Scottish Executive: The NorthLink ferry services contract

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AUDIT SCOTLAND

Auditor General for Scotland

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Summary

1. The Scottish Executive Transport Group (SETG) has responsibility for devolved transport matters, including ferries. Prior to devolution SETG was part of the then Scottish Office Development Department, which became the Scottish Executive Development Department in July 1999. In May 2003, SETG transferred to the Scottish Executive Enterprise, Transport and Lifelong Learning Department.

2. NorthLink is a joint venture between Caledonian MacBrayne (CalMac) and the Royal Bank of Scotland (RBS) which provides lifeline ferry services between the mainland of Scotland and the Orkney and Shetland Islands (the Northern Isles). It began operations in October 2002 in succession to P&O Scottish Ferries (P&O) following a competitive tendering exercise by SETG. Under a five-year contract, SETG undertook to pay NorthLink basic subsidy of £45.7 million (at April 2000 prices) to meet the net cost of carrying passengers and accompanied cars. The basic subsidy payable was to be uprated in line with inflation and supplemented, if necessary, as a result of the application of 'material change' provisions in the contract.

3. In April 2004, the Minister for Transport announced that, following financial difficulties faced by NorthLink, the contract was to be re-tendered early. In August 2005, following further reports in the media that the total amount paid to NorthLink had risen to £63 million, the Auditor General asked Audit Scotland to examine

    - Whether the competition was executed fairly, regularly and in accordance with good project management practice so as to achieve value for money
    - Whether the Scottish Executive managed well subsequent negotiations with NorthLink concerning claims for additional financial support consistent with achieving value for money
    - Whether the Scottish Executive established robust and clear arrangements for managing the contract once the contract period began
    - What the Scottish Executive is doing to ensure the continuity of lifeline service to the Northern Isles.

How the competition for the Northern Isles ferries contract was executed

4. SETG carried out a generally robust tendering exercise which, although it took longer than originally expected, was undertaken in a demanding timeframe because of the need for new vessels in 2002. There were some limitations on the information made available to bidders by the existing operator. NorthLink was awarded the contract because it submitted the lowest compliant bid for subsidy.

5. SETG's principal objective for providing lifeline transport services was to sustain the remote communities of the Northern Isles by ensuring transport costs to and from the islands were not excessive and that good accessibility to the mainland was maintained. SETG's preferred option was to offer a subsidy to a shipping operator after a competitive tendering exercise, with the private sector providing funding for the capital costs of new vessels. New ferries were expected to be required because P&O's vessels were old and, in their current configuration, would not meet new maritime safety regulations effective from October 2002.

6. EC guidelines on state-aid to maritime transport require contracts to be awarded to the bidder submitting a compliant bid and requiring the lowest financial compensation. The EC guidelines which then applied usually also limited the contract length to no more than five years. SETG were concerned, however, that this could increase the subsidy payable because there was no guarantee that the successful bidder would win a subsequent tender exercise. Potential operators might therefore base their bids for financial compensation on fully depreciating the 25-year life of the new vessels over the shorter contract period. After detailed negotiations over a period of 17 months, the EC agreed that SETG should set a maximum affordability price for the five-year contract. If bids for a five-year contract were less than the affordability price, no other contract duration options would be considered.

7. SETG formed multidisciplinary teams to provide control over the procurement process for the Northern Isles ferries contract and developed a clear project plan. The complex negotiations with the EC over the contract duration took longer than expected, however, and contributed to the contract not being signed until December 2000, a year behind schedule. SETG met the key objective of having new vessels in place before the new maritime safety regulations came into force in October 2002. To ensure service provision up to the contract start date, SETG negotiated a six-month extension of the P&O contract at a cost of £8 million, using the extension clause that was included in the contract.

8. SETG provided a clear specification of requirements to bidders which was informed by consultation with representatives of the Northern Isles and other interests. In accordance with good practice, the Invitation to Tender (ITT) was based on what service levels and outputs SETG required from the contract, with bidders left to design and cost a service which met the standards sought. The ITT clearly identified that the winning bidder was expected to bear the operational risk of its costs being higher than expected or demand for the ferries being lower but within the context of the material change provision that would be available.

9. Much of the information which SETG made available to bidders was provided by the existing operator though there were limitations to the information which P&O was able to release. NorthLink was concerned about two aspects of this information. NorthLink guaranteed the terms and conditions of maritime staff who transferred from P&O but considered that the information made available did not allow it to form an accurate view of what these costs would be. Additional costs arising under this heading were subsequently covered by material change provisions in the contract. NorthLink also found it difficult to form an accurate view of the total volume of freight previously carried by P&O.

10. Six ferry operators were shortlisted and three ultimately submitted bids. One of the three was subsequently ruled out because it proposed conditions which SETG considered unacceptable, and it was also the highest bid. NorthLink's bid for basic subsidy of £45.7 million was within the affordability price set for the five-year contract and was £14 million cheaper than the equivalent P&O bid, the only other remaining bidder. NorthLink's costs were higher than P&O's but it anticipated generating about £8 million more passenger income and £13 million more from freight surpluses because its traffic growth assumptions were higher. It was also prepared to accept less profit from the contract than P&O.

11. SETG reviewed bidders' cost and income assumptions and also carried out sensitivity analysis on the bids. The results of this analysis suggested that even if no passenger growth was achieved, losses could be contained within NorthLink's available working capital. However, due to a combination of lost income and additional costs that SETG did not anticipate from this analysis, this was not the case. As is normal in this form of contract, the operator carried the risk relating to errors in assumptions.

How SETG managed negotiations with NorthLink concerning additional financial support

12. NorthLink got into financial difficulties because competition reduced its income and some of its costs were higher than expected. SETG made additional payments in accordance with the terms of the contract but this was insufficient to solve NorthLink's cash flow problems.

13. NorthLink was concerned about its ability to deliver the contract before it went operational and again within three months of it beginning service provision in October 2002. Financial difficulties largely arose as a result of competition from Pentland Ferries which commenced operations in spring 2001, and Norse Island Ferries which was created in 2002 by a group of hauliers concerned about the higher freight prices which NorthLink proposed charging. Some of NorthLink's costs were also higher than expected.

14. In response to NorthLink's financial difficulties, SETG agreed to restructure the timing of subsidy payments and to make initial additional payments of £0.6 million in respect of certain extra costs covered by the 'material change' clauses in the contract. SETG did not pay other material change claims at that time because it was not persuaded as to their legitimacy based on available information.

15. These payments did little to help NorthLink's financial difficulties. By summer 2003 the company was indicating that it was unlikely to be able to deliver the remainder of the contract and it was likely to default on either its next £0.7 million vessel leasing payment or a £0.5 million wages bill. SETG provided additional emergency funding of £0.5 million but NorthLink indicated that it needed £3 million to avoid legal action by creditors to enforce debt recovery. In the event, NorthLink defaulted on both its July and August 2003 vessel-leasing payments.

16. In August 2003, SETG decided it would need to re-tender the Northern Isles ferry service contract because NorthLink could not continue within the terms of its contract and in order to comply with EC guidelines. SETG's priority was to secure the continuity of the 'lifeline' services, and it considered that allowing NorthLink to go into administration would not guarantee this. Following consultation with ministers, SETG decided to negotiate an interim contract so that NorthLink would continue to operate while a new tender exercise was carried out.

17. The revised contract, agreed in September 2004, is based on monthly subsidies paid to NorthLink on the basis of forecast cash projections. SETG will finance any cash deficits which NorthLink incurs but the revised contract also provides some incentive to the company by allowing additional payments to be made if its financial performance exceeds expectations and other performance standards are maintained.

How SETG has managed the NorthLink contract

18. SETG monitoring of NorthLink's performance found that services have operated reliably and to a good standard. In its first three years to September 2005, SETG has paid NorthLink £71 million.

19. SETG has monitored NorthLink's performance against the terms of both the original and revised contracts. NorthLink's regular performance reports to SETG indicate that ferry services have

operated reliably and punctually, and have been largely well received by passengers and businesses.

20. Since NorthLink began operating, SETG has paid the company £71.0 million. SETG has paid basic subsidy of £33.6 million (including increases for inflation allowed for in the contract), other payments of £16.7 million allowed for under the terms of the original contract, and additional funding to maintain the delivery of lifeline services totalling £18.2 million. SETG also provided a further £2.5 million to pay off in one instalment leases related to some of the assets used by NorthLink. As a result, SETG secured control of these assets which it intends to offer for sale to the next operator.

The new contract arrangements for the Northern Isles ferries service

21. The proposed terms of the future Northern Isles ferry services contract reflect SETG's view on the appropriate balance between the twin priorities of securing service continuity and the transfer of operational risks.

22. Re-tendering of the Northern Isles ferries contract began in April 2004 so as to secure a contract from April 2006. SETG has worked with NorthLink to provide more detailed information than was available under the earlier tender exercise.

23. SETG has concluded that an appropriate balance has to be struck between the twin priorities of ensuring the continuity of lifeline services and transferring operational risks on to the new operator. The proposed contract does not seek to transfer all such risks to the operator and recognises that costs can be higher and income lower than expected for reasons beyond the operator's control. It will therefore provide some protection to the new operator by allowing SETG to pay additional subsidy in certain circumstances. Should income fall or costs rise sufficiently in any one year, SETG will only consider paying additional subsidy if the operator's losses exceed £750,000 in any one year.

Overall conclusions and recommendations

24. Lifeline ferry services are fundamental to the people of the Northern Isles. The ferries supply them with basic living commodities, provide transport links to the mainland and support their economic well-being. When NorthLink got into financial difficulties which threatened continued operations, SETG considered, on the basis of legal advice, that it had little option than to make additional payments to secure the services and to bring forward the early re-tendering of the routes.

