excellent and I endorse his submission to the committee. There are, nonetheless, a few points that I would like to add.

Members have my paper on the proposed tendering of CalMac services. It was aired at a meeting at the Europa institute at which some members of the committee were present. Since then, the Executive has suggested that it may put the position of the operator of last resort out to tender. I would take that up as an issue that I find

unsatisfactory, and it is an extra element that I would add to my paper if I was to rewrite it.

I am grateful to Mr Alyn Smith MEP, who gave me the opportunity to meet Commission officials in Brussels, where we spent an hour and a half, shortly after the Europa institute meeting, discussing the CalMac tendering. The Commission officials asked that our discussion be regarded as bearing on technical issues and not for public airing; however, I can say that I have not changed my view on the issue of the CalMac tendering following that meeting.

I will deal with one or two points that were raised in the earlier discussion. The first of those is the need to tender, on which I will provide some clarification. The need to tender became a matter of public—in fact, political—discussion between 1997 and 2000, which was a critical period, during which the then Scottish Office decided that the routes had to go to tender. The maritime cabotage regulation of 1992 contained no mention of the need to tender; however, the need to tender appeared in the 1997 guidelines, which were designed to interpret the 1992 regulation. Then there was Altmark, and there were new guidelines in 2004 that did not mention the need to tender. That may have been coincidental or it may have been a response to Altmark.

The need to tender therefore comes from guidelines that have been replaced. The question arises whether the need to tender would be regarded as such an unavoidable strategy if the 1997 guidelines had not mentioned it.

A question has been raised since the Europa institute seminar: should the network be tendered as one network, or could it be broken up? It has been suggested that, if we go down the route that I have been arguing for, the network might be broken up. However, I want to emphasise a point in my paper about bundles of routes. In the December 2003 communication, the Commission said:

"The most appropriate size of bundles should be decided by taking account of the best synergy to be made in meeting ... transport needs."

In other words, the bundling of routes is an economic issue. Decisions have to be made on where and how economies can be achieved by bundling routes together.

That matter should not be revisited. In my opinion, it has been settled satisfactorily and I think that most people agree. The CalMac network should be bundled together for the economic reasons that have been set out.

Something that I and others have found confusing is this: what is involved in a public service obligation? I have heard PSOs mentioned in connection with the tendering of the network as

a whole, and I have heard them mentioned at route level. A problem that arises is that the PSO method is informal. It is very difficult to find chapter and verse on what is involved in a PSO.

If a PSO is to be awarded for the ferry services, it must be awarded on a route-by-route basis. PSOs are based on issues such as price, frequency and timetables. Those issues can be decided only route by route.

The question then arises of the level at which routes should be bundled together. That is a separate question.

Before we have a discussion, I want to re-emphasise something that I emphasised four years ago to this committee's predecessor, the Transport and the Environment Committee. There is a need for a regulatory watchdog. It is one thing to have strategy formulation, but strategy implementation and regulation will be critical. It still astonishes me that, four years down the line, there are proposals that do not bring in what would be regarded as minimum requirements for any system that could lead to competitive tendering for essential lifeline services.

Tommy Sheridan: Thank you, Neil, for your paper and your presentation—I hope that it is okay to call you Neil.

On page 4 of your paper, you give an extract from a discussion in the former Transport and the Environment Committee during its inquiry into the proposed tendering of CalMac services. The northern isles ferry services are mentioned. You had warned that the proposed measures were not robust, and the paper notes that the committee's reporters felt that the regime had yet to be proven effective. We now have proof—to the tune of £13.4 million of additional subsidy—that the measures taken during the tendering of the northern isles services were not sufficiently robust. Are you worried that we are on the eve of making a similar mistake with the CalMac network?

Professor Kay: Yes. When the issue of the retendering of the northern isles services came up, I wrote to the Scottish Executive and pointed out that at least the question of operator of last resort could be attended to. As I say in my paper, I did not really get a satisfactory response. Four years down the line, the question of operator of last resort has still not been attended to in that case, but it is absolutely critical to safeguarding the public interest. It will be an issue not only for the northern isles services but for the CalMac network.

The proposal for the CalMac tendering process involves an unproven system that does not take into account what I believe to be the minimal safeguards required to protect an essential service that must be provided on a continuing basis. The critical words are “essential” and “continuing”. We

cannot afford to have a situation in which the service might terminate with no replacement operator being found in time.

When I raised the matter some years ago, I pointed out that an operator could run into trouble. It was said then that there might be some months of advance warning, and it was suggested that perhaps the vesco could learn to take on, and to qualify for, the position of operator of last resort. In fact, the possibility of sudden termination of the service could be as likely as that of having several months' advance warning of termination. Provision must be made such that, if operations cease—whether the operator walks away, whether it loses its licence or whether it tries to break its contract for whatever reason—an alternative operator can step in immediately to maintain lifeline services.

Tommy Sheridan: Your evidence back in 2000-01 was to the effect that we could be making a costly public mistake as regards the tendering for the northern isles services. Your evidence—which I am sure you regretted having to give, being a taxpayer—has been borne out. So far, we have lost £13.4 million, and there are millions more to go. The evidence that you are now giving on CalMac should be—at the very least—examined more seriously than your previous evidence seemed to be.

Professor Kay: I would emphasise one point. I did not anticipate the events that led to the retendering of the northern isles services. I doubt if anyone did. The point about providing for an operator of last resort is to provide for unexpected eventualities and to allow a recognised and qualified operator to step in immediately. That should be an operator that is on tap and available on a continuing basis.

