

RESEARCH AND ADVICE ON RISK MANAGEMENT IN RELATION TO THE SUBSIDY OF FERRY SERVICES

**Deliverables 2+4: Analysis of Contract Terms and Risk
Management**

Report - FINAL

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1. INTRODUCTION

- 1.1 This report constitutes Deliverables Two and Four of the “Research and Advice on Risk Management in Relation to Subsidy of Ferry Services” study for The Scottish Executive Enterprise, Transport and Lifelong Learning Department (the Executive) before the tendering of the Clyde and Hebrides Lifeline Ferry Services. The study analyses how the EU Maritime Cabotage Regulation rules are applied within the European Union (EU), with particular regard to the way in which risks are managed.
- 1.2 In this report, we provide an analysis of how risk is managed under PSO and PSC arrangements in surveyed EU Members States, as well as in Norway, Canada (British Columbia) and Japan.
- 1.3 Lifeline island ferry services offered within the European Union and in other OECD countries, as demonstrated by case studies (Deliverables One and Three), vary widely as do the organisational structures put in place by government. It is therefore difficult to provide a completely systematic appraisal of each of the aspects of the PSO/PSC structure.
- 1.4 Instead, we can identify a number of key issues around which the present operating practices have been developed. In this report, we will first review the definition of Public Services in the various countries. It will then analyse how governments ensure that minimum levels of services are provided.
- 1.5 First, we discuss the recognition of lifeline ferry services in the various countries surveyed. Lifeline services are either operated directly by the government through government-owned companies, or through regulation or procurement in the market place.
- 1.6 We will then look at the definition and imposition of Public Service Obligations (PSOs) on privately operated lifeline routes to ensure desirable service and fare levels.
- 1.7 Public Service Contracts (PSCs) are then examined as government mechanisms to further ensure that otherwise non-commercially viable services are provided. In the context of PSCs, we analyse the different types of risks confronting domestic island ferry services and the various strategies deployed to manage these risks. The most prominent of these risks are, revenue and costs risks.
- 1.8 We conclude with a discussion on lessons that the Scottish Executive can take from international experiences.

2. LIFELINE ISLAND FERRY SERVICES

- 2.1 There is a general recognition, at the government level in each of the countries we have investigated, of the need to support domestic island ferry services. It is recognised that island communities depend on the ferry links connecting them to the mainland – and that it is within the proper locus of the government to intervene to ensure that routes are operated at an adequate level of service (with an adequate frequency across the year), at a fair price, and with an adequate level of quality. In certain countries, the responsibility for the state to provide access via ferry is treated in an analogous way to the responsibility to provide road access.
- 2.2 Lifeline services are often defined on the basis of protecting the economic wellbeing and reducing the peripherality of the off-shore islands:
- In France (Corsica) and Italy (Sicily), lifeline services are intended to foster territorial continuity.
 - In Ireland, lifeline services to the off-shore islands are seen to protect and foster the linguistic and cultural heritage of the islands in addition to supporting residents and industries on the islands.
 - In the case of Sweden and Denmark, the ferry services appear to be broadly regarded in the same light as the highway network itself.
- 2.3 Having recognised the *concept* of lifeline services, the governments we have surveyed in this assignment then adopt different approaches to support these services. These we discuss in the following sections.

3. PUBLIC SERVICE OBLIGATIONS (PSOs)

3.1 As a first step in supporting identified lifeline services, governments can, under EU regulations, identify routes where Public Service Obligations (PSOs) apply. Where a PSO is established, governments can impose conditions on ferry companies who operate, or seek to operate, services on these routes. While under such conditions the government does not provide any subsidy to operators – and does not intervene with the numbers of operators who seek to enter the market – they can be used to regulate the market to encourage stable commercial operations that fulfil the aspirations of the government.

3.2 Typical of these conditions will be a requirement that any operator will offer services across the week – and across the year. The objective of such arrangements is to provide protection to operators on the route by preventing third party operators from cherry picking the profitable peak season services.

Definition of the Public Service Obligations

3.3 There are both ex-post and ex-ante definitions for the minimum level of services that the governments, central or local, believe ought to be provided.

3.4 An ex-ante approach is where governments pick routes and services that they believe would not have been provided at the socially optimal level and quality. In many of the countries, PSO routes were routes from which private operators withdrew as a result of rising costs and/or dropping demand. When the government intervened to continue and secure the services, the PSO or PSC requirements often reflected historical patterns and practices.

3.5 In some instances, governments may also design whole services and then tender them. This would be the case in Sweden, Denmark and Norway, where islands and cross-fjord ferry services are considered part of the national/ regional/local road networks.