25. The NorthLink ferry services contract illustrated the difficulty in reconciling the need to ensure continuity of lifeline services with EC guidelines on state-aid to maritime transport if the service provider gets into financial difficulties. In subsequent lifeline ferry services contracts it will be important to reconcile the social requirements with EC guidelines on state-aid to maritime transport

in order to avoid tensions if costs exceed contractual subsidy levels. SETG considers that the new form of contract seeks to ensure this.

26. This examination also serves as a timely reminder of the need to ensure in any tendering exercise involving complex issues such as negotiations with the EC, where the timings and outcomes may be difficult to control, that project plans remain sufficiently flexible to allow key project objectives to be delivered. Progress should be monitored closely against the plan, risks to its delivery and the consequences of delay identified and assessed, and sound contingencies developed to deal with these. The SETG had to deal with complex issues arising from the requirement to award a contract which was shorter than the life of the new ferries and it developed an innovative solution to do so. These issues and negotiations with the EC took longer than expected, reflecting the complexities involved. However, they did not prevent the new ferries being operational from October 2002. As a result of the delay, SETG was required to extend P&O's contract by six months at a cost of £8 million, using the extension clause that was included in the contract.

27. The NorthLink tendering exercise also reinforces the general message that good-quality information is important to bidders so as to provide assurance as to their likely costs. This is particularly important in contracts involving the transfer of operational risk to service providers where the consequence of uncertainty is likely to be more expensive bids. SETG has taken steps to provide more detailed information in the new tendering exercise.

Part 1: Introduction

Northern Isles ferry services

1.1 The Orkney and Shetland Islands (the Northern Isles) are home to some 41,000 people. Excluding the public sector, about 40% of the working population are employed in agriculture, fisheries or tourism. Good ferry links are essential to the islanders to provide basic living commodities and transport connections, and to support the economic wellbeing of the islands by exporting agricultural produce, and importing holidaymakers and other visitors.

1.2 Four operators currently provide ferry services to the Northern Isles (Exhibit 1). The largest of these is NorthLink, a joint venture involving Caledonian MacBrayne (CalMac) and the Royal Bank of Scotland (RBS). NorthLink runs two ferries carrying passengers, cars and freight between Aberdeen and the Orkney and Shetland Islands and another crossing the Pentland Firth between Scrabster and Stromness in the Orkney Islands. It also operates two freight-only vessels between Aberdeen and the Northern Isles (Appendix 1). In the year to 30 September 2005, NorthLink carried around 300,000 passengers, 67,000 cars, 287,000 lane metres of freight, 19,000 cattle and 130,000 sheep.

Scottish Executive financial assistance to ferry operators

1.3 Responsibility for devolved transport matters within the Scottish Executive rests with the Scottish Executive Transport Group (SETG). Prior to devolution, SETG was part of the then Scottish Office Development Department, which became the Scottish Executive Development Department in July 1999. In May 2003, SETG transferred to the Scottish Executive Enterprise, Transport and Lifelong Learning Department. For consistency, the term SETG is used throughout the rest of this report.

1.4 SETG currently provides funding to NorthLink under the Highlands and Islands Shipping Services Act 1960, whereby the Scottish ministers may provide financial assistance to operators for the purpose of maintaining and improving sea transport services serving the Highlands and Islands[1]. The Scottish Executive views subsidised ferry services to the Northern Isles as maintaining a 'lifeline' link. These lifeline services are not defined in statute but SETG provides financial assistance to reduce the cost of travelling between the mainland and the Northern Isles, with the general purpose of maintaining the viability of the islands and to retain their populations.

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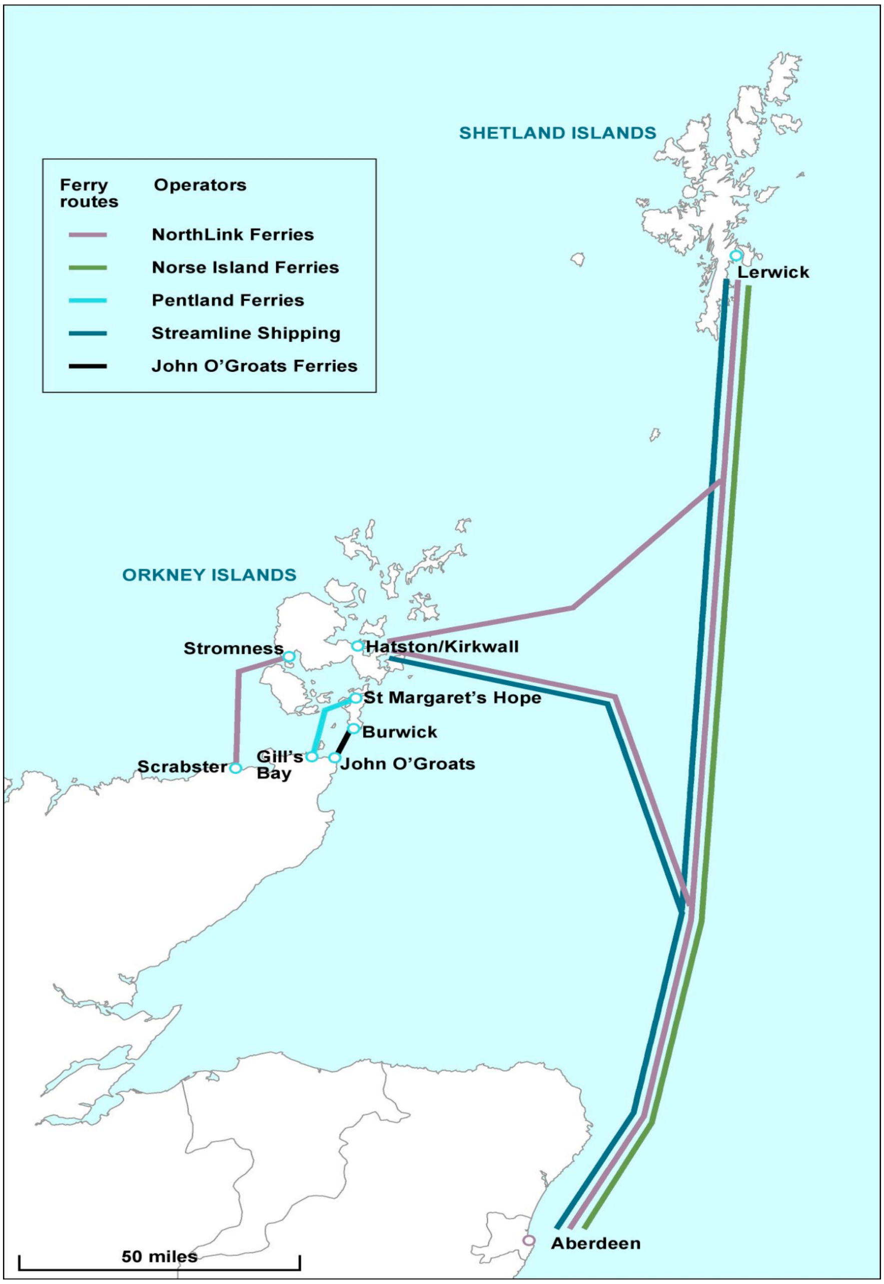
[1] The Highlands and Islands Shipping Services Act 1960 has largely been repealed. Section 70 of the Transport (Scotland) Act 2001 now provides Scottish ministers with wider powers such that they may make grants for any purposes relating to transport.

Exhibit 1

Ferry services to the Northern Isles



NorthLink operates two combined passenger car and freight vessels and two freight and livestock vessels between Aberdeen and the Northern Isles. It also operates a combined passenger, car and freight vessel on the shorter Pentland Firth crossing.

Pentland Ferries began providing a combined passenger, car and freight service across the Pentland Firth in spring 2001.

John O'Groats Ferries also operates a small passenger-only ferry on the Pentland Firth route but in summer only.

Streamline Shipping Group Ltd has operated a containerised freight vessel out of Aberdeen for many years.

Norse Islands Ferries, also operated one, and at times two, freight-only vessels between September 2002 and June 2003.

Source: Audit Scotland

1.5 Before 1997, the then Scottish Office provided financial assistance to shipping operators in the form of the Tariff Rebate Subsidy (TRS). Under the TRS scheme shipping operators' tariffs were discounted by a fixed percentage with the user of the service paying the net price after subsidy. This, however, encouraged excess capacity, low freight rates and undermined the financial viability of the main Northern Isles ferries operator, P&O Scottish Ferries Ltd (P&O). After a review, the Scottish Office decided that TRS for lifeline passenger ferry services should be replaced by a block grant awarded through a competitively tendered contract[2].

1.6 The block grant provided a subsidy to the operator to meet the net cost of carrying passengers and accompanied cars plus a profit element. Freight services were not covered by the block grant but the Scottish Executive contract required the operator to have the capacity to carry freight and encouraged operators to develop other freight services. Financial surpluses from the carriage of freight were expected to offset the subsidy required to provide passenger and accompanied car services.

1.7 P&O won the first contract to operate the lifeline ferry routes between April 1997 and March 2002 at a cost of some £55 million. In December 2000, after another competitive tendering exercise, the Scottish Executive announced that NorthLink would take over the running of the service from P&O for a further five years. SETG expected to pay NorthLink basic subsidy of £45.7 million (at April 2000 prices) over the lifetime of the contract, which would be uprated in line with inflation and supplemented, if necessary, as a result of the application of 'material change' provisions in the contract.

Why this study was carried out

1.8 In April 2004, the Minister for Transport announced that lifeline ferry services to the Northern Isles were to be re-tendered early. This reflected a need to secure a continuity of service in light of financial difficulties faced by NorthLink. SETG had paid NorthLink an additional £13.4 million on top of its basic subsidy up to this point. Revised payment arrangements had been implemented so that the company could continue to provide services until the new contract was awarded.

1.9 In August 2005, by which time the media were reporting that the total amount paid to NorthLink had risen to £63 million, Audit Scotland undertook an examination of the payments made under the NorthLink contract. Audit Scotland considered:

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[2] SETG continues to pay TRS for livestock shipments at a cost of around £750,000 per year.