With hindsight, it could be said that the problems that I suggested might apply to the northern isles came to fruition, but that was not because of anything that I foresaw. The main point is that we must make provision for unexpected problems and deal with them accordingly. We should anticipate the need for a safety net in advance, rather than trying to design one when unexpected problems occur.

Tommy Sheridan: I will come on to my final point, although I am sure that the committee has many other questions. I realised that this would require a bit of gazing into the crystal ball, but I asked Paul Bennett whether he could estimate the likelihood of legal action being taken by the Commission or by a private operator should the Executive pursue the transparent and open route of applying public service obligations to CalMac. In your opinion, is it necessary to go down the route of competitive tendering? Do you think that, as long as the public service obligation evaluation is

open and transparent, that approach would be within the law?

Professor Kay: I will make three points in response to that. First, it is a balance of risks. If the Executive goes down the route of competitive tendering as it is set out now, the risks are severe, in my view, as far as the public interest is concerned. Economics is about alternatives. The current alternative of competitive tendering carries genuine risks.

Secondly, if we were to continue with the current arrangements for CalMac, the threat of intervention by the Commission would be severe. One of the present problems with CalMac would exist irrespective of whether or not we go down the competitive tendering route. The entity is extremely opaque: there is a lack of transparency about the costs and benefits on a route-by-route basis. The Commission makes the legitimate point that the leasing of vessels should be transparent and ring fenced from the operation of the services themselves. We want to find out whether, at the level of service delivery, no more compensation than necessary is being made.

The Executive can effectively regard CalMac as an extension. A civil servant attends all CalMac's board meetings. CalMac's strategic decisions are closely intertwined with the Executive. Those matters must be dealt with. If the Commission is to regard CalMac's operations as in any way acceptable, arm's-length arrangements will have to be set up at least. The status quo is not acceptable.

15:30

Thirdly, is it possible to fashion alternative methods? I think that it is. The analysis in my paper partly involved comparing the proposed separate Gourock to Dunoon route tender with the main CalMac tender. I make the point that it is difficult to work out reasonable costs and levels of compensation for the Gourock to Dunoon service, because operators have been told to bring in their own vessels. It is difficult to find off-the-shelf vessels for a route such as Gourock to Dunoon. The second-hand market is thin; usually, boats must be designed and built specially. Should operators provide passenger-only services or dual-purpose services, involving both passengers and vehicles? What size should vessels be? How frequent should the service be? There are considerable uncertainties about the costs and levels of compensation that should be regarded as appropriate in the case of the Gourock to Dunoon route. For that reason—rightly or wrongly—tendering is seen as one way of proceeding. As the Commission says, it allows us to see what alternatives prospecting may bring in.

The draft document for the main CalMac tender specifies in detail the prices, frequency and timetable of services by route. It also specifies the vessels that must be used. The issue of whether other operators could bring in other vessels has been raised. As Dr Bennett indicated, the first problem is that the six-year life cycle of the contract limits the ability to build vessels. Secondly, the vessels on the CalMac network are specially designed for dealing with the shallow waters of the routes that are served. Typically, they are designed with a particular route, frequency and speed in mind. For example, the new ferry for Bute is designed specifically for that route. Its capacity and speed are designed to fit into a particular timetable. Because the tender document specifies the timetable, frequency and prices, operators have very little discretion in respect of the vessels that they can use.

The costs of the vessels are determined largely by factors such as fuel and manning costs. The cost of fuel is determined by market conditions and the frequency and regularity of usage, which depends on the PSO. I will make two points about discretion in respect of manning costs. The first is anecdotal, but the committee may be able to confirm it. CalMac exists in an open labour market, in which it must compete for masters and engineers under market conditions. In my view, no other operator would have great discretion in that area that would allow it to push down manning costs. Secondly, because manning levels are set by the Maritime and Coastguard Agency, there is no real scope for reducing them. As Dr Bennett mentioned, an operator might perceive that there was scope for cutting the costs of other categories of labour. However, those potential savings are thin compared with the rest of the cost elements—leasing, manning levels and fuel—where there is virtually no discretion. If we look at the costs and revenues of the CalMac network, using Altmark as a guideline, we find that an operator would have virtually no discretion to push down costs, unless it were to push industrial relations to the limit by trying to bring in cheap foreign labour, which could threaten the viability and continuity of the service.

Having compared the two tenders—that for the Gourock to Dunoon route and that for the main network—I see no real scope for any outside operator to push costs down significantly below what CalMac could achieve, given the specifications of the proposed PSOs, the fact that operators will have to use the vessels specified, the restrictions on manning levels, the fact that fuel costs are determined by market conditions and the fact that the timetable and frequency of services are tightly prescribed.

Indeed, if CalMac is operating on a non-profit basis, I simply do not see how an outside operator could contend that there is scope for it to undercut

CalMac and provide a better service. In light of the nature of the PSO proposals for the CalMac network and the way in which the draft tender document sets things up, I simply do not think that there is scope for competition or for cutting the costs of, or increasing the revenue that is generated from, running the present network.

Any scope that exists for improving services—perhaps by increasing investment or by cutting prices to stimulate demand—will lie outside the PSO and will be considered at a stage prior to the specification of fares, regularity and timetables. Although that is an important issue, it does not affect the PSO level itself.