3.6 An ex-post approach allows the market to identify non-commercially viable routes, and then the government comes in and procures the services. Greece define their PSO routes in a way that is similar to how bus services are tendered in the UK. The government is required to identify at the beginning of each year which services are to be provided commercially and which will not. Operators of non-subsidised services are required to apply and register for routes at the end of each year. Tendered services are defined as those that are not applied for by commercial operators in the free market.

3.7 In practice, a similar situation exists in Japan, where any operator operating in the “designated sea routes” to off-shore islands can apply for a subsidy out of the national “remote islands sea grant”. The government then divides up the subsidies based on the applications as well as the level of competition on each of the routes (routes where there is more than one operator are, in practice, not eligible for the subsidy).

Minimum Service Requirements

3.8 The minimum level of service applicable in each country, and on each route, is often historically based. Many of the currently subsidised services have existed for a long time, either through direct ownership by the governments, or through negotiated contracts between the operators and the governments. In countries where ferry

services have been directly provided by the government, the PSO is set by the government based on traffic patterns and perceived needs (e.g. Scotland). In Ireland, the timetables are decided through thorough consultations with island residents and local authorities.

- 3.9 Based on our research, it does not appear that all countries have formal processes put in place to define the required services, service levels, and to determine which parts of the ferry service network(s) ought to be subsidised.

Introduction of Differential Pricing

- 3.10 As part of the recognition of minimum requirements on certain routes and services, it is a common practice for governments not only to set the schedule price of such ferry services, but also to require operators to provide discounted tickets for island residents. In most cases, such a concession is reimbursed to the operator by the government.
- 3.11 Discounted prices are a way of protecting the PSO services by stimulating demand through lower fares for islanders. The governments then reimburse operators on the PSO routes the difference between discounted and regular fares.
- 3.12 Such practice is allowed Under Article 87.2 (a)¹ Commission Decision of 22 June 1987 (OJEC 87/359/EEC). Direct aid reserved to certain social categories, including island residents, is allowable under the legislation.
- 3.13 The legislation, however, prohibits any discrimination with respect to the nationality of the residents, and the transport aid granted to residents of an island must be open to every citizen of the European Union residing on that island, not only nationals.

Non-PSO Lifeline Services

- 3.14 Not all lifeline services are secured under PSOs.
- 3.15 In Spain, three routes are designated as Public Interest Services that do not fit strictly into the definition of PSOs. For each Public Interest Service route, there is a contract in place to safeguard a minimal level of service. In addition, operators who are not the Public Interest Service contractor can also provide services and receive subsidy (bonus to tariff) from the government for every archipelagos resident transported. There is, however, no restriction in terms of timetables, routes, or minimum levels of service imposed on these non-contracted operators. The minimum requirement for operation is strictly associated with safety standards. There are, however, imminent changes to the Spanish Royal Decree and minimum service provisions (PSOs) will be imposed on the Public Service Lines in due course.
- 3.16 In Finland, mainland-islands and inter-island services are essentially lifeline services as they are vital to the livelihood of the island residents. They are, however, directly funded or provided by the government and are therefore not considered to be PSOs. However, the plan is to move towards open tender for all island ferry services in

¹ “aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned”.
(<http://www.eurisles.com/Textes/OSP/etude/EN/IIirect%20or%20indirect%20aid.htm>)

Finland. This will, however, be likely to take at least three years. The Maritime Administration believes that local commercial operators will have the capabilities to provide the service, but the tendering and contracting process will take time to ensure maximal efficiency.

- 3.17 In Denmark, BornholmTrafikken is a state owned ferry company that operates passenger and freight lifeline services to and from Bornholm. The Ministry of Transport has direct responsibility for operating Bornholm ferries, which is the last remaining transport company on the Danish budget.

4. PUBLIC SERVICE CONTRACTS (PSCs)

4.1 With many lifeline routes and services, the commercial market does not provide adequate services as identified by governments despite minimum service requirements and significant financial contribution to the services through concession fare schemes. In such cases, the local, regional or national government is forced to intervene further with direct subsidy to individual routes. Public Service Contracts (PSCs) are then established.

4.2 PSCs are contractual arrangements that guarantee services at desirable levels and prices to the off-shore islands. In return, the contracts grant operators certain protection.

4.3 Governments generally employ three mechanisms to ensure that the lifeline services are provided. These are:

- Establishing discount fares for islanders;
- Imposing PSOs alongside PSCs; and
- Directly subsidising operators.

Establishing discount fares for islanders

4.4 As discussed before, discount fares for islands can stimulate demand for ferry services.

4.5 The practice of charging island residents discounted fares and then reimbursing operators for the difference between discounted and full fares applies to both PSOs and PSCs.

4.6 Our research indicates that not all countries have discounted fares for islanders.

PSOs alongside PSCs

4.7 PSOs are sometimes imposed alongside PSCs in order to protect against cherry picking during the peak seasons. By insisting that operators must provide a minimum level of service operators operating without a PSC are forced to cross-subsidise their services. Under the EC Regulation, however, in such cases the PSOs should be “light”.