- Whether competition for the contract was executed fairly, regularly and in accordance with good project management practice so as to achieve value for money
- Whether the Scottish Executive established robust and clear arrangements for managing the contract once the contract period began
- Whether the Scottish Executive managed subsequent negotiations with NorthLink well, particularly claims for additional financial support consistent with achieving value for money
- What the Scottish Executive is doing to ensure the continuity of lifeline service to the Northern Isles.

Part 2: The Scottish Executive's award of the contract

Northern Isles ferry services

2.1 This part of the report sets out SETG's procurement strategy and its approach to awarding the contract to NorthLink. It considers the extent to which:

- SETG established clear objectives for the contract, consistent with promoting and achieving value for money
- The competition was well planned
- The contract was adequately scoped to reflect those objectives and provide bidders with sufficient clear information to enable high-quality bids
- The bidder selection process was conducted fairly and in accordance with good practice.

Procurement strategy

SETG set clear objectives for providing lifeline transport services to the Northern Isles and concluded these would be best served by awarding a further subsidy contract to a private shipping operator

2.2 The high costs of providing transport services to and from the mainland mean that, without government intervention, the market would not provide an adequate transport service to the Northern Isles. SETG's principal objective was therefore to sustain the remote communities of the Northern Isles by ensuring the cost of transporting passengers and accompanied cars to and from the islands was not excessive and that good accessibility to the mainland was maintained.

2.3 In determining how best to meet this principal objective, SETG also set a number of subsidiary objectives:

- Transport services should be provided at best value for money/minimum cost to the public purse.
- The service should not be over-specified, that is it need not provide any more than a lifeline service.

- The implementation of any new procedure for the provision of transport services to the Northern Isles should not excessively disrupt local economies.

- Intervention should not cause excessive distortion of free markets. Subsidy for the provision of passenger services should not be allowed to cross-subsidise freight services with commercially run operations.

2.4 SETG concluded that offering a subsidy to a shipping operator represented its best option. The 'do-nothing' option was rejected because of concerns there was insufficient market to attract an operator without subsidy. An option of a passenger subsidy to an air operator (with cars and freight continuing to be carried by ferry) was also rejected because it would cost more and would not improve service reliability.

2.5 Private sector funding for vessel acquisition was preferred because new vessels were expected to be required for the routes. P&O's ferries were old and, in their current configuration, would not meet new maritime safety regulations effective from October 2002[3]. Compliant second-hand vessels were not expected to be available. Private sector funding for the capital cost of the vessels was expected to provide efficiencies in their procurement. The option for the Scottish Executive to procure the new vessels was ruled out because of concerns about the affordability of the estimated £100 million construction and fitting-out costs.

SETG's procurement strategy followed EC guidelines on the duration of the contract and recognised the potential impact this would have on the amount of subsidy payable

2.6 The then Secretary of State for Scotland announced in July 1997 his intention to award a longer-term contract commencing in 2002 subject to discussions with the EC. But EC guidelines on state-aid to maritime transport, also issued in July 1997, place restrictions on ferry contracts. Member states may only provide financial assistance if the shipping operator is contracted to provide a prescribed service which it would not be expected to provide on a normal commercial basis (a Public Service Contract). Under the EC guidelines which then applied, member states could usually only award a Public Service Contract after an open tender exercise with the contract length limited to no more than five years (now increased to six years). Unlike normal EC procurement guidelines where contracts can either be awarded on the basis of the most economically advantageous bid or the lowest tender, contracts under the state-aid to maritime transport guidelines can only be awarded to the bidder submitting a compliant bid and requiring the lowest financial compensation as reimbursement for the extra costs incurred in providing the service.

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[3] Maritime safety regulations were revised following the sinking of the MV Estonia with over 850 fatalities in 1994. Eight European states, including the UK, agreed to set higher new standards of ship stability in what is known as the Stockholm Agreement of 1997.

2.7 SETG was concerned that awarding a contract for only five years could increase the total amount of subsidy payable. Because there was no guarantee that the successful bidder would win a subsequent tender exercise, SETG was alert to the possibility that potential operators would base their bids for financial compensation on fully depreciating the 25-year life of the new vessels over the shorter contract period.

2.8 In June 1998, SETG approached the EC about contract duration options. These negotiations continued until November 1999 when the EC agreed that bidders should be invited to bid on the basis of contracts of five- and eight-years duration plus a contract duration which bidders regarded as optimum. SETG was also to set an ‘affordability’ price for the five-year contract which reflected its assessment of the maximum subsidy it was willing to pay consistent with achieving value for money. If five-year bids were received which were less than the ‘affordability’ price, only the five-year contract would be considered.

Procurement process

SETG formed multidisciplinary teams to provide control over the procurement process

2.9 SETG adopted a systematic and methodical approach to planning the procurement process. A Tender Working Group (TWG) was established with responsibility for leading the procurement project. Membership of the TWG comprised representatives of SETG’s Transport Group and staff from the Scottish Executive’s economic and advisory services, solicitors, accountancy services, finance and procurement divisions. Membership also included a maritime consultant, appointed after a tendering exercise, to provide technical advice on the preparation of SETG’s service specification and on any bids received. The TWG met regularly to undertake the detailed planning, evaluation and other work associated with the tendering exercise.

2.10 SETG also formed a Project Steering Group (PSG) to monitor the work of the TWG, to consider issues arising and to agree the key decisions taken. The PSG was chaired by the Head of Transport Group and, similar to the TWG, comprised relevant professionals from other Scottish Executive divisions. The PSG met regularly and the chair of the TWG attended each meeting to report progress made.

There was a clear project plan which recognised that time would be needed to construct new vessels

2.11 A key role for the PSG was to ensure that the procurement process kept on track. SETG recognised the need for sufficient lead-time between contract signing and the new operator commencing operations to allow new ferries to be built. It therefore developed a comprehensive project plan highlighting key tasks at all stages of the project timeline. The project plan was updated regularly to show progress made and to reflect revised timetables which were necessary as a result of slippage at various stages of the project.

Slippage against the plan contributed to a six-month extension to the P&O contract

2.12 The original plan was to have the contract signed in September 1999 and for the new operator to start operations in April 2002. However, in the event, this underestimated the time needed to negotiate with the EC over the contract's duration and the subsequent need to devise a means of transferring vessels for future contracts and by June 1999 the target for contract award had slipped to December 1999. In the event, the contract was not signed until December 2000.

2.13 Exhibit 2 details actual progress against the project plan of October 1998. SETG considers that many elements of the procurement process could not be entirely predicted when the project plan was prepared. The longest delay was in issuing the Invitation to Tender (ITT), largely as a result of the complex negotiations with the EC over the contract length and their implications for contract terms. The ITT was issued in December 1999, some nine months behind plan but still on track to have the new contract in place by October 2002 when the new maritime safety regulations came into force.

2.14 Slippage in the contract award contributed to NorthLink not commencing operations until October 2002, some six months behind schedule. While NorthLink was confident it could provide a reliable, if incomplete, service from July 2002, representations from local MSPs and others persuaded SETG that a summer transfer would be too disruptive to services and confusing for users. Recognising the possibility for slippage, SETG had built into the original contract with P&O scope for a contract extension and, using this provision, SETG negotiated a six-month extension to P&O's contract at a cost of £8 million.

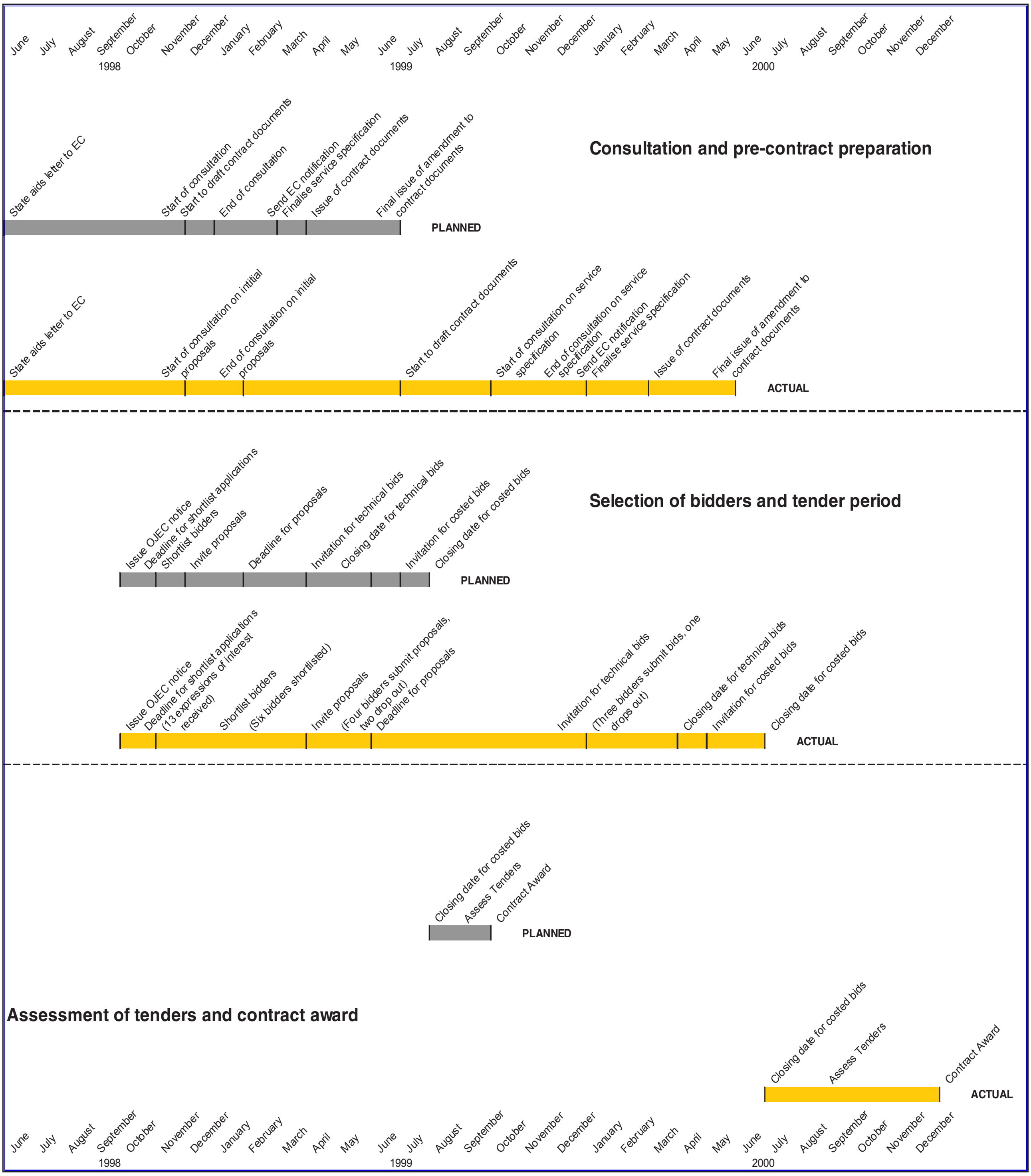
Scoping the contract

There was a clear specification of requirements which was informed by consultation with representatives of the Northern Isles and other interests

