



FIRST DIVISION, INNER HOUSE, COURT OF SESSION

**[2019] CSIH 41
P1291/18**

Lord President
Lord Menzies
Lord Drummond Young

OPINION OF LORD CARLOWAY, the LORD PRESIDENT

in the Reclaiming Motion by

PENTLAND FERRIES

Petitioners and Reclaimers

against

THE SCOTTISH MINISTERS

Respondents

**Petitioners and Reclaimers: Lindsay QC; Macroberts LLP
Respondents: Crawford QC, E Campbell; Scottish Government Legal Directorate**

23 July 2019

Introduction

[1] This reclaiming motion is concerned with the lawfulness of a proposed subsidy to be paid by the respondents under a single Public Service Contract to provide ferry services on routes between: (1) Scrabster in Caithness and Stromness on the Orkney Islands; (2) Aberdeen and Kirkwall; (3) Aberdeen and Lerwick; and (4) Kirkwall and Lerwick. The petitioners challenge the inclusion of the Scrabster route within the PSC. They maintain that subsidising that route threatens their competing business which operates between Gills Bay

in Caithness and St Margaret's Hope on South Ronaldsay. This is the nearest Orkney island to mainland Scotland. It is linked by road to mainland Orkney, via the island of Burray, across the Churchill Barriers.

[2] The primary issue is whether the subsidy complies with the Maritime Cabotage Regulation 1992 (EEC/3577/92) thus avoiding illegality under Article 107(1) of the Treaty on the Functioning of the European Union.

For ease of reference, the following acronyms are occasionally used:

NIFS	northern isles ferry services
PBA	Peter Brett Associates
PSC	public service contract
PSOs	public service obligations
SNLF	Serco NorthLink Ferries
SGEI	Service of General Economic Interest

Facts

[3] The four routes under the PSC are collectively known as the northern isles ferry services. The only one to cross the Pentland Firth is Scrabster. All four routes have been subsidised since 1997. They are presently operated under a subsidised PSC which was awarded to Serco Limited, operating as Serco NorthLink Ferries, in 2012 and expiring in October 2019. The total payments under the PSC from July 2012 to June 2018 were approximately £244 million. A projected total for the whole PSC to June 2019 is about £285 million.

[4] On 25 September 2018, the respondents published a contract notice, in terms of the Parliament and Council Directive 2014/24/EU on public procurement, inviting bids for a new PSC. The short description of the services reads:

“Provision of public services in relation to [NIFS] to or from harbours located at Aberdeen, Kirkwall, Lerwick, Scrabster and Stromness. The services shall comprise of five vessels (3 RoPax passenger vessels and 2 RoRo freighters) to deliver the Ferry Services.”

The new PSC is to run for eight years, of which the final two years will be subject to a satisfactory mid-term review. The respondents envisage a period of mobilisation which would commence on 2 August. The stated estimated value of the subsidy for the new PSC over the 8 year period is £370 million. The invitation to tender was issued on 17 January 2019, with a deadline for bids of 28 March 2019. Serco NorthLink and CalMac Ferries have submitted bids. The bids were to be evaluated by 7 June and the contract awarded by 2 August.

[5] In addition to the Scrabster route, which is operated by SNLF under the PSC, two other ferry routes cross the Pentland Firth. One is Gills Bay to St Margaret’s Hope. The other is a passenger only service, which runs only during the summer months between John o’Groats and Burwick, on Burray. The first of these two routes is operated by the petitioners, who were established in 1997 and have operated on the Gills Bay route since 2001. They have exclusive rights to use Gills Bay harbour. The petitioners’ services are not subsidised. They use the MV *Pentalina*, which is a 70m catamaran (launched 2008), on the Gills Bay route. A second, larger (85m) catamaran, the MV *Alfred*, is due to enter service this summer. The Lord Ordinary identified a contradiction in the petitioners’ stated intentions for the new vessel. Their public stance has been that the *Alfred* will replace the *Pentalina*. An affidavit from their managing director, namely Andrew Banks, states that it would be possible for the petitioners to operate both vessels to meet all of the market demand for Pentland Firth crossings.

