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TRANSPORT SCOTLAND
CÒMHDHAIL ALBA

[redacted]

By email to [redacted]

Your ref:

Our ref:
FOI/14/01212

Date:
3 October 2014

Dear [redacted]

REQUEST UNDER THE FREEDOM OF INFORMATION (SCOTLAND) ACT 2002 (FOISA)
Thank you for your request dated 15 July 2014 under the Freedom of Information (Scotland) Act 2002 (FOISA). I apologise for the delay in responding.

<u>Your request</u>

You submitted 10 requests regarding the MVA study, the concept of a "defensible subsidy" and the position of the European Commission.

<u>Response to your request</u>

Please see responses to your requests below. Information released in response to these requests is attached.

1. *Why was it not determined that a "Defensible Subsidy" was acceptable to the EC before progressing the MVA study?*

While our aim is to provide information whenever possible, in this instance the Scottish Government does not have the information you have requested. FOISA only applies to written records and we do not have any written record of information within the scope of this request.

2. *Dates and locations of meetings with EC Officials at which Apportionment was discussed and the names and positions of those participating.*

As you know from feedback to the Gourock-Dunoon Ferry Service Steering Group, John Nicholls and I met EC officials in Brussels on 11 September 2013. There were no formally agreed minutes of that meeting but a note is attached (this is an internal Transport Scotland note and has not been agreed with the Commission). This includes details of those present.

FOISA applies to "information" rather than to "minutes". In this instance much of note is within the scope of your request. I have removed some sections that are out of scope.

A telephone meeting was held on 11 December 2013. Participants were Joseph Smallwood (EC DG Competition), Lee Shedden (TS Financial Controller), Stephen Clark-Foulquier (UKREP), Jenny Gibbons (Scottish Government EU Office), John Nicholls and myself. There are no minutes of that meeting.

3. *The minutes of the above meetings.*

See response to question 2.

4. *Details of any legislation, EU or National,; any Regulations or Directives and; any decided cases or other authorities or sources of any kind cited in the discussions relevant to Defensible Subsidy and Apportionment of costs.*

The note of the meeting of 11 September 2013 refers to "EU State aid and maritime cabotage rules". Details of these rules are found in:

The Maritime Cabotage Regulation of 1992
The EC Guidance to the 1992 Regulation, latest version published April 2014
The EC Maritime State Aid guidelines from 2004, which the Commission confirmed earlier this year would continue without revision.

These documents are publicly available on the European Commission's website.

The note also refers to "the Commission Decision in 2009". I understand you already have a copy of this document.

5. *Copies of all correspondence, including emails, in which this topic was discussed.*

Please see relevant excerpts from correspondence attached.

6. *Is the Scottish Government continuing to pursue Defensible Subsidy with the EC as a basis for a new Vehicle and Passenger service, if not why not.*

While our aim is to provide information whenever possible, in this instance the Scottish Government does not have the information you have requested. FOISA only applies to written records and we do not have any written record of information within the scope of this request.

7. *Was this topic raised with the EC as the result of a complaint or representation by third parties.*

I refer you to the information released in response to questions 3 and 5.

8. *If the topic arose as a result of a complaint or representation how many parties made these.*

I refer you to the information released in response to questions 3 and 5.

9. Copies of the complaints or representations with the names of the parties redacted if necessary.

While our aim is to provide information whenever possible, in this instance the Scottish Government does not have the information you have requested. This is because any complaint referred to in question 8 would have been made to the European Commission. You may wish to contact the European Commission at address below who may be able to help you:

DG Competition Unit F2
European Commission
B-1049
Brussels
Belgium

10. Contact details within the EC of those to whom requests for information on this subject can be addressed.

This information is already publicly available. You could try for example the following link to the Commission's own website:

http://ec.europa.eu/transparency/access_documents/index_en.htm

Your right to request a review

If you are unhappy with this response to your FOI request, you may ask us to carry out an internal review of the response, by writing to:

David Middleton
Chief Executive
Transport Scotland
Buchanan House
58 Port Dundas Road
Glasgow
G4 0HF

Your review request should explain why you are dissatisfied with this response, and should be made within 40 working days from the date when you received this letter. We will complete the review and tell you the result, within 20 working days from the date when we receive your review request.

If you are not satisfied with the result of the review, you then have the right to appeal to the Scottish Information Commissioner. More detailed information on your rights is available on the Commissioner's website at: www.itspublicknowledge.info.

Yours sincerely [redacted]

[redacted]

Letter from European Commission (EC) to the UK Permanent Representation to the EU (UKREP), 28 November 2012

2.6. Please provide details on the methods to be used in order to avoid cross subsidisation between the commercial and non-commercial activities of the vessel as well as the proper allocation of costs and revenues.