Tommy Sheridan: That was a very long—and very full—answer. As regards my point about possible legal action, for which I said that you would need your crystal ball—

Professor Kay: To return to my third point, if CalMac were set up along the lines that I have suggested and leasing were ring fenced from operations, as is proposed in the current draft tender document, the PSOs and the associated level of compensation would be transparent. If we add on to that appropriate regulatory controls and auditing mechanisms so that the level of compensation that was provided to the CalMac network was demonstrably no more than could reasonably be expected from a comparable transport organisation under the Altmark ruling, I can see no basis on which CalMac could be accused of overcompensation or on which it could be argued that there was discrimination against other Community ship-owners.

As Dr Bennett pointed out, the risk of legal intervention by the Commission—either through complaint to the Commission or as a result of a unilateral Commission decision to take action—will still exist. However, I would argue that it would be better to bear that risk than the risks that we face in putting out to tender an entire network, the viability of which could be threatened by that process. I am not arguing that there is no risk at all, but I am suggesting that, on the balance of risks, there is an alternative route to tendering that should be pursued.

Dr Jackson: Can I ask a question about—

The Convener: A few other members want to come in.

Mr Davidson: I have a couple of quick points to put to Professor Kay on the back of Mr Sheridan's questions.

You made great play of the operator of last resort. Where would one find such an operator in a hurry? You said that in a competitive world people do not tend to announce that they are going to go bankrupt or bust until they have to. In such

circumstances, queues form over matters such as who gets shares of what and whose bills are paid first. That tends to be done within a tight timescale. Although the vesco would still have its vessels, where could someone be found to come in and run the services?

Professor Kay: As far as I can see, there are no obvious potential operators within Scottish waters or Scottish jurisdiction. At the moment, the question does not arise because we have CalMac, which is a qualified ferry operator and which the Scottish Executive can instruct to undertake appropriate ferry operations. There are smaller operators, but it could be argued that they do not have the skills or the capability to run an entire network. That is exactly the point that I make in my paper. As I understand it, the Executive's current proposal to put the operator of last resort out to tender, which was mooted a few weeks ago, would create a further level of risk because if that were done under European Commission rules, the operator of last resort could end up being an operator that was outside UK jurisdiction. If a replacement operator were required overnight, that would make the ensuing negotiations on bringing that operator in extremely difficult. As far as I can see, such an arrangement would be extremely problematic.

Mr Davidson: I presume that it would have to be a two-stage arrangement, in that there would be an emergency back-up—a short-term tender—that might last for a year and another tender for a long-term operator.

Professor Kay: As I mention in my paper, that question has come back from the Scottish Executive again and again. Indeed, its position has changed over the years. I have no satisfactory answer to the question, which is why I raised the issue. Given the proposed tendering arrangement, it is a severe problem.

I will answer the question by indicating why it is not a problem in other lifeline services. For other essential services under UK jurisdiction, there are often a number of qualified operators that, if necessary, the Government can require to take over the operations of a neighbouring utility as part of their normal operations. Therefore, there are a number of operators that might be qualified and mandated to act as operators of last resort if so directed. Alternatively, a public authority could be the operator of last resort—the Strategic Rail Authority was the operator of last resort for rail, and I understand that the Scottish ministers will be the operator of last resort for rail in Scotland. In the case of ferry services, matters are not so straightforward. As the Executive has confirmed, because of safety regulations, type limitations and the issue of the operator of last resort, qualification is much more complicated.

Mr Davidson: I presume that that involves the Westminster Government and the European Commission.

Professor Kay: I am sorry; will you clarify that last point?

Mr Davidson: I presume that qualification in the case of ferries would involve the Westminster Government, the European Commission and one of the international maritime awarding bodies.

Professor Kay: No. That is where the problems arise. There is little, if any, reference to operators of last resort and regulatory authorities at European level. The Commission is concerned with the operation of the internal market to ensure that there is no discrimination or overcompensation. Matters such as regulation—which is the implementation of strategy—and the designation of the operator of last resort have fallen through a crack in the floorboards and are largely left to national bodies to deal with, not because the Commission regards them as unimportant, but because it considers that they are best left to national authorities to deal with.

Mr Davidson: At the moment, which body in the UK would be responsible for ferries? Would it be the Scottish Executive or the UK Government, through the secretary of state?

Professor Kay: Do you mean who would be the operator of last resort?

Mr Davidson: Who would oversee regulation?

Professor Kay: At the moment, the only regulator is the safety regulator, which is the Maritime and Coastguard Agency; there is no economic regulator as such. Part of the problem is that, south of the border, there is not the same level of subsidised public ferry services, if any. Ferry services in Scotland are more akin to UK rail services, for which there is regulatory provision, as there is for fuel and water services. However, there is no real precedent for an economic regulator for ferry services, largely because CalMac was constituted as a nationalised industry, so it was, in effect, self-regulatory and its own operator of last resort. The designation of the operator of last resort becomes an issue only when competitive tendering and private interests are introduced into the process.

The Convener: You used the analogy of British Rail and the retention of BRB (Residuary) Ltd, under the Strategic Rail Authority, which took over the running of a franchise in England. Regardless of the approach that we take to the ferries—whether the regulatory approach that you propose or the tendering approach—would it be possible to construct a residual CalMac to act as operator of last resort instead of tendering for one?

15:45

Professor Kay: One would assume that if that were possible, the Executive—after four years, at least—would have suggested the idea, but it has not, although I am not privy to the Executive's private discussions.

We return to the point that I and others have made repeatedly for four years or more. It has now been suggested that the operator of last resort should be put out to tender, so one must presume that if a simple solution existed, it would have been found already.

Dr Jackson: I will summarise what you said initially. You think that if we went down the route that you suggest, CalMac would have nothing to fear. I take it that you are talking about the light public service obligation route within a tendering framework. Will you clarify that?