[6] The Scrabster route carries passengers, vehicles and freight. It is 28 miles long. The journey takes approximately 90 minutes using the 112m, monohulled MV *Hamnavoe* (launched 2002). There are two return sailings per day in the off-peak season and three in the peak season, which is May to September. There is capacity for 600 passengers and 350 lane metres for vehicles (68 cars). There had previously been three sailings per day in the off-peak season. Prior to the award of the PSC in 2012, the respondents (Transport Scotland) decided that it was neither necessary nor appropriate to force SNLF to provide a mid-day crossing in the off-peak season due to the limited demand. This was an unpopular decision. There were, and are, public calls for the reintroduction of this sailing.

[7] The Gills Bay route is 15 miles long. It has a crossing time of 60 minutes. The *Pentalina* is able to accommodate nine articulated lorries, more than 30 cars and 250 passengers. In peak season it can accommodate 346 passengers by employing more staff. There are three return sailings per day, with four on Saturdays in the peak season. The petitioners aver, and the Lord Ordinary accepted, that the Gills Bay and Scrabster routes are in competition with one another in the market for ferry services crossing the Pentland Firth. That is a market which does not include the other three NIFS routes.

The Law

The Treaty and the Regulation

[8] European Union law regulates the provision of subsidies by member states.

Article 107 of the Treaty on the Functioning of the European Union provides that:

“1. ... [A]ny aid granted by a Member State ... in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings ... shall, in so far as it affects trade between Member States, be incompatible with the internal market.

...

3. The following may be considered to be compatible with the international markets:

...

(e) such other categories of aid as may be specified by the decision of the Council...".

[9] In 1992, the European Council adopted Regulation EEC/3577/92 which applied the anti-competitive principle to services of maritime transport within Member States (maritime cabotage). The preamble provides *inter alia* that:

"... the introduction of public services entailing certain rights and obligations for ... shipowners ... may be justified in order to ensure the adequacy of regular transport services to, from and between islands ...".

A PSC is (Art 2.3):

"a contract concluded between ... a Member State and a ... shipowner in order to provide the public with adequate transport services.

A [PSC] may cover notably:

- transport services satisfying fixed standards of continuity, regularity, capacity and quality,
- additional transport services,
- transport services at specified rates and subject to specified conditions, in particular for certain categories of passengers or on certain routes,
- adjustments of services to actual requirements;"

PSOs are defined as:

"obligations which the ... shipowner ... if he were considering his own commercial interest, would not assume or would not assume to the same extent or under the same conditions".

[10] Article 4 states:

"1. A Member State may conclude public service contracts with or impose public service obligations as a condition for the provision of cabotage services, on shipping companies participating in regular services to, from and between islands.

Whenever a Member State concludes [PSCs] or imposes [PSOs], it shall do so on a non-discriminatory basis in respect of all Community shipowners.

2. In imposing [PSOs], Member States shall be limited to requirements concerning ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel.

Where applicable, any compensation for [PSOs] must be available to all Community shipowners.

..."

Guidance

[11] On 22 April 2014, the European Commission published guidance ("a Communication") (COM(2014)232) on the interpretation of the Regulation. It states that:

"5 Public Service

The maritime transport of passengers and goods is vital to the inhabitants of Europe's islands. That is why a special set of rules was drawn up to protect some of these maritime links not adequately served by the market.

...

5.2 Island cabotage routes on which public service obligations may be imposed

It is for the Member States ... not the shipowners to determine which routes require [PSOs]. In particular, [PSOs] may be envisaged for regular (scheduled) island cabotage services in the event of market failure to provide adequate services.