Draft letter from UKREP to EC, 8 January 2013 (final version not held by the Scottish Government)

Your letter states that "it is argued in the press that the Scottish Government contemplates on introducing a combined passenger and vehicle vessel and thus services on the Gourock-Dunoon route" and ask if this is the case.

This is not the case. However, the Scottish Government has commissioned a study into whether or not a combined passenger and vehicle ferry service could be operated on the town-centre to town-centre route with no subsidy for the vehicle-carrying element. The study is looking to see whether, under the rules laid down in the Commission's 2009 Decision, it would be commercially viable for a vehicle-carrying service to be re-introduced.

This is in response to the negative reaction from users and local communities to the outcome of the tendering exercise required by the Commission and ongoing problems with the new service provided by Argyll Ferries, in particular its relatively poor reliability in bad weather compared to the previous service provided by Cowal Ferries. Reliability is particularly important on this service as it is heavily used by commuters for their daily travel to places of work or study. There is also a strong belief in the local community that a vehicle service could be operated without subsidy if it was allowed to compete freely against Western Ferries. Furthermore, there is a belief that the procurement timetable required by the Commission's Decision, and the 6-year maximum contract length imposed by the Commission's maritime cabotage and maritime State aid guidelines, prevented bidders from coming forward with proposals based on commissioning vehicle-carrying vessels optimised for the route.

The feasibility study will report in April 2013 and only then will the Scottish Government decide whether or not to make any changes to the current service and, if so, how to make those changes, and over what timescale. We are fully conscious that any action must be allowable under EU rules on competition, State Aid and public procurement. The key point is that any possible future vehicle ferry service will have to be provided by an operator on a commercial basis, at their own risk and outside of a public service contract.

The key documents relating to the study are publicly available on the Transport Scotland website:

http://www.transportscotland.gov.uk/water/ferries/subsidised/gourock-dunoon

Until the study is concluded and the Scottish Government has considered its conclusion, many of your questions are hypothetical. However, I have aimed to provide as much information as possible at this early stage.

[...]

2.6 The separation of accounts and the proper allocation of costs and revenues would be a key requirement for any potential new vehicle-carrying service on the route. The feasibility study now underway will focus particularly on this question. For example, paragraph 3.1 of the terms of reference makes clear that subsidy must be "compatible with EU law", which includes the cost separation requirements of the 2009 Decision; paragraphs 4.2 and 4.3 require that the basis of cost projections must be itemised and transparent "to avoid any claim of cross-subsidisation" and paragraphs 6.1 and 6.2 require that this is clearly explained and verifiable. The risk of getting this wrong is specifically set out in paragraph 13.2.

Letter UKREP to EC, 5 July 2013

I provided you with detailed information about this study in my letter of 8 January 2013 in response to a number of questions you submitted.

The study has recently completed and I enclose a hyperlink to the final report that was published on 3 July 2013.

The next steps planned by my authorities are to:

- engage with potential operators to gauge their interest in providing a vehicle-carrying ferry service at their own commercial risk;

- engage with the Commission: my authorities are aware that they must continue to work within the parameters set out in the Commission Decision of 18 October 2009, in particular, that subsidy can be only be paid for passenger traffic and that a vehicle ferry service, provided on a commercial basis by the operator, will be subject to appropriate accountancy measures and audit monitoring to prevent cross-subsidisation from the passenger service to the vehicle service;

- once they have the feedback from potential operators and the Commission, as well as local reaction to the report, consider the way forward in the long-term.

My authorities in the Scottish Government are committed to remaining compliant with the maritime cabotage and state aid regulations applying to this service. In taking forward the outcome of the report, my authorities would welcome the opportunity to discuss these issues with you. Contrary to what your complainant may say, the Scottish Government has no intention of subsidising the carriage of vehicles on this route.

Note of meeting with Commission officials 11 September 2013

Attendees

Joseph Smallwood, DG Competition
Joanna Warnel, DG Mobility and Transport
John Nicholls, Scottish Government
Richard Hadfield, Scottish Government
Stephen Clark-Foulquier, UK Representation to the EU

Gourock-Dunoon Ferry Services

The Scottish Government (SG) noted ferry subsidies had been a matter of concern to the Commission (CION) for a number of years, leading to the investigation in 2008-09 and the publication of the Commission Decision in 2009. With the implementation of the Decision's findings, SG considered that all its ferry contracts and subsidies were now compliant with EU State aid and maritime cabotage rules. However, in the case of Gourock-Dunoon, the service was not to the required standard and changes needed to be made. In making changes, SG wished to ensure it remained compliant with EU rules.