4.8 PSOs are not always used alongside PSCs to protect the contracted operator(s). In Scotland, Malta and Greece, operators enter into contracts with the government to provide a minimum level of service in exchange for subsidies. There is, however, no other barrier to market entry. Any third - party operator that wishes to cherry-pick can do so without being subject to any service level requirements.

Direct subsidies

4.9 Lastly, if protection against skimming behaviours and mechanisms to boost demand is not enough to ensure service provision, the governments can enter into PSCs with, and provide direct subsidies to, operators.

4.10 Table 4.1 summarises types of government intervention set up in the surveyed countries to ensure ferry services to remote islands.

TABLE 4.1 GOVERNMENT PROTECTION OF LIFELINE SERVICES

Country	Discounted fares for islanders	Minimum Service on Route/ PSO (for all operators)	Contract/ Subsidy (for one operator on each route)	Operator
EU Member States				
Denmark	Yes	Yes	Yes (3 lines)	
Estonia	No information available			
Finland	Free for residents	Government-owned and provided		
France (Corsica)	Yes	Yes	Yes	
Germany	No	No	No	
Greece	No	No	Yes	
Ireland	Yes	Yes	Yes	
Italy (Sicily)	Yes	Yes	Yes	
Malta	Yes	No	Yes	
The Netherlands	No	No	No	
Portugal	No passenger service	Yes	No	
Spain	Yes	No	Yes	
Sweden	Yes	No	Yes (Gotland only)	
UK (Scotland)	No	No	Yes	
Non-EU				
Canada (British Columbia)	No	Yes	Yes (60-year contract)	
Japan	No	No	Yes	
Norway	Yes	Yes	Some (trial basis)	

- 4.11 Subsidised island ferry services are often paid for by the national governments. The governments either have a central agency that deals with the procurement of lifeline services out of the state budget, or they delegate the responsibility to the local authorities where these services serve.
- 4.12 Even in cases where the contracting and regulating authority has been devolved to local governments, the local governments receive grants and subsidies from the central government in order to procure the services. Table 4.2 outlines the various government bodies involved in the regulation and procurement of lifeline services in the surveyed countries.
- 4.13 In Greece, the national budget supplies the funding for the lifeline services. In addition, a 3% surcharge is imposed on all other ferry services (not subsidised) in order to subsidise the thin routes.

TABLE 4.2 LIFELINE SERVICE REGULATORS IN SURVEYED COUNTRIES

Country	Service Procurer/ Regulator	Central or Regional/ Local Body
EU Member States		
Denmark	The National Rail Authority (Trafikstyrelsen)	Central
Estonia	Ministry of Economic Affairs and Communications Estonian Maritime Administration	Central
Finland	Passenger Transport Unit Ministry of Transport and Communications	Central (International PSO) Local (island ferry services)
France (Corsica)	l'Office des Transport de la Corse (Corsican Transport Office)	Regional
Germany (Schleswig Holstein)	Kreisordnungsbehörde	Regional
Greece	YEN	Central
Ireland	Department of Community, Rural and Gaeltacht Affairs	Central
Italy	Regional authorities (e.g., Regione Sicilia)	Regional
Malta	Ministry of Communications	Central
The Netherlands	Ministerie van Verkeer en Waterstaat (Ministry of Transport)	Central
Portugal	Regional Government of Azores and the Regional Government of Madeira	Regional
Spain	General Directorate of Merchant Navy	Central
Sweden	Rikstrafiken (National Public Transport Agency)	Central
United Kingdom (Scotland)	The Scottish Executive Transport Division 4: Maritime State Aids Unit	Central
Non-EU		
Canada (British Columbia)	BC Ferries Authority	Regional
Japan	Ministry of Transport	Central
Norway	Public Road Administration	Central, Regional, Local

4.14 In addition, tax relief is in essence another form of financial subsidy by the central government. On March 2002, the European Commission approved a Finnish scheme providing a subsidy to passenger vessels. The subsidy scheme gives EU seafarers working on board Finnish passenger ships a 97-percent reduction of withholding tax on their marine work income. The tax relief benefits Finnish passenger vessels engaged in international transport and calling regularly at Finnish ports.

5. PSC RISKS

- 5.1 Once a PSC is established to secure lifeline ferry services, issues surrounding contractual terms and procurement become imminent.
- 5.2 The treatment of risks and responsibilities is a central issue in the development of subsidised contracts for tendered services across all forms of transport.
- 5.3 With the creation of the European Union and the attempt to ensure a level playing field amongst EU countries, governments procuring public services from private operators and disseminating state aid must ensure that the procurement process is fair, open, and compliant with EC rules and regulations.
- 5.4 In this section, we will go over the risks confronting island ferry services, and analyse how they are managed in the surveyed subsidised ferry markets. These risks are, namely:
- Revenue
 - Operating Costs
 - Service Offer
 - Innovation
 - Safety
 - Regulation
 - Tender
- 5.5 The ways in which the subsidised services are defined, and how the contracts are defined, will consequently affect, mitigate, or re-distribute these risks amongst the government, the operators, and the users.