2.15 SETG consulted with various island representatives and other interests at two stages in the procurement exercise – in drawing-up a Request for Initial Proposals document and in finalising the specification of requirements. Those consulted included local MSPs, the Island councils, local enterprise companies, farmers' representatives and harbour authorities. Details of the issues raised in consultation and SETG's response to them are included in Appendix 2. In summary, SETG found the consultation processes useful in focusing on what standard of service it expected from the ferry operator.

Exhibit 2

Planned and actual procurement timetable



Source: Audit Scotland

2.16 In accordance with good practice, the ITT was based on what service levels and outputs SETG required, with bidders left to design and cost a service to meet the standards sought. The ITT:

- Specified the route configuration and minimum number of sailings required but expected bidders to propose detailed timetables.

- Indicated that it would continue subsidising services for routes between the ports used in the current P&O contract ie. Aberdeen, Lerwick, Scrabster and Stromness.

- Stipulated that the services should provide for the carriage of freight, which would not be subject to subsidy. It was left for bidders to determine the precise level of freight services that would be made available, although they should be sufficient to carry at least the levels currently provided by P&O plus reasonable estimates of growth.

- Required that freight services must include sufficient appropriate capacity for the carriage of livestock. The service was to be made available all year round, and particularly during the main livestock shipment period of August to October. Livestock, and vehicles containing meat or fish products, were to be separated from passengers and their vehicles as far as practical.

- Indicated that SETG expected three combined passenger/freight vessels would be required to operate the routes but that it was willing to consider alternative proposals providing that its other service requirements were met. Vessel size, carrying capacity and speed were also matters for bidders to consider with a proviso that, as a minimum, they matched those of the current P&O operation.

- Required the successful bidder's pricing plan to be agreed with SETG and maximum tariffs to be published. It was expected that initial tariffs would not be set at a level significantly above prevailing rates.

The allocation of risks in the Invitation to Tender was clearly identified

2.17 The ITT made it clear that EC guidelines required that the contract would be awarded to the bidder offering a compliant bid and requiring the lowest financial compensation to provide the services, and that most of the risks associated with the contract would be borne by the operator. For example, the operator was expected to bear the operational risk of its costs being higher than expected or demand for the ferries being lower but with material change provisions available (Exhibit 3).

Exhibit 3

Invitation to Tender allocation of risks

Risks borne by the winning bidder
• Design and construction risks if new vessels were proposed • Commissioning risk – the risk that costs incurred in the run-up to the service becoming operational was greater than budgeted for • Operational risk – the risk of operational costs being higher than budgeted for • Demand for volume usage risk – the risk that demand for services does not match the levels planned • Maintenance risk – the risk that the cost of keeping assets in good condition is greater than budget • Inflation risk – the risk that actual inflation rates could differ from assumptions • Incorrect cost or time estimates in providing vessels and services • Defects in vessels • Industrial action • Failure to meet specified service levels and performance quality standards set out in the final service specification • TUPE costs if applicable
Risks borne by SETG
• Changes in the requirements of transport policy – for example, a change in EC or Scottish Executive policy in relation to the subsidisation of shipping operators
Shared/negotiable risks
• Policy risk – the risk of changes in policy not involving legislation • Legislative risk – Would depend on circumstances. Changes in corporate tax legislation and rates would fall on the operator. Scottish Executive specific legislation would fall to SETG • Force Majeure – natural disasters or other 'Acts of God'

Source: Invitation to Tender, Scottish Executive, December 1999

Some concerns have been expressed about the level of information made available to bidders

2.18 The ITT provided historical data supplied by P&O on the traffic carried on the Northern Isles routes and P&O's current vessel capacity. It also provided some technical information on the docking facilities at the ports to be used. NorthLink was concerned about two aspects of the information made available:

- First, the ITT drew attention to the Transfer of Undertakings (Protection of Employment) Regulations 1981 (as amended) (TUPE) but noted it was the bidding operator's responsibility to consider whether TUPE applied and to tender accordingly. During the tender exercise, P&O provided average salary costs for different groups of staff and their general terms and conditions of employment. It did not, however, release information on individual staff members or their costs because it was concerned about breaching the

Data Protection Act 1998 if it released personal information. NorthLink decided to act as if TUPE did apply, and to guarantee the terms and conditions of P&O maritime staff who transferred to it, but it considered that the information made available did not allow it to form an accurate view of what these crew costs would be. The final contract protected NorthLink in relation to costs arising from TUPE, in particular, and staff transfer more generally (paragraph 2.32).

- Second, some of the freight information provided by P&O was expressed in units carried and some in lane metres occupied. Due to the method used by P&O to record freight carried, NorthLink found it difficult to form an accurate view of the total volume (in terms of lane metres) of freight carried. This was important to NorthLink because lane metres determined the size of the ships needed and was the unit of measure used for billing.

Tender assessment and contract award

Shortlisting of bidders was based on clear, predetermined criteria

2.19 In November 1998, 13 shipping operators initially expressed an interest in the contract after advertisement in OJEC. Each was subjected to a weighted scoring system which awarded points against a range of criteria covering financial and professional standing, and previous experience and the top six scorers were shortlisted to submit initial proposals. Two shortlisted operators subsequently withdrew from the competition, leaving four to submit initial proposals in June 1999. SETG held detailed discussions with each operator on its proposals and decided that all four were of sufficient quality to proceed to the Invitation to Tender stage.

CalMac showed strong commitment to the Northern Isles ferry operations although it took some time before NorthLink's funding structure was finalised

2.20 In March 1997, the Minister of State in the then Scottish Office announced that CalMac, as a government-owned nationalised industry, would not be allowed to bid for the 1997-2002 contract won by P&O because government policy was to allow the private sector, wherever possible, to deliver services. The new administration, however, stated in July 1997 that CalMac should investigate a basis for entering the Northern Isles ferry market in time for it to participate in the next tendering exercise.

2.21 CalMac showed strong commitment to the Northern Isles ferry operations but, like many similar arrangements, proposals to fund its proposed private/public joint venture changed several times over the procurement exercise. CalMac did not originally expect to bear any of the risks associated with running the NorthLink joint venture because it did not propose providing any equity investment. It expected to provide ship management services only with any profits resulting being used to reduce the subsidy requirement on its Clyde and Hebrides ferry operations. Operating funding was to be provided by venture capital participants or existing ship-owning interests. In summer 1999, however, CalMac indicated to SETG that it would now invest £250,000 in shares. Another ferry operator (who subsequently withdrew) would also subscribe to £250,000 of shares, and banks were willing to subscribe to a further £3 million of shares.

2.22 Further discussions between CalMac and proposed investors eventually resulted in NorthLink's share capital being 1.5 million ordinary shares at £1 each split evenly between CalMac and RBS. RBS also agreed to provide a £2.5 million loan to be used as working capital in the period before contract start and £3 million reserve funding to address any short-term cash flow problems. The NorthLink corporate structure was not finalised until it was announced as the preferred bidder in September 2000.

SETG adopted a two-stage evaluation approach to comply with EC guidelines on state-aid to maritime transport

2.23 The ITT was issued on the basis of a two-stage evaluation process. Bidders were required initially to submit a technical bid, including details on factors such as the vessels to be used, sailing timetables, crewing arrangements and proposals for marketing the service and tariffs payable. The technical bid was to be compared to the service specification and subjected to a pass/fail threshold. Bidders who passed this stage were then asked to submit costed bids, setting out the amount of subsidy required. SETG adopted this approach as an aid in ensuring compliance with EC guidelines on state aid to maritime transport which required the contract to be awarded to the lowest compliant financial bid received, rather than a wider assessment of value for money.

2.24 One bidder withdrew from the contract prior to the submission of bids. The three remaining bidders, NorthLink, P&O and SERCO-Denholm, passed the technical evaluation. This process took longer than expected, however, because P&O unexpectedly included options for the refurbishment of its existing ferries in its bid, which were considered then rejected.

NorthLink's bid was cheapest mainly because its passenger traffic growth assumptions were higher and it expected a higher surplus to be made from its freight operations

2.25 SETG set its 'affordability' price (paragraph 2.8) for basic subsidy at £20 million per year. The price was based on the level of subsidy paid to P&O plus SETG's estimates of the extra subsidy likely to be necessary to have new vessels on the Northern Isles routes. All three bids included proposals for a five-year contract which were within the threshold agreed with the EC. Accordingly, SETG set aside other bids for alternative contract lengths.