The main change foreseen was for new vessels to be introduced, purpose built for the route. New vessels could be provided either by the operator or by SG, through its asset-owning company CMAL. If the operator was going to bring vessels then a longer duration service contract would be needed. If CMAL were to build vessels then SG would need to be able to stipulate their use on the route.

SG also explained the aspirations for a vehicle-carrying service on the town centre route and noted that the CION Decision did not explicitly exclude the possibility of a subsidised passenger ferry service to also carry vehicles. If this did happen, sufficient safeguards would need to be in place to prevent any cross-subsidisation to the vehicle service. The safeguards would need to include a fair and transparent cost allocation method which would demonstrate that the vehicle service was not loss making.

DG Competition (COMP) noted that the 2009 Decision was their reference point for any consideration. COMP confirmed SG's reading of the Decision as it applied to the carriage of vehicles on the route.

COMP saw the current issues falling into 3 time periods: pre-2011, [redacted]; 2011-2017 (the current contract) and post-2017, the next contract. [redacted] A very detailed methodology which spells out how costs were allocated would be needed for a future vehicle and passenger service to demonstrate compliance with the 2009 Decision.

SG explained the MVA approach (the 'incremental approach') and noted that this differed from the approach used by Cowal Ferries. The approach Cowal Ferries had taken to cost allocation was driven by their dependence on the existing large vehicle and passenger ferries in use on the route at that time. A new vehicle and passenger service would not be in this position and would therefore have to take a different approach to cost allocation. SG noted that it would be necessary to demonstrate to the CION that appropriate and transparent cost allocation was in place in order to avoid any risk of cross-subsidisation.

DG Mobility and Transport (MOVE) noted that, under the maritime cabotage regulations, subsidies had to be related to a real public service need. In the case of Gourock-Dunoon, the 2009 Decision had identified this need only for passengers. It followed that the public authority could only require an operator to provide or operate a vehicle-carrying vessel if they were able to sufficiently demonstrate the real public service need for such a type of vehicle service (e.g. in case of a market failure). Otherwise, both the options identified by SG were conceivable. The 6-year duration had been set in guidance to ensure that the market was not closed for too long. There had been cases of longer contracts agreed by the CION where the specific design of vessels or the requirements of ports means that appropriate vessels could not easily be found and therefore longer contracts had been allowed on a case-by-case basis to allow for recoupment of the significant investment costs in a vessel. The same applied to the requirement to use a public authority's own vessels; in this case there would be no need for longer contracts. MOVE were open to further discussion on the basis of a detailed justification.

In response to a question from SG, MOVE confirmed that the public service need for a passenger ferry service had been demonstrated but the existence of another vehicle-ferry provider only a short drive away made it difficult to claim that there was a market failure. COMP added that, in the case of the passenger service, State aid still needed to be proportional to need.

SG noted that options for part of the coming winter were currently being considered and these included the deployment of a vehicle-carrying vessel in passenger-only mode, which it was hoped would prove less susceptible to weather cancellations. SG considered that this could be achieved under the existing contract. The CION noted this information.

Transport Scotland
September 2013

Letter EC to UKREP, 19 December 2013

The Commission's State aid decision C 16/2008, has certain requirements with regard to safeguards against cross-subsidisation of any future commercial vehicle service operating on the Gourock-Dunoon route.

1. Please confirm how this requirement of the decision is likely to be met, given current planning of a tender for services to commence 1 July 2017 upon expiration of the current contract?

In answering the above question, it would be useful to see a draft of the likely information to be provided to tenderers, in order that they fully understand what the requirements of decision C 16/2008 mean in practice.

(a) In particular, please indicate the method of cost allocation to be required by the future operator? e.g. Allocation by "available capacity", (as per the previous Cowal Ferries service), or allocation by revenue, or allocation based on the extra cost of a vehicle-carrying vessel, or allocation by passenger numbers? (If an allocation by passenger numbers, please indicate the counting methodology for all vehicle types, including cars, coaches and commercial vehicles).

(b) Please indicate which cost categories the above methodology will apply to? e.g. The cost categories in the detailed table supplied in your letter of 8th April 2013 (Table 2 Detailed Revenue/Cost Allocation to Public Service and Commercial Service) with financial information for Cowal Ferries Ltd for the financial years 2009-2010, 2010-2011 and 2011-2012? Would the methodology apply to all of these cost categories (apart from vehicle dues)?

(c) Please confirm whether penalties are envisaged on any future operator when a loss is made by a future commercial vehicle service? When such a loss is made, will there be an assumption of overcompensation for the subsidised passenger part of the service? And therefore will there be contractual obligations on overcompensation, such as for instance a clawback mechanism whereby the operator is required to repay any losses to the contracting authority? What frequency would such a check against losses be made? e.g. Annually?

(d) Please indicate the frequency and timeliness of publication of cost allocation data to be required of any future operator. e.g. Annually?