Dr Bennett gave us examples from Norway and Portsmouth of labour force issues. You said that such costs would be marginal. Why did the operators in Norway and Portsmouth go down the route that they chose? Was that because they are private enterprises?

Professor Kay: Two basic issues relate to tendering. The first concerns state aids and overcompensation or discrimination. If the arguments that I make are pursued, it is possible to show that CalMac can be arranged as an operational entity without overcompensation or discrimination. The crucial issue comes down to one sentence in article 4 of the 1992 maritime cabotage regulation, which says:

“Where applicable, any compensation for public service obligations must be available to all Community shipowners.”

That is the sticking point for whether tendering is required.

Tendering is one device for showing credibly that no discrimination or overcompensation exists, although it is not sufficient. Is it the only way to show that? I have argued—and that argument should be pursued—that it should be possible to formulate CalMac along the lines of an operational entity, with ring-fenced leasing and appropriate regulatory and auditing controls, such that we can show that no overcompensation exists and so there is no discrimination against other Community ship-owners.

If that could be done, if avenues remained by which Community ship-owners could say that they could provide the service more cheaply and if it could be shown transparently that CalMac was operating on a cost-only, non-profit basis, it would not be necessary to tender. That is the argument that I advance, which should be tested. Once the other controls and safeguards are put in place, the

entity could be constructed such that it operated in the public interest on a least-cost, non-profit basis, without the need to tender.

Dr Jackson: Will you elaborate on that? At what point in the process would those safeguards be put in place?

Professor Kay: The only option that the Executive has on the table is tendering. I have suggested a route by which CalMac could be reorganised, partly in response to points that have been made about the need to ring fence the leasing of vessels from CalMac's operations. It is critical to separate those matters. The Commission's communication of December 2003 expressly notes that as a device for making transparent the fact that the operation of ferry services is not subject to overcompensation.

The problem with not separating out the leasing of vessels from the operation of services is that the provision of grant aid and soft loans can muddy the waters so that it is not transparent whether the compensation that CalMac receives is the lowest amount possible. That is why it is important that the leasing of vessels should be ring fenced.

Another fundamental point is the need for a regulatory framework. As the Commission will be worried about civil service interference in the operation of ferry services, a regulatory authority is needed to act as a buffer between the operator and the civil service. The need for such a regulator is taken for granted in other essential services in the UK. In my view, we require a regulator to implement strategy, to ensure that CalMac is pursuing the public interest and to demonstrate to the Commission that CalMac is not overcompensated and that other Community ship-owners are not discriminated against. In my opinion, the status quo is not tenable, but it could be remodelled in such a way as to prevent the need for a tender.

Dr Jackson: When you talk about bringing the public interest into the process, do you mean public service obligation issues such as fare prices?

Professor Kay: The current proposal for tendering CalMac services fails to consider how ferry policy and strategy are developed. Currently, CalMac, as the operator, has the additional responsibility of developing strategy, for example by proposing new vessels, the extension of routes and increases in the frequency of services. Even if CalMac's services are not put out to competitive tendering, CalMac's role will need to become simply that of an operational entity and deliverer of services. Consequently, strategy formulation and ferry policy, such as decisions on whether to build new vessels, will be left, almost by default, to the

Scottish Executive. We have all focused on the implementation of public service obligations, but ferry policy on matters such as whether fares and service frequency should increase is an important social and economic issue. The fact that, whatever happens, CalMac's current role, which includes strategy formulation, will need to be reduced to operational status means that a whole area of public policy could be neglected by default or put into the hands of the Scottish Executive's transport division.

Dr Jackson: I have one further question.

The Convener: I had intended to allow you only a short supplementary.

Dr Jackson: My question is related to that last point about issues such as fare levels under a public service obligation. Obviously, to a large extent, fares will depend on labour costs. Could a regulator take those types of issues into account to ensure that a fair assessment was being made?

Professor Kay: The labour costs would not affect fares. As part of the PSO, maximum fare levels would be set for the operator, who would thus have no discretion to increase fares. Given the inability in the short term to deliver any increase in passenger volume on most routes to compensate for any reduction in fares, a monopoly operator would not normally consider reducing fares. De facto, fares would be frozen at their present levels, which are specified in the current CalMac timetable. That freezing of fares and of service levels comes with the PSO specification, so some further provision is required for revising the PSO.

Everybody has been concerned about how we deliver the PSO, whether by tendering or whatever, but a fundamental problem is how we decide what the PSO should be. For example, it is quite conceivable that it might be decided as a matter of public policy to reduce fares on the Gourock to Dunoon route, which is now a PSO route. Such a reduction would be a legitimate public policy that might be proposed for economic and social reasons, but how would that proposal enter into the debate? Historically, CalMac has had responsibility for deciding fares according to certain criteria such as commercial considerations and what is in the national interest. If CalMac is to become only an operator, that strategy formulation process would need to be removed from it and be found a home elsewhere. It is not clear where that home would be.

Fergus Ewing: In the section of your paper entitled "Final Thoughts", you say that the Executive has defined the problem too narrowly in saying that it is

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

In arguing that the question must be wider, and to ensure harmony with the approach required by EU law, you suggest that the issue should be

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

That wording adopts much of the EU's language.

When I leave here today, I want to be clear about the precise alternative that you are proposing. You have already argued that the first step should be ring fencing, with a separate accounting system for leasing the vessels. I understand that. As I see it, the second step is to apply PSOs to each route, which we would welcome.