2.26 The SERCO-Denholm bid required the Scottish ministers to procure the transfer of its ferries or take over their leasehold in all circumstances of contract termination. This was unacceptable to SETG. In addition, Serco-Denholm's bid was the highest and was therefore ruled out.

2.27 NorthLink's subsidy bid was £45.7 million[4] for the five-year life of the contract. This was £14 million less than P&O's equivalent bid for the new contract and, at an average of £9.14 million per year, about £2 million less than the annual subsidy SETG was already paying. Although NorthLink's estimated costs over five years were some £19 million more than P&O's, it required less subsidy because it:

- Anticipated generating £8 million more passenger income over five years. NorthLink's charges were lower than P&O's proposals but its demand predictions were higher. NorthLink assumed that P&O would increase its passengers carried from 239,000 in 1998 (the latest year where full data was available when bids were submitted in June 2000) to 252,000 in the final year of its operation. Passenger numbers would then increase by 52% over the contract period to 386,000 in the final year. P&O assumed no passenger growth in the run-up to the new contract and no increase in traffic on the Aberdeen – Orkney/Shetland route over its duration. It did, however, expect Pentland Firth passenger traffic to increase by 10% over the period of the contract (Exhibit 4).

- Expected to generate freight surpluses of £13 million more than P&O over five years. NorthLink expected an annual increase of 3% in the amount of freight carried. P&O assumed no overall increase in freight traffic.

- Was prepared to accept less profit from the contract than P&O. NorthLink expected to generate profits, after subsidy, of £2 million less than P&O.

2.28 NorthLink expected to generate more passengers because of new ships, improved services, lower fares and special offers on certain routes. It also envisaged a more customer-orientated timetable providing more crossings and faster sailings, and more proactive marketing. Its projections were informed by analysis carried out by the Scottish Office in the 1980s which demonstrated a step growth in traffic when CalMac introduced new ferries on its Clyde and Hebrides routes. NorthLink told SETG that transport economists had validated its traffic projections.

2.29 SETG reviewed bidders' cost and income assumptions, and also carried out sensitivity analysis on the bids. The results of this analysis suggested that even if no passenger growth were achieved,

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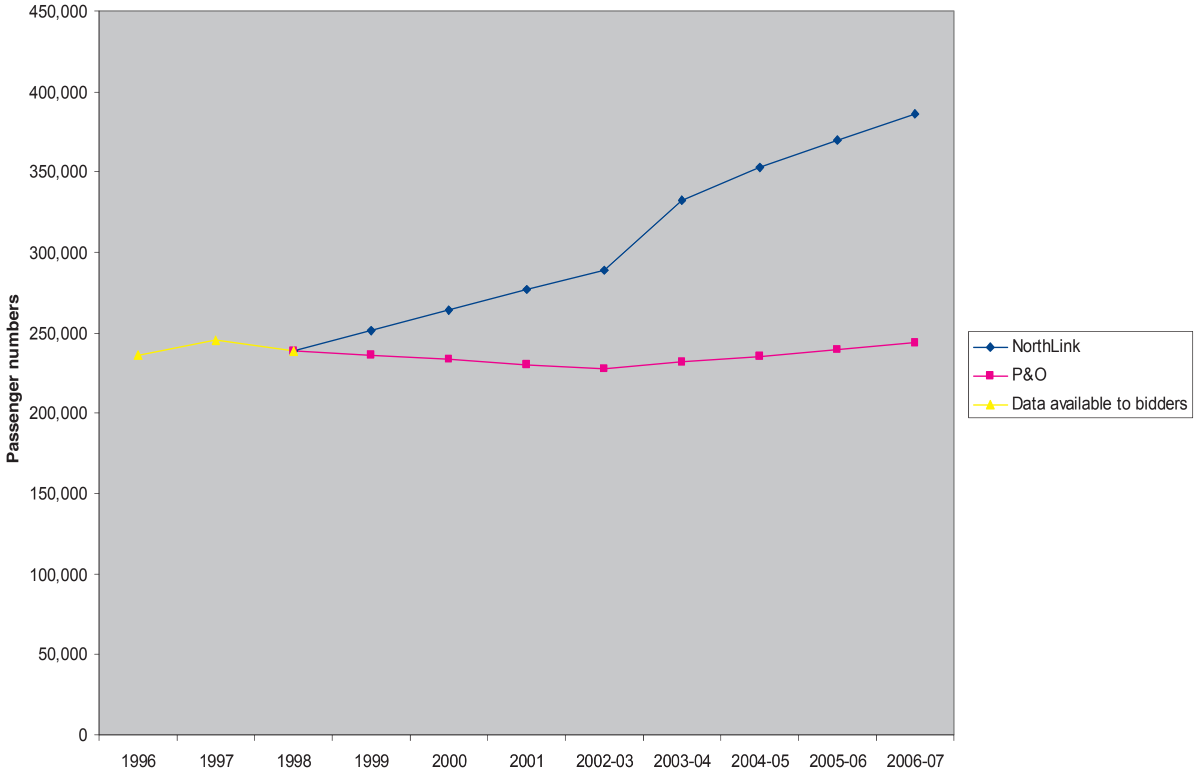
[4] All monetary figures in this paragraph are presented at April 2000 prices. The contract stipulates that payments of block subsidy would increase in line with inflation.

losses could be contained within NorthLink's available working capital. However, due to a combination of lost income and additional costs that SETG did not anticipate from this analysis this was not the case (Part 3). As is normal in this form of contract, the operator carried the risk relating to errors in assumptions.

Exhibit 4

Actual and predicted passenger traffic growth 1996-2007



Note: Actual passenger numbers for 1996 to 1998 are in calendar years because this was what P&O had provided to SETG and what was made available to bidders. NorthLink's and P&O's annual traffic projections cover the period 1 July to 30 June. At the time of bidding, SETG expected the contract to become operational with effect from 1 July 2002, and bidders were expected to bid on this basis.

Source: Audit Scotland

Extensive post-tender negotiations took place between SETG and NorthLink prior to finalisation of the contract

2.30 Once NorthLink was selected as the preferred bidder, comprehensive negotiations were held to formalise and finalise the contract. The negotiations centred on what would happen to the new vessels if, in a subsequent tender exercise, a new operator replaced NorthLink. SETG expected to limit the subsidy payable (see paragraphs 2.7-2.8) by including in the NorthLink contract a provision which enabled the ferries to be transferred to a new operator at the end of the contract should this prove necessary. It also provided that bidders for the next-again contract would be required to use these vessels. Because NorthLink's vessels were leased from Lombard Corporate Finance[5] rather than owned by it, the transfer of assets ultimately involved a tripartite agreement involving SETG, NorthLink and the lessor.

The contract provided for some operational risks to be transferred to NorthLink but it also required SETG to make additional payments in some circumstances

2.31 The contract committed SETG to pay NorthLink a basic grant of £45.7 million (at April 2000 prices) over the five years of the contract to provide the approved ferry services, with this figure to be adjusted in the light of inflation and supplemented by legitimate material change claims. It also included arrangements for deducting grant in the event of NorthLink failing to achieve specified levels of reliability and punctuality, and to clawback grant at the end of the contract if NorthLink made excessive profits (Appendix 3). As such, NorthLink was expected to bear the risks of, for example, passenger forecasts not being achieved.

2.32 The contract also contained arrangements requiring the Scottish Executive to pay additional grant if NorthLink's return on capital was less than 5.2-5.7% (depending on the year of operations), and if one or more 'material changes' resulted in NorthLink's revenue and costs changing for reasons outside its control. NorthLink could claim additional subsidy for two main reasons:

- If its revenue or costs were adversely affected by the realisation of risks which the ITT identified as being borne by SETG, or were shared or negotiable. For example, NorthLink could claim additional subsidy if its revenue or costs were materially affected by changes in law or as a result of any action by Scottish ministers, the UK government or the EC.

- If its revenue or costs were adversely affected by certain other factors outside its control. NorthLink could claim additional subsidy if:

  - P&O failed to operate its passenger and accompanied car services in the ordinary course of business or made detrimental service changes in the run-up to responsibility for service provision passing to NorthLink.

  - The average price of fuel for the vessels increased by more than 10% in real terms from the average price at 1 April 2000.

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[5] Subsequently Royal Bank Leasing Ltd.

- Harbour dues and charges were higher than the level forecast in its financial model. The scale of harbour dues payable was unknown when financial bids were submitted, not least because port authorities had still to decide whether to refurbish existing facilities or build new ones at Scrabster and Kirkwall harbours to accommodate the larger vessels which NorthLink proposed using.

- The total costs resulting from any transfer of staff from P&O to NorthLink as a consequence of the application of TUPE or otherwise exceeded the amount allowed for in NorthLink's financial model. As described in paragraph 2.18, NorthLink considered that the information made available during the tender exercise did not allow it to form an accurate view of its crew costs.

2.33 SETG also agreed to pay NorthLink additional subsidy if the aggregate capital costs and expenses used to calculate its vessel-leasing payments exceeded £88 million. The extra subsidy was limited to the lower of £400,000 per annum or the annual increase in leasing payments resulting from increased capital costs. NorthLink had intended to use Ferguson's Shipyard in Port Glasgow to build the ferry to be used on the Pentland Firth crossing. Just prior to the contract being signed, Ferguson's withdrew and responsibility for building the ship was passed to a Finnish yard. This was expected to cost more because the timing of the order meant it missed out on an EC shipbuilding subsidy scheme which expired in December 2000.

Part 3: Events after NorthLink began operations

3.1 This part of the report reviews developments following NorthLink commencing operations in October 2002. It considers:

- The extent of NorthLink's cash flow problems which it experienced within months of assuming the contract, and SETG's response
- SETG's decision to re-tender the contract and to negotiate an interim agreement with NorthLink to ensure the continuation of ferry services
- SETG's payments to NorthLink to date
- NorthLink's performance in providing ferry services
- The current re-tendering exercise and evidence of 'lessons learned'.