According to the conditions laid down by the Regulation, Member States may impose [PSOs] in order to 'ensure the adequacy' of regular maritime transport services to a given island ... where Union shipowners, if they were considering their own commercial interest, would not provide services of an adequate level or under the same conditions. Trade should otherwise remain free.

When imposing public service obligations for services described in Article 4(1) of the Regulation, Member States must limit their intervention to the essential requirements referred to in Article 4(2) ... in respect of all Union shipowners interested in serving the route. This requirement must be strictly observed when deciding on the content of the obligations to be fulfilled and during the administrative procedure resulting in the selection of an operator of a given service or establishing the amount of compensation.

5.3 The obligations that may be imposed

...

Member States can impose [PSOs] and conclude [PSCs] only if they have determined, for each route in question, that the regular transport services would be inadequate (ie they would not be provided to the extent or under the conditions defined by the public authorities as appropriate) if their provision was left to market

forces alone. Moreover, the [PSO] or contract must be necessary and proportionate to the aim of ensuring the adequacy of regular transport services to and from the islands. In other words, Member States may not subject to [PSOs] and [PSCs] services which are already provided satisfactorily and under conditions, such as price, continuity and access to the service, consistent with the public interest, as defined by the State, by the undertakings operating under normal market conditions.

The Commission recalls that although Member States have a wide margin of discretion in defining the need of public service and the extent of such service, the decision of Member States in this respect is subject to the Commission's control of manifest error of assessment.

...

5.5 Market access and competition on public service routes

By imposing [PSOs], Member States intervene in the conditions of market access on certain routes, which may distort competition if not done in a non-discriminatory way. Such interventions may be considered both legitimate and lawful in view of the aim pursued (to ensure the adequacy of regular – scheduled – transport services to, from and between islands). Any intervention ... should remain proportionate to the aim pursued. Should it go beyond what is strictly needed, it would unnecessarily restrict a freedom which is essential for the proper functioning of the internal market."

The Guidance confirms (Art 5.5.3) that the bundling together of routes to and from different islands, in order to achieve economies of scale and to attract operators, is not unlawful, provided that the bundling does not lead to discrimination or "undue market distortions". It states (Art 5.6) that subsidies must comply with EU law, as interpreted by the Court of Justice of the European Union, and with the rules governing aid for Services of General Economic Interest.

The CJEU

[12] In C-205/99 *Asociación Profesional de Empresas Navieras de Líneas Regulares (Analir) v Administración General del Estado*, [2001] ECR I-1271, the Spanish requirement for a regular island cabotage route to be authorised, and to be subject to certain conditions, came under challenge. The CJEU provided guidance on Article 4 of the Regulation as follows:

“31. ... [T]he purpose of imposing [PSOs] is to ensure adequate regular transport services to, from and between islands ...

32. ... [PSOs are] obligations which the ... shipowner ..., if he were considering his own commercial interest, would not assume or would not assume to the same extent or under the same conditions

33. ... [T]he aim of the [PSC]... was expressly defined ... as being to provide the public with adequate transport services.

34. It follows that the application of a prior administrative authorisation scheme as a means of imposing [PSOs] presupposes that the ... national authorities have first been able to determine, for specific routes, that the regular transport services would be inadequate if their provision were left to market forces alone. In other words, it must be possible to demonstrate that there is a real public service need.

35. Second, for a ... scheme to be justified, it must also be demonstrated that such a scheme is necessary in order to be able to impose [PSOs] and that it is proportionate to the aim pursued, inasmuch as the same objective could not be attained by measures less restrictive of the freedom to provide services...”.

[13] In C-280/00 *Altmark Trans and Regierungspräsidium Magdeburg* [2003] 3 CMLR 12, a subsidy for scheduled bus services was challenged as contrary to Article 92(1) of the EC Treaty (the equivalent of Article 107(1) of the TFEU). The CJEU held that:

“87 ... [W]here a State measure must be regarded as compensation for the services provided ... so that those undertakings do not enjoy a real financial advantage and the measure thus does not have the effect of putting them in a more favourable competitive position than the undertaking competing with them, such a measure is not caught by Article 92(1) of the Treaty.