The third step in your proposed alternative is to appoint an independent regulator for Clyde and Hebridean ferry services. Will you describe to the committee how you envisage such a regulator operating and tell us why you believe that that would constitute part of an alternative to compulsory tendering?

Professor Kay: The regulator would be an integral part—but only a part—of an alternative system. As a point of reference, I draw the committee's attention to how essential lifeline services are organised elsewhere. The proposal in my paper is uncontentious and straightforward; indeed, it is self-evident and obvious to those who deal with such matters. The problem is that, in Scotland, we have not encountered these regulatory authorities very often. That does not reflect anything lacking in or any incompetence by the Scottish authority; it is simply a lack of experience. The fact is that most experience of regulatory authorities, such as those that deal with gas, electricity, postal services, rail services and so on, has been at a UK level.

The function and statutory responsibilities of such entities are pretty well described and prescribed. They monitor and assess firms' performance to ensure that there is no anti-competitive behaviour and guard the public interest in the maintenance of prices, costs and so on. The role of the regulator in most other sectors is pretty well set out in statutory guidelines.

Fergus Ewing: Just to play the devil's advocate, I point out that, although you say that there are regulators for other services such as rail, electricity, gas, water and so on, the operation of rail services has just been tendered and there is competition in the sector, albeit that subsidy is required to maintain services. That said, as I understand the situation, Network Rail is different. If we take rail as an example, how does having a regulator mean that tendering is not needed?

Professor Kay: Let us say that the operation of the northern isles services is retendered and that, halfway through the period of the contract, the new operator says that it cannot meet the terms of the contract and is going to walk off into the sunset unless another £30 million of subsidy is paid. If the civil service in Edinburgh deals directly with the matter, it will be difficult for it to evaluate the matter independently, because it both awards and polices the contract. By removing the regulatory function and creating, if you like, a separate policeman that is independent of the civil service, there is more chance of creating transparency and objectivity that can be communicated to Brussels than there would be if those who award the contract also police it.

The problem with awarding and policing the contract for the northern isles services is that there might well be a built-in incentive to allow renegotiations to take place. After all, it might be difficult for the civil service to verify independently whether there have been any breaches of contract. In such cases, it would be the regulator's job to assess professionally whether contracts had been appropriately adhered to. Such functions, divorced from the civil service, are the responsibility of a professional regulator.

16:00

Fergus Ewing: I understand the functions of the regulator and that an element of independence would be involved. However, I do not understand why having a regulator would mean that a country could avoid tendering. Rail is an example: there is tendering, albeit that public rail services are subsidised.

Professor Kay: My proposal suggests that, along with tight auditing and investigatory controls by appropriate statutory bodies such as Audit Scotland and the Accounts Commission for Scotland, the regulator should be able to audit and monitor the operation of services in such a way as to communicate to the Commission that no more than the appropriate level of compensation, and therefore no overcompensation, has been paid in the conduct of services. The proposal is for what would probably be a six-year contract, subject to revision at the end of that time. Issues will arise in the course of the six-year period that will require renegotiation or discussion with the appropriate authorities. If the civil service in Edinburgh is doing that discussion and negotiation, the political process is brought into play and that is something about which Brussels would, at the very least, feel uncomfortable. However, having the cushion of a professional body—the regulator—that discusses issues with CalMac would insulate the political process from the operational process.

Fergus Ewing: Okay. I turn to the last two steps in your proposal. The fourth step would be for

“the Auditor General to set up procedures both now and on a regular basis in the future to assist the Regulator”.

You go on to describe that at some length. Would not the Auditor General say that his role is retrospective and it is not his job to do that?

Professor Kay: That might well be the case. However, a provision for independent auditing could be tacked on to the process.

Fergus Ewing: Right. So, there would be an audit, but perhaps not right at the beginning.

You say that the fifth step would be

“to have CalMac instructed to pursue its operations on a least cost, non-profit basis with 100% claw back of any profit made.”

Why is that a part of your proposal and how, along with the other four steps, does it mean that we would not be required to tender?

Professor Kay: The first point is whether an excess level of compensation could be expected. In the paper, I go through the extent to which CalMac as an operator could expect discretion to push at revenues or push down costs if the appropriate measures were taken to specify PSOs along the expected lines in the proposed tender document. The question is whether it would be possible to structure CalMac in such a way as it was expected to squeeze extra revenue or reduce costs beyond what we would expect from a normal operation. The argument that I put forward in my paper is that discretion would be almost squeezed out of the system, because so many of the costs would be outside the control of CalMac and there would be limited discretion—if any—to generate extra revenues. Certainly, price discretion would be squeezed out of the system.

If CalMac is operating and delivering on a cost-only, non-profit basis, the question that arises is whether it would be subject to challenge by another European firm that claimed that it was excluded from the compensation that CalMac was receiving. Under the Altmark guidelines, an operator can expect to obtain compensation of cost plus reasonable profit. It is difficult to conceive of conditions and circumstances in which an outside operator could reasonably make a technically credible claim that it could undercut a cost-only, non-profit CalMac and still make a reasonable profit into the bargain.

Although the solution or process that I have outlined does not remove the risk of legal challenge, it gets close to making such a challenge unlikely, which is the line that should be pursued in testing and evaluating it as an option for CalMac services.

Fergus Ewing: I suppose that if there was a legal challenge by a company that said, “The Scottish Executive and Nicol Stephen broke the law by not putting the services out to tender,” the company would have to quantify its claim by estimating the profits that it could have made if it had won the tender. You argue that if the service was regulated in such a way as to involve no profits, the challenger’s claim would by definition have no value, even if it was well founded.

