Gourock-Dunoon Ferry Service – Vessel Procurement

Introduction

1. It is widely accepted that lasting improvements to the reliability of the Gourock-Dunoon town centre ferry service can only be achieved by deploying more suitable vessels on to the route. A search of the second-hand and charter markets has not resulted in the identification of any ships that would be expected to bring significant improvements. It is therefore likely that new, purpose-built tonnage will be required under a new public service contract.

2. This paper considers the options open to Ministers under the relevant EU legislation and guidelines.

Background

3. There was until recently a mismatch between the maximum contract length set out in current European Commission (EC) guidelines (6 years) and normal amortisation periods for commercial vessel investment. Potential operators of a short-duration contract had to determine the investment risk that they are prepared to take on the residual value (RV) of their vessels and may well have sought to recoup a large amount of their investment during the period of the contract.

4. In the case of Gourock-Dunoon, this would increase the costs of a subsidised (passenger) service and, in the case of a vehicle-carrying service, also increase the costs to the operator of the unsubsidised (vehicle) element.

5. This is not a problem unique to Gourock-Dunoon and we have had to tackle this across the subsidised ferry network in Scotland. The Annex to this paper gives further information on the situation of other contracts subsidised by the Scottish Government (SG). This boils down to 3 approaches:

(i) SG makes available to all potential operators vessels it owns or has at its disposal but bidders are free to bring their own vessel solutions;

(ii) operators are required to use vessels owned by or at the disposal of SG;

(iii) operators are required to bring their own vessel solutions, whether owned or chartered.

6. The Gourock-Dunoon contract tendered in 2011 was limited to 6 years and required operators to bring their own vessels in line with approach (iii) above. Due to the limited time period allowed for the tendering exercise by the EC (a request from SG for an extension was refused), bidders were reliant on vessels they already owned and vessels readily available on the second-hand and charter markets.

Developments since the last Gourock-Dunoon tendering exercise

7. Scottish Ministers and officials have been engaging for several years with the EC on the question of contract length. After a long consideration, the EC have recently publishing their conclusions in the form of revised guidelines to the Maritime Cabotage Regulation[1]. The guidelines clarify that the EC will consider longer contracts in certain circumstances, on a case by case basis, primarily where the operator is investing in vessels and/or shoreside infrastructure. There is evidence from other EU countries that operators can be attracted to contracts requiring investment in vessels if the duration is at least 10 years.

8. EC officials have also indicated (during their meeting with SG officials last September) that they could consider permitting SG to require the use of vessels designed and built by CMAL for the route, provided we could make a substantiated case as we did for the CHFS fleet. They are aware of the difficulties we have had in finding a suitable replacement for the MV AliCat on either the second-hand or charter markets over the past 2 years. If the EC agreed, this would mean that SG could, as with CHFS, require vessels we have procured through CMAL to be used by the operator of successive 6-year contracts. However, the EC officials also made clear that they would find it very difficult to agree to operators being required to use a vehicle-carrying vessel as this is not needed for the delivery of the specified public service on the route, which they have defined in their 2009 Decision as the passenger service. So, in practice, the option of requiring the use of Government tonnage would only be available for passenger-only vessels and that would be subject to further detailed discussion with the Commission.

9. The EC also clarified that they considered the options of longer contracts or making SG vessels available (or requiring their use) to be “either/or” – in other words, if the vessels were built and made available (or their use required) then contract length would be limited to 6 years. Longer contracts would likely only be permitted if the operator was supplying the vessels.

Options for the next Gourock-Dunoon contract

Option (i) – SG makes available to all operators vessels it owns or has at its disposal but bidders are free to bring their own vessel solutions

10. The SG would be able to procure new vessels (through CMAL)[2]. The SG could build either passenger-only or vehicle and passenger vessels and make these available to all bidders on a non-discriminatory basis. Bidders would have the option of using these vessels or deploying their own (or, conceivably, a mixed approach for a 2-vessel service).

[1] COM(2014) 232 of 22.4.2014 – Communication from the Commission on the interpretation of Council Regulation (EEC) No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States (maritime cabotage).

[2] It is assumed that these would be funded through SG loans although in theory private finance could be used – although the consequence of this would be likely to be higher vessel charter costs for both the subsidised (passenger) and, in the case of a vehicle-passenger vessel, the unsubsidised (vehicle) elements of the service. As budgets are finite, providing funds to CMAL for Gourock-Dunoon vessels may have an impact on the overall CHFS vessel replacement programme.

11. When the SG procures vessels for the Clyde and Hebrides ferry services through CMAL, this is done in partnership with the operator (CalMac) and in consultation with the local communities. CMAL would be expected to take the same approach to any vessels they procured on behalf of SG for the Gourock-Dunoon route. This would mean commissioning new tonnage only once the operator of the next contract had been selected through the tendering process. It should then also be clear whether that operator would be providing a vehicle-passenger or a passenger-only service.