However, for such compensation to escape classification as State aid in a particular case, a number of conditions must be satisfied.

First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined. ...

Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings.

...

Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the

relevant receipts and a reasonable profit for discharging those obligations. Compliance with such a condition is essential to ensure that the recipient undertaking is not given any advantage which distorts or threatens to distort competition by strengthening that undertaking's competitive position.

Fourth, where the undertaking which is to discharge public service obligations, ... is not chosen pursuant to a public procurement procedure ... the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

...

94 ... when public subsidies granted to undertakings expressly required to discharge public service obligations in order to compensate for the costs incurred in discharging those obligations comply with the conditions set out in paragraphs 89 to 93 above, such subsidies do not fall within Article 92(1) of the Treaty...".

[14] In T-454/13 *Société nationale maritime Corse Méditerranée (SNM) v European Commission*, 1 March 2017, the validity of a subsidised PSC on five routes between Marseilles to several ports on Corsica came under challenge from a private unsubsidised operator which was providing services from Nice and Toulon to some of the same Corsican destinations. The Marseilles routes consisted of basic passenger and freight services plus additional passenger only services in the peak tourist season. The Commission had found (Decision 2013/435/EU) as follows:

"135. ... [T]he compensation of specific obligations under a [PSC], subsidising a range of services, clearly constitutes an obstacle to the free movement of services. The obstacle may be justified only under restrictive conditions establishing the necessity and proportionality of the definition of all the services exempted from the scope of free competition in relation to a real need for transport, which is not met under conditions of free competition.

136. By analogy with ... *Analir* [(supra)] ... the scope of the public service remit as defined by the [PSC] must be necessary and proportionate to a real public service need, as demonstrated by the lack of regular transport services under normal market conditions."

[15] The Commission determined that the basic service met a clearly defined public service need which other operators could not provide. The bundling of the five routes was legitimate. There were clear standards of continuity, regularity, capacity and pricing. The basic service was therefore necessary and proportionate to the need. The same did not apply to the additional service. France had manifestly erred in classifying it as a service of general economic interest. The short distance between Marseilles and Toulon produced a high degree of “substitutability”. There was no shortage of private initiative for the additional service. The combination of the basic services from Marseilles and the non-subsidised routes from Toulon were sufficient to meet the additional service demand.

[16] The CJEU noted the four *Altmark* criteria. It observed (paras 93 and 111) that the member state enjoyed a “wide discretion” in defining an SGEI. The court’s jurisdiction to review was confined to cases of manifest error. The state’s power was not unlimited and (para 112) “may not be exercised arbitrarily for the sole purpose of allowing a particular sector to circumvent the application of the competition rules”. The CJEU endorsed the Commission’s reasoning that the state’s discretion was limited by the Maritime Cabotage Regulation and continued:

“120. ...[T]he granting of financial compensation to a particular service provider ... is liable to impede or render less advantageous the provision of those same services by operators not benefitting from the same compensation. The amount of the compensation allows its recipient to enjoy a decisive advantage over its competitors and, consequently, to dissuade them from offering the services concerned.”

Having explained that the use of an open procurement process did not mean that there was no interference with free movement, the CJEU added:

“133 ... [F]or a maritime cabotage service to be classified as a SGEI, it must meet a real public service need, demonstrated by the insufficient regular transport services in a situation of free competition, and that the scope of the SGEI is necessary and proportionate to that need. It is ... the responsibility of the Member State ... to make out proof of this by adducing sufficiently convincing evidence ... [T]he Member

State cannot merely rely on the existence of a ‘general interest in the broadest sense’. The absence of any evidence provided by the Member State establishing that the abovementioned criteria have been met or disregarded is liable to constitute a manifest error of assessment ...”.