Professor Kay: A company could not say, “The Executive broke the law by not putting the services out to tender,” because tender itself is not embedded in the legal framework; it is a device whereby compliance with the legal framework can be demonstrated. The company would have to make its case in another way.

Provided that the system was open and transparent, one approach might be to advertise in the *Official Journal of the European Union* every six years that there is a proposal to award the public service contract for CalMac again. I see no reason why it could not be regarded as open to all Community ship-owners at least to express an interest in the running of CalMac and to put forward technical proposals if they thought that they could do better in relation to costs and operation, if there was an avenue that was open to them to do that. However, that is a legal point, which should be tested.

Fergus Ewing: If, as you propose, a notice were to be placed in the OJEU to indicate that, instead of having a tender process, the Scottish Executive had decided that CalMac would continue to provide the service—in your model, a regulator would be appointed and the four other steps that you describe would be followed—and companies that wanted to challenge that decision would have to notify the Executive that they thought that they could do better, would such companies also have to lodge an interdict or initiate legal proceedings to prevent the Executive from taking a decision that the companies would argue was prejudicial?

Professor Kay: The maritime cabotage regulation is opaque and open to interpretation on the matter. It says:

“Where applicable, any compensation for public service obligations must be available to all Community shipowners.”

If we read that closely, it is clear that the compensation can be available only to one Community ship-owner: the firm that is the incumbent or which wins the tender. One would interpret the provision as meaning that all Community ship-owners—presumably that means the ones that are qualified ferry operators—would have the right to seek compensation if they wished

to do so. How that would be done is a matter that could be pursued.

Currently, the only route that is under consideration is the tender route, but it has been established that tendering is neither necessary nor sufficient to demonstrate compliance with EC law, as the Trasmed example showed. It would be worth while considering whether the route that I propose would be sustainable. The proposal takes us into uncharted waters; we are all dealing with novel situations and problems, but we should consider the matter.

I want to add one point. Over the years, the Executive considered the problem and produced solutions that raised other problems, for example in relation to the question of the operator of last resort. The matter therefore went back to the Executive and the Executive identified alternative solutions, which also raised problems. For several years, there has been a loop in which problems and solutions have gone back and forward between the Executive and the public. A different approach is needed now: outside agencies should consider the matter in a cool, detached manner, evaluate the options and ascertain whether there are other means of addressing the problem. That needs to happen, because major problems and dangers are attached to the tendering route, as I and others have said. This is no reflection on the experience that is available in Scotland, but the experience, capabilities and skills that are required in judging such issues lie to a large extent at a UK level, rather than at a Scottish level. I urge that appropriate expert advice be taken from the regulators and legal experts who have experience and knowledge in the area.

Fergus Ewing: I wanted to touch on a few other areas, but I will come back to them at the end of the meeting, if there is time.

The Convener: I would like to ask a couple of questions about your model, Professor Kay. You are absolutely right to say that we should be trying to explore every possible alternative to establish the best option for the ferry routes. My questions are about your proposals for regulation and the need to ensure that there is no overcompensation. You have identified some of the potential problems in your paper. Potential operators might believe that some routes could be profitable, and there is some debate around whether all CalMac's services would require subsidy. If they did not require subsidy, they would not require a PSO. If the regulator examined all the routes and identified three or four of them that were potentially profitable, would there be a danger that they might be cherry picked by another operator?

We might think that there are currently many constraints on CalMac, but we should bear in mind the rail analogy: the franchise agreements place a

number of constraints on the rail operator. The first time round, in 1996, when the then ScotRail management team bid for the franchise, it was outbid by the successful National Express Group. I contend that the team did not set out to lose: it put in what it probably thought was a realistic bid, but someone else produced one that was seen as credible by the Government and others. The second time round, the incumbents, National Express Group, lost out to another bidder. It seems that, even in a heavily regulated industry, there is the potential for different companies to come in with bids that they believe will bring a more efficient and profitable result than the existing operators can achieve.

Professor Kay: On those exact points, I refer members to the Europa institute meeting at which I presented a paper and at which the northern isles case was raised. The issue was mentioned by a senior European official, and the question why a light PSO was not used was raised. European Community law contains the communication of 22 December 2003, which sets the matter out in some detail.

The provision for light PSOs, as they are known, states that, even if it is not the main part of the contract that is concerned, operators will be obligated to provide certain levels of service. To give an example of a light PSO, if an operator tries to cherry pick the summer trade on a route, it can be obligated to run it all year round. There is also a provision for exclusivity, which means making a route exclusive to a particular operator that has the right to run that route and receive subsidy. That provision could also be pursued.

I do not know whether the problems encountered in the case of the northern isles service represent a failure of the Executive to apply light PSOs or exclusivity, but that is exactly the kind of question that a regulator would take into account. A regulator would be concerned about the control and maintenance of competition throughout the whole network. In dealing with questions of market entry, a regulator would consider whether cherry picking could take place and, if so, what could be done about it. There are mechanisms under EC law to deal with cherry picking. It is dealt with expressly by the December 2003 communication.

The Convener: Let us go back to the railway analogy. Back in 1996, the incumbent, ScotRail management, was outbid by the incomer, National Express Group. What if another operator out there believes that it could run the existing CalMac operation more efficiently than existing CalMac management?

Professor Kay: I ask you to consider the breakdown of the costs, investment and leasing—all the elements on the PSO side of the process.