Letter UKREP to EC, 11 February 2014

Thank you for your letter of 19 December 2013 where you ask a number of questions about the Scottish Government's intentions for the Gourock-Dunoon town centre ferry service and, in particular, how cross-subsidisation will be prevented in the event that a future contract is provided by an operator who also chooses to provide a vehicle-carrying service on a commercial basis and at their own commercial risk. At the outset, I should state that my authorities are clear about their obligations under the Commission's Decision from 2009 and keen to work with you on maintaining compliance with that Decision.

The current contract runs until 30 June 2017. Consequently, there is no immediate operational need for the Scottish Ministers to finalise their views on many of the points raised by the Commission. There is a process of policy deliberation and market engagement currently on-going that will allow the Scottish Ministers to reach a view but at the moment it is not possible to be definitive on a number of points raised in your letter of 19 December 2013.

[...]

You ask for some specific information.

(a) The method of cost allocation

As set out above, the Scottish Government is at a very early stage in the tendering procedure for a new contract and so officials there are not yet in a position to answer this question. They are considering the methodologies that have been previously discussed with Commission officials, as listed in your letter, to determine what might be appropriate. I will keep you informed of those considerations and a further discussion with Transport Scotland officials at a future date may be mutually beneficial.

(b) Which cost categories the above methodology will apply to? E.g the cost categories in the detailed table supplied in your letter of 8th April 2013 (Table 2 — Detailed Revenue/Cost Allocation to Public Service and Commercial Service) with financial information for Cowal Ferries Ltd for the financial years 2009-2010, 2010-2011 and 2011-2012?

In principle, the cost allocation methodology should apply to all common costs that are shared between the passenger and the vehicle-carrying portions of the service.
The principal ones are indeed those set out in Table 2 of our letter of 8 April 2013, i.e.:

- Crew
- Fuel
- Vessel charter
- Insurance
- Cost of sales
- Maintenance
- Berthing dues
- Passenger dues
- Port staff
- Management fees
- Utilities

Would the methodology apply to all of these cost categories (apart from vehicle dues)?

Transport Scotland's working assumption is that whatever methodology is agreed upon would be applied to all cost categories which represent common costs shared between the passenger and vehicle portions of the service. It would be simpler for the same methodology to apply to all common costs although there may be a good case for different treatments to be applied to individual costs in a manner that best reflects their basis of consumption by each element of the service.

Vehicle dues are likely to be excluded as this cost category only applies to the vehicle-carrying portion of the service and is not therefore a common cost shared with the passenger-carrying portion. Consequently any vehicle dues would be wholly applied to the vehicle-carrying portion.

(c) Whether penalties are envisaged on any future operator when a loss is made by a future commercial vehicle service?

Any future commercial vehicle-carrying service would be provided by the operator outside the terms of their contract with the Scottish Government, as that contract will only cover the subsidy of passengers. Therefore the Scottish Government will have no instrument through which to apply penalties. The main penalty would therefore be the requirement of the operators to fund the loss themselves. Furthermore, we do not believe that the EC Decision of 2009 makes any mention of such a requirement for penalties.

When such a loss is made, will there be an assumption of overcompensation for the subsidised passenger part of the service?

No. The cost allocation and reporting methodology should ensure there is no overcompensation. If the vehicle-carrying part of the service makes a loss then the operator – who has taken that commercial risk – will have to carry that loss. There would be no compensation paid to the operator in respect of losses incurred on the vehicle-carrying part of the service.

And therefore will there be contractual obligations on overcompensation, such as for instance a clawback mechanism whereby the operator is required to repay any losses to the contracting authority?

All of the Scottish Government's current ferry service contracts contain a clawback mechanism in some form. The Commission, in its 2009 Decision, recognised the value of these provisions. The inclusion of such a clause in the future Gourock-Dunoon contract is something that will need to be considered.

The function of those clawback clauses is to ensure that the operator is not overcompensated for the services that they are contracted to provide (this can happen, for example, if annual revenues are higher or costs lower than was forecast at the outset of the contract). Through the clawback mechanism, the operator pays back to the Scottish Government the majority of any —excessll profits. It would not be possible for such a clawback mechanism to repay —lossesll related to the vehicle-carrying portion of the service, as they would be outside the contract and therefore excluded from the subsidy paid and the application of any clawback mechanism.

(d) Please indicate the frequency and timeliness of publication of cost allocation data to be required of any future operator e.g. annually?

From 2009 to 2011, cost allocation data was published annually alongside Cowal Ferries' annual reports and this level of frequency would seem appropriate. When it comes to setting out the detailed provisions of the new contract we will consider whether we require more frequent reports to be provided to Transport Scotland as the contracting authority.