[17] The CJEU endorsed, as an alternative verification of the first criterion in *Altmark*, a three stage test whereby the member state required to prove:

“130 ... first, that there was user demand; second, that that demand was not capable of being satisfied by the market operators in the absence of an obligation imposed by the public authorities to that end; and, third, that simply having recourse to PSOs was insufficient to remedy that shortage”.

“Thus” the CJEU continued:

“134 ...first of all, if there is no demand from users for all or part of the services falling within the scope of the public services remit, as defined by the national authorities, that public service ... cannot be considered necessary and proportionate in relation to a real public service need. Next, nor can there be such a need if the user demand is already capable of being met by the market operators in the absence of a [PSO] ... [I]n the absence of a shortage of private initiative, there can be no real public service need. Lastly, if there is a user demand and that demand is not capable of being met by the interplay of market forces alone, the national authorities should still give preference to the approach which is least harmful to the essential freedoms for the proper functioning of the internal market”.

The European Commission’s analysis

[18] In 2009 the European Commission had examined the provision of state aid to CalMac and SNLF for all ferry routes to the Scottish Islands (Decision of 28 October 2009; No C 16/2008) which had been provided in terms of the Highlands and Islands Shipping Service Act 1960. The Commission noted that, between 2002 and 2006, NorthLink 1 (a joint venture between CalMac and RBS) had operated the Scrabster route and a triangular one from Aberdeen to Kirkwall and Lerwick. These routes had been taken over by NorthLink 2 (CalMac only) in 2006 using 2 car ferries and 2 freight boats.

[19] The tender process from 2002 specified the routes and minimum sailings, with timetables and fares to be agreed. Freight was to be unsubsidised. Thirteen shipping operators had expressed an interest. Six were shortlisted but only three submitted bids, one of which proved unacceptable. NorthLink 1 was preferred; seeking a basic subsidy of £45.7 million for 5 years and beating the previous provider (P&O) by £14 million.

NorthLink 1's projections proved over optimistic, partly because of the intervention of the petitioners and Norse Land Ferries, which began to carry freight to and from Shetland. The latter ceased operations in 2003. However, even then, NorthLink 1 was unable to operate realistically and came close to insolvency. Further payments were made, totalling £71 million for 3 years (2002-2005) with another £21.6 million over the next two (2005-2006).

[20] A new tender process, which included subsidised freight services, commenced in 2004 for 2006-2012. It attracted two bids, with NorthLink 2 (CalMac) selected. The invitation to tender had met all the parameters in the Maritime Cabotage Regulation, ie "ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels" (*Altmark* criterion 1 para 215). However, the parameters for compensation were not all objective or transparent (*Altmark* 2). There were procedures in place to ensure no over compensation (*Altmark* 3) and a tendering process had taken place (*Altmark* 4). The route bundling had not called into question the open, non-discriminatory and transparent nature of the tender. However, the requirement to use the NIFS vessels, whilst reasonable, could have led to higher costs in comparison with a situation in which bidders were free to use their own ships. On that basis the Commission concluded that the PSC with NorthLink 2 contained elements of state aid.

[21] The Commission held that both the NorthLink 1 and NorthLink 2 services were sufficiently defined in terms of the Maritime Cabotage Regulation. In assessing

proportionality (with over compensation and anti-competitive behaviour), the Commission observed that its task was not to check on whether the service could be delivered more efficiently. In the NorthLink 1 contract (2002-2006) the average excess public funding was only £200,000; being less than 1% of the subsidy of £23.2 million per annum (£92.8 million for 4 years). NorthLink 2 (2006) had resulted in excess funding of £1.2 million per annum; being 4.5% of the subsidy of £26.6 million per annum. The principle of reasonable profit for discharging public services was endorsed and the amounts were regarded as reasonable. There was, overall, no over compensation. NorthLink did not carry out any activities beyond the scope of the PSC. Given their published freight tariffs, it would be difficult for them to undercut the petitioners.