NorthLink's early cash flow problems

NorthLink was expressing concern at its ability to deliver the contract before it went operational and again within three months of its start

3.2 NorthLink informed SETG in August 2002 that, largely due to competition on the ferry routes, it was considering whether to commence operations. Competition arose from two sources:

- Pentland Ferries, which began harbour development work in 1999 with a view to operating a combined passenger, car and freight service on the Pentland Firth crossing. Pentland Ferries started its ferry service in competition with P&O in spring 2001, almost a year after NorthLink had submitted its costed bid in June 2000 and six months after the contract had been signed.
- Norse Islands Ferries, which began carrying freight between the Shetland Islands and Aberdeen in September 2002, having announced its intentions in July 2002.

3.3 At the time of contract signature in December 2000, NorthLink predicted total shareholder returns over the five-year lifetime of the contract of £14.9 million. Following the emergence of competition, which impinged upon NorthLink's traffic forecasts, NorthLink's revised business model showed that it was unlikely to be able to trade profitably within the five-year life of the contract. NorthLink considered it was unable to draw upon its £3 million reserve funding facility with the RBS because the funding was only intended to be available to address short-term cash flow deficits and NorthLink was unlikely to be able to repay the reserve funding if it was drawn. SETG indicated that it would be willing to consider options to assist NorthLink to address any shortfall in its financial projections but any additional support would be subject to approval, where necessary, by the EC and/or the Scottish Parliament.

3.4 NorthLink began operations on 1 October 2002. Within three months, the company indicated that it was experiencing serious cash flow problems due to a combination of both loss of income and extra costs incurred:

Loss of income

- NorthLink began operations later than it originally expected due to the delay in signing the contract. It therefore missed the high-revenue months of summer 2002 when cash reserves were expected to be built up. NorthLink's financial model indicated that the company expected to generate profits, after subsidy, of £2.8 million in its first three months if operations had commenced in July 2002. Without these reserves, NorthLink considered that the lower winter revenue would be insufficient to keep it going.

- Competition from Pentland Ferries. By the time NorthLink began operations, it estimated Pentland Ferries had secured about 50% of the Pentland Firth market. NorthLink's income from passenger services on the Pentland Firth crossings in its first year was £1.6 million less than forecast.

- Competition from Norse Islands Ferries. Some hauliers considered they were paying lower freight prices to P&O compared to NorthLink's proposed charges when it published its freight prices in late 2001. In response, they formed a new ferry company, Norse Island Ferries, which began operations in September 2002, having announced their intentions in July 2002. By October 2002, NorthLink estimated Norse Islands Ferries had captured 80% of the Shetland freight market despite the former lowering its freight rates. NorthLink's actual freight revenue in its first year was £2.1 million less than forecast.

Extra costs

- Improvements to Scrabster harbour were delayed by a year with the result that NorthLink's Pentland Firth ferry could not berth and it incurred extra costs and loss of business. The ferry was laid-up for six months in Leith while a smaller vessel was chartered from CalMac to operate the route.

- NorthLink guaranteed the terms and conditions of seafaring staff who transferred to it from P&O (paragraph 2.19). After winning the new contract, NorthLink discovered that its assumptions regarding the costs of these staff had been substantially on the low side.

SETG agreed to restructure the timing of subsidy payments and to allow claims for additional payments under the contract's 'material changes' clause to be considered when they arose

3.5 In view of NorthLink's financial problems, and to ensure it complied with EC guidelines, SETG discussed with the EC in early 2003 the possibility of renegotiating the ferry leases in order to reduce NorthLink's annual leasing payments. Another option was to increase the subsidy payments to NorthLink. The EC considered that these measures would not comply with its guidelines on state aid to maritime transport and advised that, if NorthLink could not operate within the terms of the original contract, the contract should be re-tendered as soon as practicable.

3.6 To address the seasonal pattern of NorthLink's revenue, SETG agreed to restructure the timing of subsidy payments. Under this arrangement, NorthLink would not receive subsidy payments during the summer months when its fare revenues were expected to be higher. By April 2003, SETG had advanced NorthLink all of the £10.8 million basic subsidy due to the end of its first year of operations in September 2003. To further assist NorthLink's financial position, SETG also agreed to pay valid 'material change' claims as they arose, rather than wait until the end of the each year as originally intended.

Despite extra funding in the summer of 2003, NorthLink continued to experience cash flow problems

3.7 During the spring of 2003, NorthLink submitted a series of 'material change' claims totalling around £4.4 million representing its view of its entitlements under the terms of the contract since it started operations:

- £0.4 million in respect of additional costs incurred as a result of transferring the construction of its Pentland Firth ferry to Finland (paragraph 2.33).

- £1.2 million in respect of additional harbour charges which could not be confirmed when bids were submitted (paragraph 2.32).

- £0.4 million in respect of additional security costs as a consequence of the 9/11 terrorist attacks.

- £0.6 million in respect of the need to employ more crew staff than anticipated to comply with the EU Working Time Directive and crewing levels set by the Maritime and Coastguard Agency (MCA).

- £0.9 million in respect of additional staff costs as a consequence of underestimating the terms and conditions of former P&O crew staff (paragraph 3.4).

- £1.0 million as a result of loss of revenue on the Pentland Firth crossing. NorthLink claimed this was a material change because P&O had failed to actively market its service in the run-up to NorthLink commencing operations, enabling Pentland Ferries to build up its market share.

3.8 Following legal advice on the validity of the claims, SETG agreed to make initial payments to NorthLink totalling £0.6 million in respect of staff transfer costs (£0.4 million), harbour dues (£0.1 million) and compensation for abortive marketing costs incurred on the Pentland Firth route (£0.1 million). SETG did not pay other material change claims at that time because it was not persuaded as to their legitimacy based on available information.

3.9 In June 2003, Norse Island Ferries ceased operations and NorthLink chartered the vessel which Norse Island Ferries had been using to provide it with extra freight capacity. Extra freight capacity was required because, in order to meet higher-than-expected demand to carry cars, freight was being displaced from NorthLink's combined passenger/freight ferries. While chartering the extra vessel was intended to ensure there was adequate capacity to meet demand, it created a situation whereby freight capacity actually exceeded demand. The additional costs of running another vessel exceeded the extra income generated, and added to the current cash flow difficulties.

3.10 The extra payments by SETG in response to NorthLink's material change claims did little to ease NorthLink's cash flow problems. At meetings with NorthLink in July and August 2003, it became clear to SETG that the gap in NorthLink's finances could not be bridged by legitimate material change payments. NorthLink advised SETG that it would default on its next £0.7 million monthly vessel-leasing payment to Lombard Leasing or a £0.5 million wages bill. The company was pessimistic about its ability to deliver the remainder of the contract and remain solvent. SETG held extensive internal discussions on possible solutions within the terms of the contract to ease NorthLink's financial difficulties. It provided additional emergency funding of £0.5 million but NorthLink indicated that it needed £3 million to avoid legal action by creditors to enforce debt recovery. In the event, NorthLink defaulted on both its July and August 2003 vessel-leasing payments.

3.11 As NorthLink's cash flow problems became more apparent, SETG sent in consultants in September 2003 to examine NorthLink's financial position. The consultants reported that NorthLink's balance sheet showed net liabilities of £2.3 million, and they projected NorthLink would suffer losses before subsidy of £47.8 million in the 30 months to 31 March 2005. NorthLink continued to trade based on legal advice and on the commitment made by SETG to work with the company to attempt to identify solutions to the financial difficulties.

Renegotiation of the contract

SETG decided there was no option but to continue to support NorthLink in the short term to guarantee continuity of service

3.12 In August 2003, SETG decided, on the basis of legal advice, that it would need to re-tender the Northern Isles ferry service contract because NorthLink could not continue within the terms of its contract. SETG's priority was to secure the continuity of lifeline services, and it considered that allowing NorthLink to go into administration would not guarantee this. Following consultation with ministers, SETG decided to negotiate an interim contract so that NorthLink would continue to operate while a new tender exercise was carried out. SETG was keen to achieve value for money from the interim contract, but also to avoid discrediting the service which could have dissuaded potential operators from bidding for the re-tendered contract.

3.13 These negotiations took over a year, largely due to the issue of incentivisation for NorthLink and other issues such as the agreement of budgets and reporting arrangements. SETG wanted to ensure that NorthLink continued to provide a reliable and satisfactory service, and maximised its income and controlled its costs as far as possible so as to minimise the call on subsidy. Equally, the company was unwilling to continue to run the ferry service through to the end of the revised contract without some assurances of basic recompense to its shareholders to accept the risks of so doing. While negotiations regarding the revised contract were ongoing, SETG made a series of emergency payments to NorthLink to enable it to pay its creditors, and confirmed its intention to re-tender the contract early.

3.14 The revised contract, agreed in September 2004, involves a monthly subsidy to be paid to NorthLink on the basis of forecast cash projections. It also provides some incentive to NorthLink by allowing additional payments to be made, dependent on NorthLink's financial performance against an independently vetted budget and it meeting performance standards for punctuality, reliability, quality of service and call centre telephone answering.