12. However, bidders would require sufficient information on outline vessel designs and proposed charter costs in order to make informed decisions on:

- whether to use the vessels made available by SG or to provide their own;
- what costs (charter fees, crew costs, harbour charges etc) to include in their bids; and
- whether to include carriage of vehicles, at their own risk, in their proposed service.

13. The detailed design and build would then be taken forward in partnership between CMAL and the chosen operator. Charter costs would be set commercially by CMAL and include an assumption on residual value (RV) at the end of the contract. The RV risk would reflect the possibility that a bid using an operator's own vessels would win the subsequent contract and that therefore the CMAL vessels would not be needed for the Gourock-Dunoon contract and would have to be deployed elsewhere, chartered out or sold.

14. If the winning bidder proposed to operate a vehicle as well as a passenger service using new (vehicle-passenger) vessels to be provided by CMAL, then it would not be possible to require these to be used under future contracts (see Option (ii) below). SG could make them available to all potential operators of future contracts at a commercial charter rate but bidders would be free to bring their own compliant tonnage. In addition, under this scenario, SG would need to be satisfied that the successful bidder met the requirements set out in the 2009 EC Decision for separation of accounts and appropriate allocation of common costs in order to avoid any cross-subsidisation. For example the vessel charter costs would need to be allocated appropriately by the operator between the subsidised passenger service and the unsubsidised vehicle-carrying service. The SG is discussing with the European Commission how to interpret this requirement as there is no standard methodology for the appropriate allocation of common costs.

15. If the winning bid was for a passenger-only service using new vessels provided by SG, then it may be possible to negotiate an agreement with the EC that the use of these vessels can be a requirement under future contracts (see Option (ii) below). Otherwise, SG could make these vessels available to all potential operators of future contracts at a commercial charter rate but bidders would be free to bring their own compliant tonnage, including vehicle-passenger vessels.

Option (ii) - Operators are required to use vessels owned by or at the disposal of SG

16. If we were able to secure an agreement from the EC to require all bidders to use vessels provided by SG then this would give the best value for money from the Government's investment as there would be no residual value risk and charter fees could be set at a level that reflects the whole assumed working life of the vessels (25-30 years).

17. However, based on discussions with the EC, this option is only likely to be available for passenger-only vessels, as these are what are required to deliver the specified public service on the route, which they have defined in their 2009 Decision as the passenger service.

18. This would therefore only be an option if the next contract was for a passenger-only service. Exercising this option would also assume that future tendering exercises would exclude bids that included a vehicle-carrying element as all bidders would be required to use the passenger-only vessels provided by SG.

19. This option would therefore not deliver a service which carried vehicles as well as passengers.

Option (iii) - Operators are required to bring their own vessel solutions, whether owned or chartered.

20. The revised guidance from the EC that longer contracts are likely to be permitted in certain circumstances increases the probability of securing new tonnage under this option. Sufficient time would be needed for the successful bidder to design and build new tonnage but this is likely to be similar to the time it would take CMAL under Options (i) or (ii) above. If the winning tender for the next contract is from the private sector then there could also be some reduction in the vessel procurement timescale, given that private sector operators would not be bound by the EC procurement rules that apply to DML and CMAL.

21. The main challenge with this option would be ensuring that prospective operators bid with, and the successful operator provided, ships that were appropriate for the route and met the required standards of, in particular, reliability. Given that vessel costs (direct and indirect, including crew, fuel and harbour charges) represent a high percentage of operating costs, bidders would need to ensure that their vessel plans met the required standards whilst achieving a competitive bid price. This could be supported by, for example, setting an appropriate balance between the cost and quality tender evaluation criteria which eases the pressure on the cost element of bids.

22. The risk can also be managed through the tendering process, with bidders required to provide designs that meet clearly specified input and/or output criteria. The high-level specifications set out by TMG for vehicle-passenger and passenger-only vessels as part of the feasibility study would provide a useful starting point. Robust evaluation of designs would be needed, informed by expert maritime technical advice. Finally, we would expect partnership working between the

successful bidder and the SG (probably through CMAL) during the detailed design and shipbuilding phase.

23. Regardless of whether the operator or CMAL were in the lead on vessel design and construction, there would be opportunity for community engagement during the process.

24. Indeed, in practice, whether vessels were provided by SG/CMAL or by the operator, the process for designing and building the ships – in partnership and with consultation – may look very similar. However, under options (i) and (ii), investment costs and risks would lie with SG/CMAL and under option (iii) with the operator.

Market Engagement – vessel provision

25. The recent market engagement exercise asked the 6 potential bidders their preferences in respect of the provision of vessels. Two operators identified that they would prefer to use vessels provided to them; two operators would prefer to provide their own vessels, one operator had no preference and one operator reported that it would depend on what the Scottish Government can do regarding the provision of vessels.

26. The two operators who preferred to use vessels provided to them would be content to charter these at commercial rates. The two operators who preferred to provide their own vessels would both source new build.