Revenue Risks

- 5.6 Revenue Risk is a central issue in the development of subsidised service contracts across all modes of transport. On one hand, the operator can take, as part of their income, revenues generated directly by passengers (farebox revenue), accepting potential fluctuations in this revenue stream, thus bearing revenue risks. On the other hand, they can receive a fixed income from the government in exchange for services provided. The government, in this case, effectively takes on the risks associated with variable revenues from users.
- 5.7 In cases where the operator bears the revenue risk, the operator has an incentive to maximise revenue generated from passenger demand. However, in a subsidised market where wider economic and social benefits play an important part, the governments usually intervene by controlling the service and fare levels. In this case, where the operator must adhere to a pre-agreed level of service at controlled prices, they would be keen to ensure that competition is minimised, and that protection is available in order to mitigate the revenue risks.
- 5.8 All of our surveyed administrators relayed that revenue (or demand) remains the biggest risks in the island ferry service market. There are two sources for these risks. First, demand for island ferry services is highly seasonal. Second, market-skimming

practices by new entrants can hugely affect the profitability of the operator under contract.

Operating Cost Risks

- 5.9 Cost fluctuations are considered to be a big risk by the governments surveyed. Due to the long contract duration (5 to 6 years), bidders have to project their operating costs very far in advance. Much can change during that timeframe, especially fuel prices. In response, some countries include clawback clauses, and make provisions for fuel price adjustments in their PSCs.
- 5.10 Inclement weather conditions not only lead to non-sailings, but can also increase the operating costs of the shipping company. In 2003, Saaremaa Laevakompanii (in Estonia) reported that the difficult ice conditions in the winter caused the company EEK 7.6mn (USD 520,000) in extraordinary expenses. The ice conditions damaged ships, and forced the company to make use of expensive icebreaker services. The ferry operator also had to use more fuel than usual. These costs were eventually covered by the operator's insurance.
- 5.11 Government subsidies constitute different proportions of the total operating costs of the lifeline services in different countries. In Denmark, the Danish central government covers up to one-third of the costs of ferry traffic to and from Bornholm. In Ireland, financial returns for subsidised ferry operators (profit after interest and tax as percentage of turnover) was between -8% and 27% in 2001/02.

Gross Cost vs. Net Cost Contracts

- 5.12 As we mentioned before, the situation across the EU is diverse. Governments take on different stances over the issues relating to revenues and operating costs risks. Overall, there are currently two broad types of PSCs in the surveyed countries: gross-cost contracts and net-cost contracts.
- 5.13 In Sicily, the regional government adopts gross-cost contracts, where the operator receives a pre-agreed fixed sum to cover operating costs. Under a gross-cost contract, the operator bears no revenue risk and is thus indifferent to the existence of competing services. These contracts require no protection.
- 5.14 The majority of the subsidised island ferry contracts, however, are net-cost contracts. In this case, the operator collects, and keeps, the revenue generated by the services, and receives a fixed subsidy from the government. The fixed subsidy is calculated based on forecasted demand, and of the subsequent forecasted operating deficit. Should the actual revenues fall below the projected levels, the operator would suffer a loss in profits. Operators under net-cost contracts with little influence over service schedule and prices would seek protection from competition. Table 5.1 summarises the type of contract adopted, and the protection available to operators, in each of the surveyed countries.

TABLE 5.1 SUMMARY OF CONTRACT TYPES IN SURVEYED COUNTRIES

Country	Type of Contract	Protection from Revenue Risks
EU Member States		
Denmark	Government-owned or joint-venture operators	
Estonia	No information available	
Finland	Government-operated services	
France (Corsica)	Net cost	Compensation can be adjusted by up to 4 % in line with the difference between actual revenue and the reference revenue laid down in the contract.
Germany	No service is currently defined as a lifeline service	
Greece	Net cost	Exclusive contracts renewed annually (revenues and costs are forecasted only one year in advance).
Ireland	Net cost	No explicit protection mechanism.
Italy (Sicily)	Gross cost	
Malta	Net cost	Operator can ask for a revision of the tariff structure at anytime during the contractual period
The Netherlands	No contract	No protection (naturally protected from competition by unique harbour conditions and high sunk costs of market entry)
Portugal	No contract	No protection
Spain	Net cost	None (currently). However, the new royal decree will impose PSOs on operators operating on the Public Services Lines.
Sweden	Gross cost	Government guarantees to cover all operating losses
United Kingdom (Scotland)	Net cost	Current Northern Isles contract contains a material change clause which provides some opportunity to revise subsidy where total revenue is less than expected. Scottish Executive is considering alternative approaches.
Non-EU		
Canada (British Columbia)	Net cost	Monopoly (exclusive contract)
Japan	Net cost	Exclusive contracts