The answer is that an operator has no real discretion. We tend to think of competition in terms of reductions in prices among competing firms, the introduction of new services and so on. That is not what the PSO process is about. Most of the process, with investment in new vessels and competition based on fares, would be excluded by the time that we put in place a PSO, which is about the delivery of a certain level of fares, frequency, timetabling and so on. Such discretionary aspects as manning levels and fuel costs are squeezed out of the system. The scope for innovation and competition is largely squeezed out of the system once the PSO is put in place.

16:15

The Convener: Is it not the case that all those constraints were in place in relation to the railways, yet bids still came in that varied by many millions of pounds? Some railway franchises have been more successful than others in achieving market growth through better marketing, increased quality and so on.

Professor Kay: A 10 per cent increase in rail fares would be a transport problem, as it would lead to a switch to cars and buses, and a 10 per cent reduction in rail fares would result in a switch from cars and buses to rail. As there are alternative modes of transport to the railway, we would describe such switches as transport problems. However, if ferry fares were increased, or reduced, by 10 per cent, there would be a regional development problem and a problem of maintaining regions, because there is not the same degree of flexibility and flux as exists between alternative modes of transport. Apart from partial and limited examples of air fares to some islands or peninsulas, there are not usually alternative modes of transport to the ferry. As the ferry is a monopoly provider of the transport service, there is not the same potential for increasing services, increasing demand or getting people to switch from alternative modes of transport that exists in the case of rail.

The Convener: Could not an operator grow the market by increasing the tourism trade to the islands?

Professor Kay: It could, but, as I say in my paper, someone does not go to Mull to use the Mull ferry service—they use the Mull ferry service to go to Mull. The appropriate level at which tourism, holidays and so on are developed is that of the tourism or development agencies. We would not expect transport operators to indulge in such work. The ferry journey is a means to an end, rather than being an end in itself. Even though I—along with many others—find ferry journeys enjoyable, they are a means to a final objective: they provide transport to the islands. It is at the

level of the promotion and advertising of islands that advertising should take place. I do not see much scope for ferry operators to boost their revenues by advertising their services.

Bruce Crawford: I will tease out the issues that Bristow Muldoon has raised. You are telling us that the process will effectively be to tender to manage and provide a service. Issues such as the route, the timetable, the type of ship, the maximum level of fares, the freezing of service levels, the level of manning and the cost of fuel are pretty much regulated and will be tightly defined.

If I were an operator other than CalMac that knew about all those definitions, I would find it a simple job to go through the company accounts and the annual report, look at the level of subsidy and come to the conclusion that I could find margins only in shore-based central services. If I attack that area, knowing that everything else is pretty much fixed, I could put in a tender price that recognised all the established factors but which was lower precisely because I had attacked the only area that I could attack. I might not make much profit but, by God, I would have my hands on a pretty big service for the future and could make long-term economies of scale for something else that I wanted to do. If I went for that narrow, defined area and showed that there was the capacity to produce savings in the company accounts, I could end up walking away with the CalMac services under my belt without doing a lot of work.

Professor Kay: I am not here to defend CalMac. Allegations have been made in the past of a high level of overheads and staffing costs at headquarters in Gourock. It is well worth my pointing out that, in part, that high level of overheads and staffing costs reflects the fact that CalMac still has responsibility for developing the structure. A good example is the new Bute ferry, which CalMac designed and built. Given that CalMac owns and manages its vessels and develops its markets, it has a level of commitment that we would not expect a lean, mean operator to incur.

The second point that you make is exactly right. As I mention in my paper, if there is a weakness in relation to the question whether there is too high a level of subsidy, it is at headquarters level. That is why those issues should be tackled now rather than be allowed to drift on. As long as we are assured and can be convinced that the level of overheads at Gourock is not too high, that aspect can be dealt with.

Bruce Crawford: You have just confirmed what I said. If the operator is no longer involved in building the ships—that work will be removed from mainstream activity, although it will still add to the cost base—and if it is no longer involved in route

development because that area is fixed—again, that work will be stripped out, although it will still add to the cost base—an outside operator will need simply to look at the area aggressively and put in a lower tender. It will have a good idea of what everything else costs. If I could convince the banks that I could put up a credible case, I could go and do that job tomorrow.

Professor Kay: Yes, but at the moment those activities have to be done. They will still have to be done—

Bruce Crawford: But not by CalMac.

Professor Kay: Exactly.

Bruce Crawford: They will be done by the Executive. Unless CalMac is prepared to strip out those costs as well, they will still be part of its overall cost base when it submits a tender. That will not be the case for other operators.

Professor Kay: If I was a banker who was looking at the costs, I would say, "Wait a minute. At the moment, CalMac has a higher level of costs as a result of having to take on these functions. Who is going to carry out those functions afterwards?" The potentially high level of overheads can and should be examined, but it reflects the particular case of CalMac, the history of which is that it was a nationalised company with many functions other than just operations.

Bruce Crawford: That suggests to me that, despite the certainty that some people have about the big bundle of contracts in the tender, there is no guarantee that CalMac will continue, because if someone looks at the tender properly they will probably find a way to put in a lower bid.

Professor Kay: If—

Bruce Crawford: There are lots of ifs.

Professor Kay: It is suggested that we strip out and ring fence various functions. First, there is the vessel owning and leasing function. Secondly, there is the regulatory function, which is somewhere in the ether because nobody seems to be picking it up—I presume that, by default, it falls to the transport division of the Executive. Thirdly, there is the strategy development function, which is concerned with planning new ships. Provided that homes are found for those essential functions, CalMac as an operational entity could be seen as the least-cost entity, along the lines that I suggest in my paper.