[22] In the Commission's view (para 361) the provisions of the PSC were appropriate to prevent over compensation. Compensation was limited to operating costs (including reasonable profit) less operating revenues, with a clawback mechanism in place. The profit margin resulted from a competitive tender process to ensure that the margin was set at a reasonable level. The PSC set strict conditions on pricing, which would be infringed if NIFS reduced prices in order to drive existing competitors out of the market. Any adjustments to timetables required approval and cross subsidisation was prohibited. Accordingly the Commission held that the state aid granted to NorthLink 1 and 2 was compatible with Article 86(2) of the Treaty.

The Ferries Plan (2013-2022)

[23] In December 2012, following a review of ferry services throughout Scotland, the respondents published their Ferries Plan. This recognised the essential nature of ferries as part of the transport network. The quality of service had an impact on both mainland and

island communities. The aim was to “maximise” the economic and social potential of “remote rural and island communities”. The quality, reliability and affordability of transport links was vital for successful social and economic growth. The Plan set out proposals for the future in terms of specific vessels, routes and the requirements of PSCs. It was said to be based on a robust overarching framework or methodology based on objective evidence. This defined what each community needed in terms of their ferry service, the priority of these needs, and the model service to meet those needs. A comparison of model and existing services was undertaken. Where there were two routes to an island, the Plan concluded that all second routes offered some element of time saving, thus becoming the main route for certain trips. They fulfilled a different purpose from the main route, including tourism.

[24] Specifically in relation to the NIFS, the respondents concluded that these were broadly fit for purpose. The Pentland Firth services, taken together, were considered sufficient to meet the needs of the Orkney community. The proposal to retain a broadly similar service, to that which was currently provided, was reflected in the contract for 2012 to 2018. Emphasis was placed on the key service elements of maintaining the 90 minute Scrabster route, an avoidance of previous dry dock problems, an assurance that services were available for time sensitive freight (fish, seasonal livestock and supermarket food) and an improved passenger experience.

Preparation of the PSC

[25] Before advertising the new PSC, the respondents (Transport Scotland) commissioned Peter Brett Associates, a consultancy of engineers, planners, scientists, and economists to appraise the options. PBA produced five documents headed “Appraisal of

Options for the Specification of the 2018 Northern Isles Ferry Services Contract” in the following chronological order: (i) Socio-Economic Baselineing and Future Planning Horizon, 4 March 2016; (ii) Draft Market Analysis, 2 May 2016; (iii) Draft Consultation Report, 15 May 2016; (iv) Pre-Appraisal & Part 1 Appraisal Report, 27 September 2016; and (v) Final Report, 25 April 2018.

[26] The “Baselineing” report outlined the economic situation in the Northern Isles and Caithness in order to inform future funding and investment decisions. The population of Orkney had grown some 12% between 2000 and 2014 to 21,590. The report detailed Orkney’s demographics, economic output and cost of living. The minimum income required in order to achieve an acceptable standard of living was higher in Orkney than in other areas of Scotland and well above that in the rest of the United Kingdom. This was caused in part by the cost of occasional trips to the mainland and delivery charges for imported goods. Overall, Orkney was in reasonably good economic health. Renewables offered substantial opportunities, although hydrocarbons would remain important to the economy. Orkney had a vibrant and growing tourism market. “The NIFS would be important in sustaining and facilitating this key industry” (para 3.3.14). “The food and drink sector, particularly high quality agriculture, is of critical importance to Orkney and the [NIFS] are crucially important and (*sic*) transporting produce off the islands” (para 3.3.16). The forecast economic data did not suggest a fundamental change in local activity which would lead to a significant alteration in the demand for ferry services, albeit that the growth in tourist trade could mean an increase leading to capacity issues during peak periods. In Caithness, the population was in decline at 26,067. The need to retain the younger cohort was a key challenge.