Norway	Net and Gross cost	A variety of contract arrangements are in place and being evaluated. Coastal Voyage is an exclusive contract
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Service Level, Quality and Fares

- 5.15 Governments that procure ferry services are confronted with the risk of not getting the services that they desire, at socially optimal prices and quality.
- 5.16 Contracts can often specify the levels of service during peak and off-peak periods, and control fare fluctuations. In Greece, contracts specify that boats serving lifelines must be less than 35 years of age, and requires that operators have back-up vessels in case of breakdowns. However, Public Service Contracts should not be so onerous in terms of contract structure or setting over-optimistic prices that they drive operators into default.
- 5.17 Countries we have surveyed are moving towards establishing PSCs that create incentives for operators to provide good service, and penalise for failures. This is always coupled with monitoring mechanisms to ensure that operators are providing the contracted level of service. This is then linked to the periodic subsidy payments.
- 5.18 The incentivised gross-cost contract is a solution to ensuring service quality while protecting the contracted operator.

Innovation

- 5.19 The ways in which contracts and operations are designed determine operators' incentives to innovate in terms of service quality improvements.
- 5.20 If vessels and infrastructure are owned and operated by the government, private operators have little pressure and/or opportunities to adopt new technology and to introduce a better and possibly more efficient fleet.
- 5.21 The length of the contract influences operators' incentives to innovate. A contract duration that is too long, or one which bars entry of competition, means the contracted operator can afford to be complacent, thus having little incentive to continually improve service quality. On the other hand, a contract duration that is too short also deters operators from investing in capital equipment, for they cannot recover their investments in such a short timeframe.

Safety

- 5.22 Safety can be compromised as operators try to manage operating costs, fulfil service requirements, and perform within the confines of the contract.
- 5.23 In order to maintain the required level of service and to avoid non-sailing penalties, operators may be tempted to operate in inclement weather conditions, thus compromising the health and safety of passengers.
- 5.24 It is therefore important that incentives built into the contract must not conflict with safety.

- 5.25 In all countries surveyed, a central government body is in charge of the licensing of ferries. Licenses are granted based on each country's maritime and safety codes. The licensing body is often also the body that regulates and enforces safety standards.
- 5.26 The government authorities that classify and regulate public service obligation routes differ amongst the countries. In some countries, the national/central government decides and provides the subsidies, whereas in others the decision has been devolved to regional or local authorities. There are also examples where the central government collaborates with local authorities to support lifeline services.
- 5.27 Most lifeline services are monitored for two reasons. The first is to ensure that services meet safety and regulatory standards. The second is to control quality and to ensure that operators are fulfilling their contract obligations. Monitoring is done either by the agency overseeing PSOs, or by the maritime licensing/safety authority.
- 5.28 The following table summarises the licensing and ferry service regulating bodies in each of the surveyed countries.

TABLE 5.2 LICENSE AND SAFETY REGULATORS IN SURVEYED COUNTRIES

Country	Licensing/ Safety Regulator	PSO Regulator
Denmark	The Danish Coastal Authority	The National Rail Authority (Trafikstyrelsen)
Estonia	Estonian Maritime Administration	Ministry of Economic Affairs and Communications Estonian Maritime Administration
Finland	Finnish Maritime Administration	Passenger Transport Unit Ministry of Transport and Communications
France (Corsica)		l'Office des Transport de la Corse (Corsican Transport Office)
Germany (Schleswig Holstein)	See Berufsgenossenschaft	Kreisordnungsbehörde
Greece	Ministry of Merchant Marine (YEN)	Ministry of Merchant Marine (YEN)
Ireland	Marine Survey Office	Department of Community, Rural and Gaeltacht Affairs
Italy	Ministry of Infrastructure and Transport	Regional authorities (e.g., Regione Sicilia)
Malta	The Malta Maritime Authority	Ministry of Communications
The Netherlands	Ministerie van Verkeer en Waterstaat	Ministerie van Verkeer en Waterstaat
Portugal	National Council for Ports and Sea Transport (CNPTM)	Regional Government of Azores and the Regional Government of Madeira
Spain	General Directorate of Merchant Navy	General Directorate of Merchant Navy
Sweden	Sjöfartsverket (Swedish Maritime Administration)	Rikstrafiken (National Public Transport Agency)

United Kingdom (Scotland)	The Maritime and Coastguard Agency	The Scottish Executive Transport Division 4: Maritime State Aids Unit
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Regulatory Risks

- 5.29 European Union rules seek to level playing fields, but can in effect compromise local objectives in maximising economic benefits.
- 5.30 In addition, EU countries have to abide by European laws regarding tendering and contracting procedures. Countries whose domestic island ferry cabotage rules and contracting procedures are in violation of Council Regulation EEC 2577/92 are warned and can be brought to court.
- 5.31 The following table summarises formal action taken by the Commission against member states since the Legislation came into effect in 1992.