Bruce Crawford: Something has to happen, whether it is based on your proposals or whether a tender process is undertaken. A mechanism has to be found to satisfy the Commission. From what I have heard, I am pretty sure that a tender process will not improve the level of service or the structure of the service and will not help to reduce

costs for passengers. How would your proposal enable a reduction in fares or an improvement in the service?

Professor Kay: If the option that I suggest is pursued, costs and revenues for each route will be visible, observable, measurable and transparent. On that basis, it will be possible to evaluate whether costs are too high or too low. There will be transparency and manageability in determining the appropriate level of subsidy for each route. There will still be an issue about the allocation of overheads—for example, some ships are shared between routes—so I am not suggesting that the approach will be entirely straightforward and simple, but it gets closer to the spirit of what is intended in the EC regulation.

The regulation asks that in the delivery of a particular public service obligation—in this case, the obligation involves delivering an essential service to island and peninsular communities—no more compensation is paid than is required to deliver what is specified in the PSO. It is up to policy makers to decide what is specified in the PSO, such as fares, the frequency of services and the timetable. When that has been decided, the pursuit of the least-cost option would be facilitated by the procedures that I suggest, many of which are indicative of the advice on ring fencing and leasing that is already on the table.

Mr Davidson: In your paper, you make no mention of any hunger from local authorities—or from the regional transport partnerships that are coming through—to operate ferry services in the public interest on a not-for-profit basis or to convince their populations that they are able to deliver the additional or more user-friendly services for which many island and peninsular communities seem to be looking. Is there any reason for that?

Professor Kay: There are two aspects to the matter. First, Argyll and Bute Council and Western Isles Council have not shown great enthusiasm for any of the services. A corollary of the gains to be had from the CalMac network is that hiving off individual routes is difficult to manage on a route-by-route basis—that is an essential point. It has been convincingly argued that if there are economies from shared vessels, staff, marketing and so on at the network level, hiving off individual routes on a council-run basis would be impractical or undesirable and would take councils into areas in which they do not have great experience.

There is another important issue. When evidence was taken four years ago, councils were wary of the possibility of a regulator being appointed, which was understandable. Councils see many policy decisions being taken in Edinburgh, which is divorced from where they are, and they thought that a regulator would be

divorced from them too. I do not want to speak for councils, but I think that they feel that there is a lack of involvement in the strategy-formulating process. Again, there are two aspects to that matter. Once there is a PSO, the question is how it should be delivered—tendering has been on the table so far. However, there will be a fundamental problem before the PSO is in place. What fare and service levels should there be? How frequently should vessels run? Should there be new routes? Those are important questions of strategy formulation from which councils have understandably felt divorced.

Aside from the tender issue, I have strongly argued that fares on the CalMac network are set at a historically high level and that there is scope for reducing them, particularly given their importance in the context of regional development. That is an important issue—as is the role of councils—that probably fits in with people's involvement in the strategy-formulation process. Implementation requires a professional regulator, and I think that the lack of such a professional regulator contributed to the problems in the northern isles. A regulator is needed, but involvement at the strategy-formulating stage is also needed.

Mr Davidson: Do you have a model? Perhaps you could drop the committee a note that gives us an idea about the point at which local communities and elected bodies could have an input in the process.

Professor Kay: We must be careful. One thing that has come out of studies of regulatory authorities is the importance of regulators' independence from the political process. It would be easy for their role to be subverted. For example, the Commission would be wary of the role of a regulator who favoured a national firm over a firm from outside the national boundaries. People who have considered the process have strongly argued that it is important that regulatory authorities are independent of the political process. There is potential for bringing in councils and other interested parties in deciding what the PSOs should be, but implementation and maintaining and promoting appropriate levels of service should be left to regulators, as independent entities, to deal with.

Mr Davidson: In other words, local authorities and transport partnerships should have opportunities to express opinions when the original PSO is being set up, which, I presume, would be done with the involvement of the Scottish Executive in your model.

Professor Kay: Exactly. However, they should have more than just an opportunity to express opinions. There should also be opportunities for seeing the ferries not only as a transport problem,

but as an integral part of regional development. Opinions should be directly fed into the strategy-formulating process, of which councils should be an integral part. That would be prior to the PSO; once the PSO is in place, transparency and maintenance of fairness and objectivity on the part of the regulator will become all important.

Dr Jackson: How much time do we have to follow up your suggestions?

Professor Kay: The question is: what are the alternatives? We can deal only with the alternatives that are available. If the alternative is competitive tendering as formulated, the arguments that I give against that still hold. My paper has an appendix on the northern isles services in which I make the point that the northern isles experience was—at the least—not one that the Executive wanted. However, we have a continuing service in the northern isles, and rushing in to retender would be worse than continuing with a clearly unsatisfactory process.

No ideal scenarios exist, but time should be taken to consider what is best for the CalMac network and particularly for the communities that depend on it. In a sense, the Executive has rushed in the past few years, during which the deadline has always been a few months ahead. When the proposed tender was first announced in April 2000, the deadline was about a year after. That was five years ago, yet the deadline is now still some way ahead.

To think that the situation can be solved immediately would be a delusion. It is far more important to get it right than to rush into an unsatisfactory and incomplete solution.

The Convener: That brings us to the end of questions. I thank Neil Kay for his evidence.

We have reached the end of the agenda, so that was a remarkably short meeting for the committee. I thank all members for attending.

Meeting closed at 16:32.

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