[27] The Market Analysis recorded trends in “carrying” across all the NIFS routes. As at 2015 some 298,000 passengers were carried annually, with about 34,000 on the Aberdeen-Kirkwall route and 125,000 on the Scrabster route. The equivalent figures for cars were 58,580, 470 and 34,000. The Scrabster route had shown a noticeable decline since the introduction of the new, larger and faster *Pentalina* in 2008 and the cutting of the mid-day sailing. The freight figures, in metre lengths, were 464,000, 100,500 and 53,219. The number of freight metres had generally increased by 43% in 8 years, but it had decreased on the Scrabster route because of the commencement and expansion of the petitioners’ services, which had captured most of this market. As might be expected, passenger and car volumes are seasonal. An interesting feature of the Scrabster route is its bed and breakfast service, which allows passengers to book into cabins on the night before an early morning sailing to Stromness. Passenger capacity on the Scrabster route was never an issue, even in the summer. Vehicle deck use could be a problem on Saturdays during the summer, but that was all.

[28] The Appraisal of Options Report expressed an overview recording the essential nature of the NIFS to the island communities. It repeated most of the economic data captured in the baseline study (*supra*). The NIFS played a critical role in facilitating the economics of the island groups. Mainland connections were an essential issue for residents in terms of their own travel and “the impact of these connections on the availability and price of goods and services” (para 2.5.3). The Appraisal reiterated a significant decline in the use of the Scrabster route. This had coincided with the withdrawal of the mid-day sailing and the introduction of the *Pentalina*. For freight, the steady decline of 15% between 2007 and 2015 had been caused by enhanced services on the Aberdeen-Kirkwall route and the “ramping up of operations” by the petitioners. The petitioners had negotiated

individual pricing packages with freight operators. These included volume discounts. On whether the Scrabster route was an SGEI, residents travelled to the mainland four to six times per annum. Business employees travelled two to three times. Eighty five per cent of survey respondents had used a NIFS ferry in the previous year, of whom 91% had used the Scrabster route.

[29] The removal in 2012 of the mid-day sailing on the Scrabster route had been seen by the public, business and the Orkney Islands Council as having a negative impact on Orkney, particularly in relation to onward travel to the other Orkney islands from Stromness. The weather related closure of the Churchill barriers linking South Ronaldsay to the mainland, resulted in a lack of “resilience” (para 4.2.63). The report concluded that, together, the Scrabster and Gills Bay routes provided the capacity to meet the demand for Pentland Firth crossings.

[30] The consequences of the new PSC in relation to the Pentland Firth market were addressed as follows:

“4.4.23 ... It is and will continue to be challenging to develop options and appraise their potential impact when there is a competitive dynamic in the market, not to mention State Aid/[public service obligations] considerations. ...

4.4.24 ..., there is an equilibrium of sorts in the market but there are a number of prospective changes which could impact on this before or during the next contract. These include:

- Pentland Ferries is believed to be considering the purchase of a new medium-speed catamaran. The MV *Pentalina* is currently experiencing capacity constraints at peak times and it is likely that any new vessel would be slightly larger ... It is our understanding that this vessel will replace rather than supplement the MV *Pentalina*. This easing of capacity constraints could lead to an increase in market share for Pentland Ferries, whilst a two-vessel service would be transformative. Questions could therefore be raised over the justification for a continuing PSC service across the Pentland Firth, particularly in any two-vessel scenario.
- Pentland Ferries also has a long-term aspiration to develop the short sea crossing between Burwick and John O’Groats. This service would reduce

the journey time between Orkney and the Scottish mainland to around 30 minutes compared to the 90 minutes on Scrabster-Stromness (a journey time which in itself requires a relatively high speed monohull vessel to achieve) or the 60 minutes from St Margaret's Hope to Gills Bay.

- Pentland Ferries also has a legitimate right to make a competitive response to any change in the NIFS PSC. This makes it difficult to forecast the impact of any option on carryings with any degree of certainty.