27. The market engagement did not, therefore, in itself identify a clear way forward in respect of the choice between the options set out above for the provision of vessels.

Summary

28. There is an interaction between vessel provision, contract length and how the next contract is delivered. The following options are available:

Option	Service provided	SG/CMAL vessels are made available?	Operators are required to use SG vessels?	Contract length	Cost and RV risk
(i)	Vehicle-passenger or passenger-only	Y	N	6 years	SG/CMAL
(ii)	Passenger-only	Y	Y*	6 years	SG/CMAL**
(iii)	Vehicle-passenger or passenger-only	N	N/A	12 years	Operator

* subject to agreement of EC
** no residual value risk

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ANNEX

Experience elsewhere on the subsidised ferry network

1. There are a number of possible approaches to securing vessels for contracted ferry services. The following table sets out how vessels are currently provided for Scottish ferry contracts (those in bold are vessels purpose built for the services); the Northern Isles lo-lo freight contract has recently expired but this has also been included:

Contract	Operator	Vessels	Owner	Approach
Clyde & Hebrides (CHFS)	CalMac	**CMAL fleet**	CMAL	SG requires use
		Clipper Ranger	SeaTruck	Operator charter
		Loch Seaforth	Lloyds Bank*	SG requires use
Northern Isles	Serco NorthLink	**Hrossey Hjaltland Hamnavoe**	RBS**	SG makes available
		Hildasay Helliar	SeaTruck	Operator charter
Gourock-Dunoon	Argyll Ferries	Argyll Flyer AliCat	DML***	Operator charter
Northern Isles lo-lo freight	Shetland Line	Daroja	H&h Bereederung Drochtersen	Operator charter

* This is a short-term arrangement (8 years) in order to meet the accounting definition of an operating lease. Otherwise, under accountancy rules currently in place, costs would be scored as a finance lease and scored as a capital spend by CMAL and by the Scottish Government;

** This is a tri-partite operating lease between the Scottish Government, RBS and the operator: it is for a longer period (18 years) in line with the accountancy rules then in place;

*** Owned by the parent company and chartered to its subsidiary at a market rate.

2. This boils down to 3 approaches:

- operators are required to use vessels owned by or at the disposal of SG;

- SG makes available to all operators certain vessels it owns or has at its disposal but bidders are free to bring their own vessel solutions;

- operators are required to bring their own vessel solutions, whether owned or chartered.

3. For CHFS, we have secured an agreement with the European Commission (EC) that we can require all bidders to use the CMAL fleet. This is an exemption from the general presumption against this type of arrangement which excludes potentially competitive bids from operators with their own vessels. The EC have accepted SG's argument that the uniqueness of the CMAL fleet (in terms of the number and size of vessels and the accessibility of many of the harbours) would put

the incumbent owner-operator in an impregnable position in a competitive tendering exercise as it would be impossible for another prospective operator to assemble a fleet in order to submit a compliant bid.

4. For the Northern Isles, the smaller number and larger size of vessel, and the relatively limited access restrictions at the designated harbours, means that the arguments used to justify an exemption for CHFS do not apply. The pre-2002 vessels were provided by the operator (P&O Scottish Ferries) but these were not available, due to their non-compliance with new safety at sea regulations, under the next contract. SG therefore tendered for an operator to bring their own vessels on condition that those vessels were made available to future bidders on a non-discriminatory basis. Vessel specifications were set out in the invitation to tender. The contract was won by CalMac-RBS (who traded as NorthLink) and SG entered into a long-term operating lease agreement with RBS in 2002 to use the 3 large ro-pax vessels until 2018. The 3 vessels were therefore made available to all bidders for the subsequent Northern Isles services contracts (2006 and 2012) but there was no obligation for bidders to use to use the 3 RBS vessels. Bidders for the 2012 contract were advised that the costs to SG arising from those agreements would be included in the evaluation of the “most economically advantageous tender”. Given the significance of the costs of terminating the tripartite lease agreement prior to 2018, this would have been a factor in the decisions of bidders over whether to use the vessels made available or to provide their own.

5. It is however unlikely that SG would be able to put in place arrangements like those with RBS again given changes to the accounting treatment of leases that are likely to restrict the ability to keep capital investments from scoring their values against the capital budget in the year they come into use. It is also questionable whether we would want to do this given the increase in expenditure that would be incurred over the lease period compared with direct capital grant funding (the method used to fund the majority of CMAL vessels).

6. In addition to the 3 RBS vessels, successive Northern Isles operators have used additional freight vessels. NorthLink operated the MV Hascosay and MV Clare until around 2011: the former was owned by NorthLink and the latter was chartered. These were replaced by 2 chartered vessels, the MV Hildasay and the MV Helliar. The same 2 freight vessels have been chartered by Serco but bidders could have brought alternative vessels as there was no ongoing obligation to the vessel owners SeaTruck.