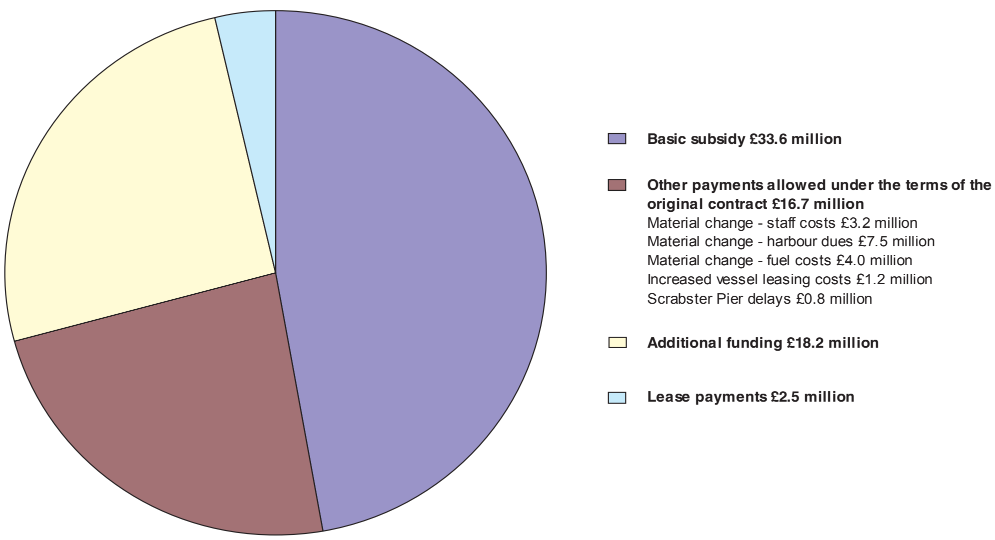
3.15 SETG has monitored NorthLink's performance against the terms of both the original and revised contract. It has also examined all claims for additional payments since NorthLink began operations in October 2002 and its monthly cash projections under the revised contract.

Since NorthLink began operating the Northern Isles ferry services, SETG has paid the company £71.0 million

3.16 The original contract stated that the Scottish Executive would pay NorthLink a total of £29.7 million in basic subsidy for the first three years of the contract at April 2000 prices, plus any sums due under the 'material changes' clause. NorthLink received a total of £71.0 million during the three years to 30 September 2005 - basic subsidy of £33.6 million (including increases for inflation allowed for in the contract), other payments allowed for under the terms of the original contract of £16.7 million, and additional funding to maintain the delivery of services totalling £18.2 million. SETG also provided a further £2.5 million to pay off, in one instalment, leases related to some of the assets used by NorthLink. As a result, SETG secured control of these assets which it intends to offer for sale to the next operator. Exhibit 5 shows a breakdown of payments to NorthLink to end September 2005.

Exhibit 5

SETG payments to NorthLink: October 2002 to end September 2005



Note: Material change payments are notional. From April, 2004 support to NorthLink was provided through a single monthly payment without a specific sum hypothecated for material change.

Source: Scottish Executive

Throughout, NorthLink's services have operated reliably and to a good standard

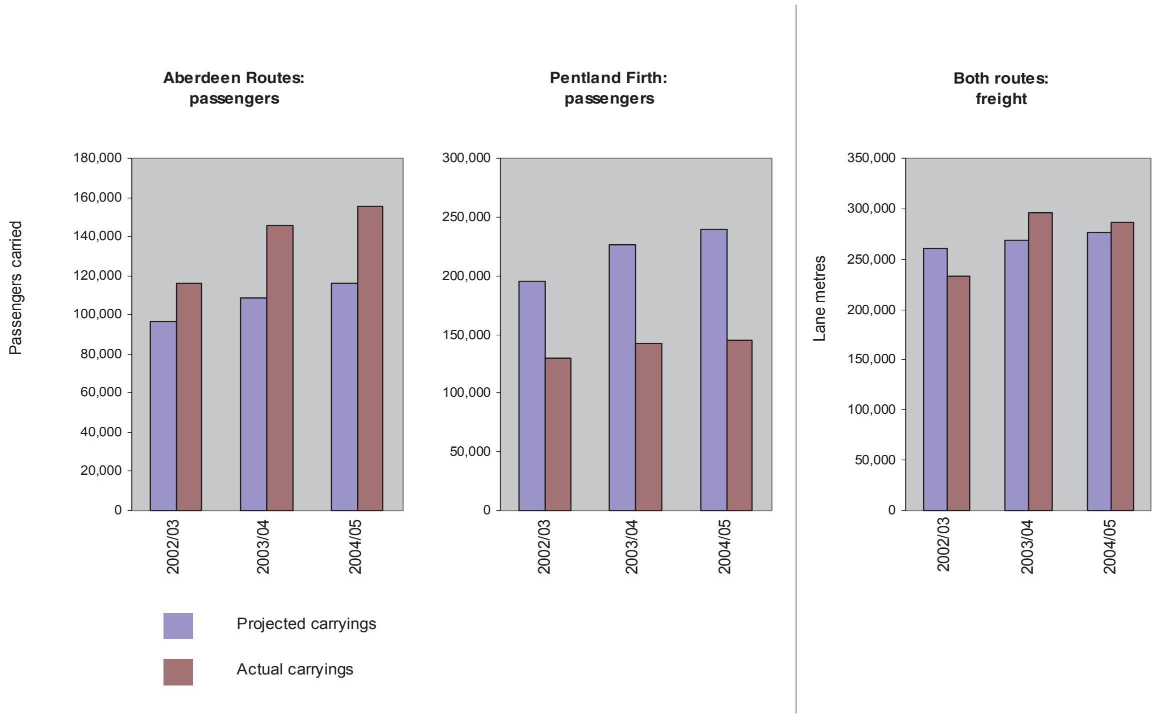
3.17 NorthLink's regular performance reports to SETG indicate that services have operated reliably and punctually. Excluding sailings which were late or cancelled as a result of various relief events allowed for in the contract, for example as a result of bad weather, there were only 19 sailings defined as late and 10 which were cancelled in the three years to September 2005. In October 2005, Audit Scotland spoke with a number of interested parties in the Northern Isles (see Appendix 4) to obtain, amongst other things, their views on the services provided by NorthLink. All those spoken to indicated that NorthLink had provided a good level of service.

NorthLink has not achieved all the traffic growth it expected but the revised contract is intended to ensure that it will be able to continue operations and provide a performance-related return to its shareholders

3.18 NorthLink has met its traffic forecasts for sailings between Aberdeen and the Northern Isles, although the number of passengers carried on the Pentland Firth crossing has only been 63% of that predicted (Exhibit 6). Overall, its income to the end of September 2005 is £5.7 million down on projections, almost all of which is due to less traffic on the Pentland Firth route (Exhibit 7).

Exhibit 6

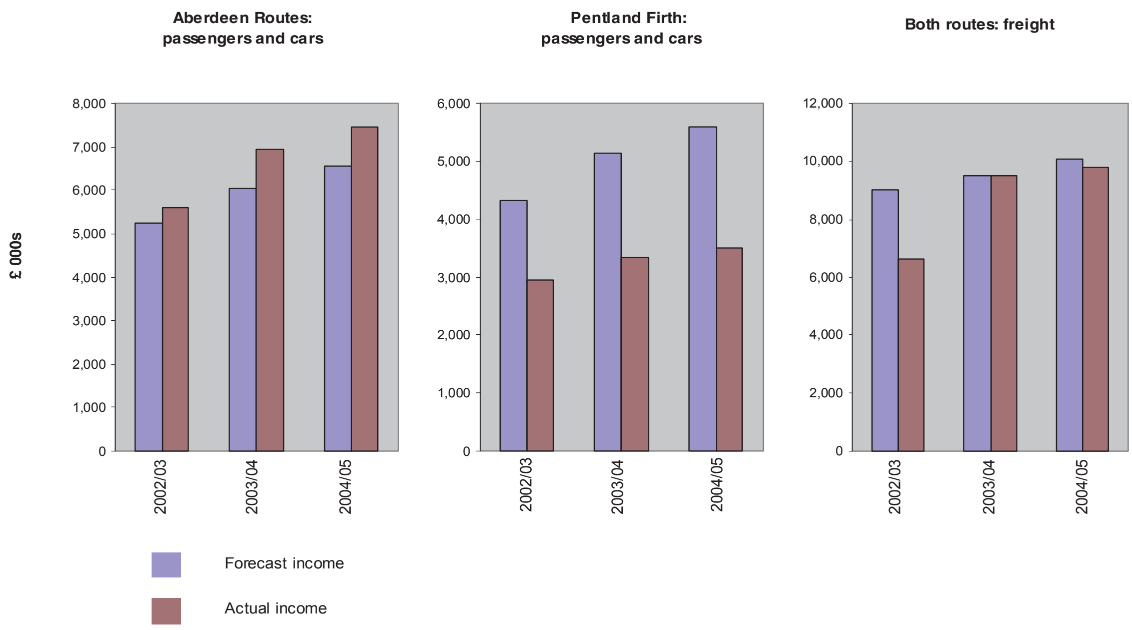
Actual traffic carried by NorthLink versus forecasts



Source: NorthLink

Exhibit 7

Actual income generated by NorthLink versus forecasts



Source: NorthLink

3.19 The revised contract is intended to ensure NorthLink can continue operations until the new operator is in place, because SETG will finance any cash deficits incurred. But it also gives NorthLink a financial incentive to deliver the services as efficiently and effectively as possible and, in so doing, to earn a performance-related return for its shareholders. Under the incentivisation formula contained in the revised contract, NorthLink is entitled to share in any revenue gains or cost savings that are achieved in comparison with the agreed budget. The balance of such gains and savings is retained by the Scottish Executive.

What lessons SETG is applying to the new tendering exercise

3.20 The re-tendering of the Northern Isles ferries contract commenced in April 2004 with a view to the new contract commencing in April 2006. The ITT was issued in July 2005. Three bidders were originally shortlisted to bid but one subsequently withdrew, leaving the two remaining bidders to submit their bids by December 2005. Similar to the NorthLink tender, bidders will be required to pass a technical evaluation before their financial bids are considered.

The arrangements for payment of grant under the current re-tendering exercise reflect SETG's view on the appropriate balance between the twin priorities of ensuring the continuity of service provision and the transfer of operational risks

3.21 NorthLink's financial problems have led SETG to conclude that an appropriate balance has to be struck between the twin priorities of ensuring the continuity of services and transferring operational risks on to the new operator. The proposed contract does not seek to transfer all such risks to the operator and recognises that costs can be higher and income lower than expected for reasons beyond the operator's control. It will therefore provide some protection to the new operator by allowing SETG to pay additional subsidy in certain circumstances. Should income fall or costs rise sufficiently in any one year, the operator will be required to bear the impact of not making its anticipated return from providing the service plus a further £750,000 of losses before SETG will consider paying additional subsidy. Similar to the NorthLink contract, the new contract will include financial penalties for non-performance and the clawback of subsidy if excessive profits are made.