TABLE 5.3 INFRINGEMENTS OF EEC 3577/92

Country	Reference	Content	Resolution
Spain		In December 1998, the European Commission opened an investigation into state financing made available to the publicly-owned Spanish company Compania Trasmediterranea S.A. (Transmed) to exploit ferry services between the Spanish mainland and various islands.	Following the investigation Spain was required to re-tender the ferry services.
Spain	C-205/99	Royal Decree No 1466 was inconsistent with Community law, in particular Articles 1, 2 and 4 of Council Regulation (EEC) No 3577/92	Spain changed from an "authorisation" system to a "notification" system. Royal Decree is being re-written to comply with Community law.
Portugal		An infringement procedure was started against Portuguese decree-law No 194/98 of 10 July 1998 on maritime cabotage. The Commission sent a reasoned opinion to the Portuguese authorities inviting them to amend the text to bring it into line with Council Regulation (EEC) No 3577/92.	Portuguese authorities have committed themselves to revising the text in question. The Commission decided not to submit the matter to the Court of Justice.
France	IP/02/1226	The European Commission initiated a formal investigation procedure into the proposed restructuring aid to Société Nationale Corse-Méditerranée (SNCM), examining the restructuring plan to check whether the aid proposed is compatible with European state-aid rules, notably to assess any distortion of competition and to ensure that	In July 2003, the EC delivered the judgement that the restructuring aid was legitimate, on the grounds that it would prevent SNCM's competitor from monopolising the market.

		the plan can restore the company to long-term health and viability.	
Greece	IP/04/159	The Greek legislation of 2000 did not appropriately reflect the EU basic principle according to which public service obligations can be imposed on ship-owners performing island cabotage in the event of market failure to provide adequate services. Moreover, some of its provisions are also in breach of EU legislation, such as the requirement that all the non-Greek members of the crew should hold a certificate proving their knowledge of the Greek language.	The Commission informed the Greek authorities about these issues in 2001, when the national legislation was enacted. Now that the period of the temporary exemption has expired, the Commission has taken further action. The Commission sent a letter of formal notice to Greece on 3 February 2004.
Italy		In 1999, the European Commission opened a State aid investigation against Italian ferry company Gruppo Tirrenia di Navigazione with regard to subsidies paid by the Italian authorities to the six companies of the ferry group Gruppo Tirrenia di Navigazione. The Commission has serious doubts as to the way in which the PSOs have been entrusted to Tirrenia and other companies in the group. It appeared that it was not the State itself which set the PSO requirements but the companies, even though the format must be approved by the State.	The investigation never materialised into a law suit.

Tendering Risks

- 5.32 Tendering risks refer to when the tendering process does not yield a desired level of competition or results. These risks would result in a tendering exercise with a lack of bidding interests, a set-up where playing fields are not level, or where the winning bidder cannot carry out the contract.
- 5.33 Tendering risks are a function of regulations and the definition of the tendering terms.
- 5.34 Bearing such risks in mind, the tendering of public service contracts must not be so onerous that competitive bids are not received. The transfer of risks should be balanced and managed in order that a tendered service is possible.
- 5.35 Access to required capital equipment, such as vessels, harbour facilities, and marketing/distribution channels, are prerequisites for private operators to compete and operate in the subsidised ferry market.

6. RISK MANAGEMENT AND CONTRACT PROCUREMENT

6.1 Our case studies reveal a variety of contractual arrangements and risk allocation mechanisms in the procurement of island ferry services in Europe and abroad. In this report, we have chosen to concentrate on the most common risks, as well as widely adopted mechanisms designed to manage them.

Revenue and Cost Risk Management

6.2 Cost fluctuations are considered to be a big risk by the governments surveyed. A popular response amongst countries is to include clawback clauses, and make provisions for fuel price adjustments within the PSCs.

6.3 In response to revenue risks and fluctuations in demand, contracts may include revisions to the subsidy amount up to a ceiling, or may include revised fares.

6.4 Inclement weather conditions not only lead to non-sailings, but can also increase the operating costs of the shipping company. PSCs may detail what happens and who bears the costs in case of unsafe sailing weather.

Service Requirements and Quality

6.5 Public Service Contracts should not be so onerous in terms of contract structure or over-optimistic prices that it drives operators into default.