More detailed information is being made available for bidders

3.22 SETG has worked with NorthLink to provide more detailed information to bidders than was available under the earlier tender exercise. Under the terms of its contract, NorthLink was required to provide to Scottish ministers all information regarding the vessels and their operation, their employees, volumes of traffic and other matters which ministers may require for the purpose of inviting tenders from prospective new service operators. As well as providing base data on volumes of traffic carried and technical information on docking facilities which was included in the previous ITT, NorthLink produced a separate information document for prospective bidders.

3.23 The information provided describes current services and arrangements, including information about operating costs and revenue by route, the operation of the ferries and their maintenance records, and NorthLink's various contractual arrangements for ship and crew management, livestock handling and stevedoring, etc. While legal advice was that NorthLink could not release details of individual staff terms and conditions due to data protection concerns, substantial information has also been provided on an anonymised basis about staff benefits offered and average salary paid to each staff grade. It has also provided standard contracts and terms and conditions of employment for officers and ratings. SETG has also made further information available to bidders in response to specific requests.

The new ITT also intends to bring the carriage of freight within the terms of the contract

3.24 Under the previous contracts with P&O and NorthLink, subsidy was not available for the carriage of freight because Scottish Executive policy was that freight could be carried on a commercial basis. The level of freight charges and the resultant competition from Norse Island Ferries was one of the key factors which contributed to NorthLink's financial problems. At the time, SETG had little influence over how the issue was resolved. The Scottish ministers have subsequently decided that freight, including livestock, should now be included along with passengers and accompanied cars in a single grant structure.

Appendix 1: NorthLink's ferry services

Pentland Firth route: MV Hamnavoe

Timetable				
	Weekdays	Weekends		
		Saturday	Saturday*	Sunday
Stromness - Scrabster	3 sailings per day	2 sailings per day	3 sailings per day	2 sailings per day
Scrabster - Stromness	3 sailings per day	2 sailings per day	3 sailings per day	2 sailings per day

* Peak season schedule Saturday 11 June - Saturday 20 August inclusive

Crossing time: 90 minutes

Vessel Specification	
Length	110 m
Beam	18.5 m
Draft	4.5 m
Passenger capacity	600
Vehicle Deck capacity	300 running metres
Deadweight Tonnage	1,200 tonnes
Accommodation	40 berths
Speed	19 knots

North Sea route: MV Hjaltland and MV Hrossey

Aberdeen - Kirkwall - Lerwick (northbound)							
	Mon	Tues	Wed	Thurs	Fri	Sat	Sun
Dep A'deen	19.00	17.00[1]	19.00	17.00	19.00	17.00	17.00
Arr Kirkwall	-	23.00[2]	-	23.00	-	23.00	23.00
Dep Kirkwall	-	23.45	-	23.45	-	23.45	23.45
Arr Lerwick (next day)	07.30	07.30	07.30	07.30	07.30	07.30	07.30

[1] Departure Aberdeen 1900 from 1 Jan - 27 Mar & 1 Nov - 31 Dec

[2] No Kirkwall call from 1 Jan - 27 Mar & 1 Nov - 31 Dec

Vessel Specification	
Length	125 m
Beam	19.5 m
Draft	5.4 m
Passenger capacity	600
Vehicle Deck capacity	450 running metres + 22 cars/ vans in lower hold
Deadweight Tonnage	1,563 tonnes
Accommodation	300 berths
Speed	24 knots

Lerwick - Kirkwall - Aberdeen (southbound)							
	Mon	Tues	Weds	Thurs	Fri	Sat	Sun
Dep Lerwick	17.30[1]	19.00	17.30	19.00	17.30	19.00	19.00
Arr Kirkwall	23.00[2]	-	23.00	-	23.00	-	-
Dep K'kwall	23.45	-	23.45	-	23.45	-	-
Arr A'deen (next day)	07.00	07.00	07.00	07.00	07.00	07.00	07.00

[1] Departure Aberdeen 1900 from 1 Jan - 27 Mar & 1 Nov - 31 Dec

[2] No Kirkwall call from 1 Jan - 27 Mar & 1 Nov - 31 Dec

Freight services: MV Hascosay

MV Hascosay carries livestock and freight between the Northern Isles and Aberdeen. NorthLink also charters a second freight vessel for use on the same routes.

Appendix 2: Consultation on the 2002-07 contract

SETG held two consultation exercises during the contract tendering process: one on its draft proposals document used to seek initial proposals from shortlisted bidders, and one on its draft final service specification. Responses were received from the local MP and MSPs, affected Councils, enterprise companies, farmers' representatives and harbour authorities. SETG accepted the majority of points put to them by those consulted. The main issues which were raised by consultation, and the SETG's response to them, are set out below.

Aberdeen as the designated port for the Shetland service

Respondents' comments led SETG to specify that Aberdeen was to be the mainland port for the Shetland service. Originally the mainland port was to be left for bidders to determine.

Length of contract

Responses stated that a contract of more than five years was necessary to encourage higher-quality bids. Those consulted considered there was a risk that a short contract period would put off anyone from considering building the necessary new vessels. This was in line with SETG's own view but it was aware it had to comply with relevant EC guidelines.

Kirkwall – Invergordon freight service

Some respondents felt that the freight service which then operated between Kirkwall and Invergordon should be reclassified as lifeline and therefore be subsidised. SETG rejected this proposal. In response to a suggestion from Jim Wallace MSP, SETG agreed in principle to keep options open as to the services required. Ministers subsequently decided not to incorporate the Kirkwall - Invergordon route into the final contract.

Integrated Islands' service

Some respondents were opposed to SETG specifying that the service should cover both Orkney and Shetland. The reasons put forward were that each island group had different needs, and that bidders' innovation should not be restricted by a requirement to provide an integrated service. SETG rejected these arguments because, in its view, an integrated service provided scope for economies of scale, and separate contracts could result in one of the Islands groups attracting no bidders.

Level and quality of service

Responses on the level and quality of service required concentrated on the need for more detail to be added to the service specification. Respondents sought a clearer specification on standards of accommodation, passenger safety, refit periods and numbers of vessels to be used. While amending some aspects, SETG maintained that the approach was to focus on desired outputs, stating what service it wanted provided rather than being overly specific on the inputs which a vessel or operator should provide.

Consultation on progress and preview of bid documents

SETG accepted respondents' requests that they be kept informed about the progress of the tendering exercise. The Councils and local MSPs also requested involvement in the review of technical bids. SETG rejected the involvement of MSPs. It did, however, accept that senior Council officials could review the technical aspects of the bids relating to their harbour and marine responsibilities and report back to members on a strictly confidential basis.

Orkney Islands Council to purchase the vessels

SETG rejected Orkney Islands Council's suggestion that they could buy the vessel serving the Pentland Firth on the grounds that it was a fundamental change. If the suggestion had been accepted, it was possible that the whole tendering process would need to be restarted.

Tariffs

Detailed commentary on tariffs was received. SETG left the detail of the tariff structure to the bidders, with a ceiling at the maximum brochure prices then in use. Any future increases would have to be subject to agreement between the operator and SETG, and be inflation-linked.

Appendix 3: Clawback and deduction terms in the original NorthLink contract

Subsidy clawback provisions

The grant agreement allowed any excess profits made by NorthLink to be shared between Scottish Ministers and the company. Excess was defined as being above 7.5% rate of return on capital employed. The share of excess profits was defined as follows:

Excess Return Rate	Scottish Ministers	NorthLink
above 7.5% but not exceeding 8.5%	25%	75%
plus (where applicable) above 8.75% but not exceeding 10%	50% of excess over 8.75%	50% of excess over 8.75%
plus (where applicable) above 10%	75% of excess over 10%	25% of excess over 10%

Deduction regime: Provisions for Reliability

This deduction regime applies to circumstances where ferries do not complete or commence their scheduled journeys. Reliability is measured over successive six-month periods of the contract.

Level of reliability	Classification	Deduction
98% - 100%	Compliance Band	No deduction
75% - 98%	Default Band	The Scottish ministers may require NorthLink to explain this default in the provision of services
50% - 75%	Deduction Band	Deduct 25% of the subsidy payable over the period concerned
less than 50%	Deduction Band	Deduct 50% of the subsidy payable over the period concerned

Deduction regime: Provisions for Punctuality

This deduction regime applies to circumstances where ferries complete their scheduled journeys late. The definition of late is set out below. Punctuality is measured over successive six month periods of the contract.

Level of punctuality*	Classification	Deduction
95% - 100%	Compliance Band	No deduction
75% - 95%	Default Band	The Scottish Ministers may require NorthLink to explain this default in the provision of services
50% - 75%	Deduction Band	Deduct 5% of the subsidy payable over the period concerned
less than 50%	Deduction Band	Deduct 10% of the subsidy payable over the period concerned

* Pentland Firth service is deemed punctual if it arrives within 20 minutes of the scheduled time. North Sea services are deemed punctual if they arrive within 1.5 hours of the scheduled time.

Appendix 4: Audit Scotland study site visits

In October 2005, Audit Scotland visited the following interested parties to discuss the services provided by NorthLink:

Shetland

Shetland Islands Council

Shetland Transport

Visit Shetland

Lerwick Port Authority

Orkney

Orkney Auction Mart

Orkney Islands Council

Orkney Enterprise

Scottish Executive: The NorthLink ferry services contract

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Audit Scotland
110 George Street
Edinburgh EH2 4LH

Telephone
0131 477 1234
Fax
0131 477 4567

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