6.6 PSCs should incentivise operators to provide good service, and should penalise for failures. This would require close monitoring of the operations and the penalties may be subject to challenge and negotiations.

6.7 The incentivised gross-cost contract is a potential solution to ensuring service quality while protecting the contracted operator.

Innovation

6.8 The definition of the subsidised network should be market-driven. Economic benefits and commercial interests ought to be taken into account when designing the tender.

6.9 The design of the contract should incentivise service improvements and efficiency.

6.10 As such, we recommend that PSCs should be of:

- Limited tenure to allow for changes to be incorporated;
- Sufficiently long duration to allow for recuperation of any capital investment.

Safety

6.11 Incentives built into the contract must not conflict with safety.

6.12 Sailing in bad weather conditions is a big risk. In response, PSCs may want to detail what happens in case of inclement weather.

Tendering

6.13 The tendering of public service contracts must not be so onerous that competitive bids are not received.

- 6.14 The transfer of risks should be balanced and managed in order that a tendered service is possible.
- 6.15 Access to required capital equipment, such as vessels, harbour facilities, and marketing/distribution channels are pre-requisites for private operators to compete and operate in the subsidised ferry market.

The Maritime Cabotage Regulation

- 6.16 Council Regulation (EEC) 3577/92 (the Regulation) applies the principle of freedom to provide services to maritime transport within European Union Member States. The goal of the EC directive aims to promote competition and non-discrimination amongst Member States.
- 6.17 There are, however, three derogations specified in the Regulation. Firstly, Member States have the power to impose manning rules on board vessels performing island cabotage services between two ports in the territory. Secondly, Member States may impose public service obligations on ship-owners in order to ensure an adequate level of services. Lastly, Member States may ask the EC to adopt safeguard measures to remedy a serious disturbance of the internal market. Articles 3 and 4 of the Regulation are most relevant to the purpose of this study.
- 6.18 In 2003, the Commission adopted a communication on maritime cabotage with a view to simplifying the rules concerning small islands. The Communication provided for an exemption for small islands from the legislation EC 3577/92, which applied the cabotage rules indiscriminately to islands irrespective of size. The unique situation of small islands led the Commission to consider that public service contracts for maritime services to small islands should be awarded simply on the basis of a call for expressions of interest, rather than the full tender process. “Small islands” are understood to be islands where the total annual number of passengers carried by sea to and from the island is around 100,000 or fewer. Where the same operator services several small islands, the total number of passengers carried by that operator in the context of the public service is taken into account when determining whether the threshold is reached. The European Commission believes that 40% of the islands in the European Union will, in the future, fall into this category.
- 6.19 On 22nd December 2003, a communication from the Commission to the European Parliament (COM(2003) of 22/12/2003) was presented, for information only, about the interpretation of Regulation 3577/92, however, no alteration to the Regulation has been proposed.
- 6.20 Steer Davies Gleave consultants met with administrators from the European Commission’s Directorate-General for Energy and Transport in Brussels during the course of this research study. The objectives of the meeting were to:
- Understand how the rules regarding maritime cabotage and Public Service Obligations/ Contracts have changed, and to confirm and clarify our understanding of regulation 3577/92 and the subsequent communications (especially the most recently published *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 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) COM/2003/0595 ; and

- Gauge the Commission's data and understanding of the situations in the member states, so as to identify issues that researchers should pay particular attention to in the course of our research. Our conversations concentrated heavily on the Commission's stance on the bundling of routes, exclusivity, manning and vessel ownership.

Bundling

- 6.21 Member States are free to decide on whether to tender the subsidised services as individual routes, or as a bundle(s). Recently, Greece was denied the ability to bundle popular services with non commercially viable ones on the grounds of cross-subsidy.

Exclusivity

- 6.22 The Commission believes that exclusivity should be applied as a last resort. Other means should be considered first to mitigate the competition risks confronting the Public Service Contract (PSC) operator. For example, if skimming activities do take place, where operators enter the market during the peak season, the government can then also impose a PSO on that particular route. The PSC would then run alongside the PSO. The PSO must be a light one.

Crew

- 6.23 In general, manning rules of the Member States apply. These rules, however, cannot distort the goal of the EC directive, which aims to promote competition and non-discrimination. Member States can prohibit non-European Union crew from bidding or manning the PSO routes, but cannot extend it to other Member States (including the EEA countries, such as Norway). While a country can impose a language and nationality requirement out of safety reasons, it must be deemed reasonable by the Commission.
- 6.24 EEC No 3577/92 prohibits Member States from obligating an operator to take over crew from its predecessor.

Vessels

- 6.25 As Members States liberalise their cabotage and privatise / tender formerly government-run operations, the fleets are usually owned by private operators. Based on our research to date, almost none of the governments directly own the vessels that service the PSO routes (with the exception of Ireland, where the government is currently in the process of selling its last remaining vessel and Scotland where the Clyde and Hebrides fleet is owned by a limited company which is, in turn, owned by the Scottish Executive). Regarding the taking over of vessels, Article 5.3.2.1 of the Communication COM/2003/0595 specifically addresses the situation in Scotland. The Commission reiterated that where serving an island requires the use of a vessel with a unique design, the vessel could in this case be leased under very clear conditions set out in the tender documents. It is also possible for the new operator to take over the vessel(s) directly from its predecessor. This condition, however, does not extend to the crew on the vessel.

Ports

- 6.26 The Commission indicated that the proposal for a directive on freedom to provide services to ports has been adopted by the Directorate-General, but still needs to go through proceedings. Until then, the Commission's stance on staffing, pilotage, towage and mooring at ports has not yet been clarified.

Freight

- 6.27 Member States have different provisions in their PSCs in relation to freight transport. For example, in Portugal, the subsidised ferries between the mainland and the Azores only carry freight, whereas in Spain, the Public Interest Services routes only pertain to passenger transport and no freight transport is subsidised. In Greece, an operator can be contracted to transport both freight and passengers on the thin routes. In Ireland, there is a trend towards separating contracts for freight from those for passengers for reasons related to health and safety, and flexibility. In some cases, such as in Ireland and Malta, the PSC operator has separate contracts with the government to carry mail and garbage.
- 6.28 There is no separate treatment of freight from passenger PSOs according to the European Commission. Other contracted services with the government, such as mail and garbage collection, also have to be tendered openly.

Procurement and Tendering

- 6.29 Countries where private operators provide lifeline services under public service contracts are moving towards competitive tenders.
- 6.30 The early joiners, such as France, Italy, Portugal and Spain, had an earlier start in their market liberalisation process. As a result, they have managed to openly tender and procure their domestic lifeline services in compliance with the EC regulation.
- 6.31 In Sicily (Italy) slow ferry services to the minor islands are undertaken by a state-private joint venture, Siremar (it is partly owned by private company Tirrenia). These contracts are still in operation, and provide a public service that is stipulated directly by the Ministry. These contracts will expire in 2005, at which point they will be substituted by standard PSO contracts let by the Region, as was done for the fast passenger and freight services.
- 6.32 Greece enjoyed a derogation until early 2004, and, along with Scotland and Malta, is currently drafting new tenders and contracts. The Maltese PSO services will be tendered openly by 2010. There is currently no plan in place to prepare for the tender. As the first contract only began in 2004, the Maltese Government is going to observe the current contract and see what the problems and difficulties may be before drafting the new tender and contract.
- 6.33 The more recently ascended countries, such as Finland and the Baltic Countries, have started re-shaping their markets. It may be another 3 to 6 years before an open tender will happen.
- 6.34 The degree of competition, however, differs amongst the surveyed countries. The degree of competition is influenced by the nature of the routes and the capabilities of local operators. For example, in Malta, the government predicts that the contract for the Gozo services will go to a foreign operator due to lack of domestic capabilities. In

the case of the Netherlands, the unique design of the vessels highly increases the costs of market entry for new operators, therefore minimising the degree of competition in the market.

6.35 Amongst the countries that have successfully tendered their PSCs to date, almost all of the final contracts were awarded to domestic operators. A prevalent reason for this is that the islands are so remote and the sunk costs of setting up operations are so high that foreign ships are unlikely to be able to compete.

6.36 Table 6.1 summarises the status of the PSC tendering process in the surveyed EU countries.

TABLE 6.1 PSC AND TENDERING STATUS FOR SURVEYED EU COUNTRIES

Country	Contract (for one operator, minimum requirements, subsidised)	Are current services provided in compliance with EU rules?	Future plans (to bring services into compliance with EU rules)
Denmark	Yes (3 lines)	Some	In the process of drafting new law covering EU-compliant ferry rules.
Finland	No	No	Moving towards open tender for all island ferry services, will likely to take at least three years.
France (Corsica)	Yes	Yes	
Germany	No	Yes	
Greece	Yes	Yes	
Ireland	Yes	Yes	Plans to un-bundle contracted services to the Aran Islands.
Italy (Sicily)	Yes	Yes	
Malta	Yes	No	PSO services will be tendered openly by 2010. There is currently no plan in place to prepare for the tender.
The Netherlands	No	N/A	
Portugal	No	N/A	
Spain	Yes	Yes	The Merchant Navy is going to pass a new Royal Decree this year to impose a minimum level of service (PSO) on the Public Service routes.
Sweden	Yes (Gotland only)	No	A new tender will go out in autumn 2005, with a shorter contract duration (five years).
UK (Scotland)	Yes	Some	Re-tender the Northern Isles services ahead of schedule; at time of writing reviewing requirement to tender the Clyde and Hebrides services.