4.4.25 There is a wider question for Transport Scotland as to whether there should be a 'floor' set in terms of carryings/market share on the Stromness-Scrabster route, beyond which the viability of the route should be considered."

[31] The Report examined the option of discontinuing the Scrabster route and deploying the MV *Hamnavoe* to the Aberdeen-Kirkwall route. This would mean that there would only be one car and freight route across the Pentland Firth. This was rejected in the Report for "reasons of public acceptability". It would not have been acceptable to remove the Scrabster route as "a publicly supported lifeline service" (para 6.5.18). PBA's, and the respondents', view was therefore that the Scrabster route was an SGEI. There was no specific explanation on why it had to be combined with the other three NIFS routes under a single PSC. The reason, as stated in the contract notice, was that:

"A single operator will mean reduced contract management costs (when compared to lotting which would result in additional operator(s)) and economies of scale in terms of overheads and resources."

[32] The Final Report dealt with the implications of the introduction of the Road Equivalent Tariff (RET), which is not directly relevant for present purposes. It examined pricing and timetabling options in some detail and in that context. Lack of capacity would still not be a problem on the Scrabster route. Consideration was given to the reintroduction of the off-season mid-day sailings and to stagger sailings in conjunction with the petitioners.

The parties' affidavits

Mr Laidlaw's affidavit

[33] The respondents produced an affidavit from Graham Laidlaw, who has been Head of the Ferries Unit since 2008. Mr Laidlaw explained that the vast majority of ferry routes were subsidised. The Orkney and Shetland routes had been subsidised since 1990, when P & O had announced that they could no longer operate the routes on a commercial basis. The respondents did not consider that adequate ferry services could be provided by the market alone. There was therefore a need for a subsidy.

[34] Mr Laidlaw provided some updated statistics on carryings. In 2017 the four ferry routes to Orkney had carried 382,000 passengers and 102,000 cars. The Scrabster and Aberdeen routes had carried 185,000 lane metres of freight. The freight carried by the petitioners' service was (at the time of this affidavit) unknown. Mr Laidlaw summarised the findings of PBA's Appraisal and Final Reports (*supra*). The respondents (Transport Scotland) had concluded that: (a) the Scrabster and Aberdeen routes were both lifeline services; (b) their provision was of crucial importance to the operation of the communities and the economies of both Orkney and Shetland; (c) their provision was key to maintaining and growing connectivity to and from the Islands; and (d) it would be publicly unacceptable to remove any of the services. The socio-economic sustainability of the islands was dependent on a safe, reliable and affordable ferry service for the transport of people, vehicles and goods. Without a lifeline service, island life would not be viable and would lead to depopulation and terminal economic decline.

[35] The Aberdeen route was used to provide a convenient link for a range of purposes including health, leisure, shopping and sport etc., especially at weekends. This was a distinct market that could not be provided by a Pentland Firth service, given the road

distances involved. The timetable on the Aberdeen route was less frequent, with only three or four sailings per week. It was a key livestock route with a dedicated infrastructure. The cost exceeded revenue by £11.8 million in 2017 and by £9.3 million in 2018. The relative subsidy figures were £13.2 million and £10.7 million.

[36] The Scrabster route was a necessary one, which could not be provided by the market alone. Costs exceeded revenue by £7.4 million in 2017 and £6.9 million in 2018. The subsidies were £8.1 million and £7.5 million. The route was not, and could not be, commercially viable if left to market forces alone. Two commercial operators could not compete on the Pentland Firth. The petitioners had exclusive rights to the harbours at Gills Bay and St Margaret's Hope. In the absence of state intervention, the petitioners would have almost 100% of the Pentland Firth market. If the market was operated on the basis of the petitioners' current timetable, ferry services would be inadequate because of: (a) an undesirable level of market concentration; (b) disadvantageous fare levels; (c) a reduction in connectivity and accessibility for specific market segments; (d) an inferior timetable or reduced certainty of travel; (e) dependence on sub-optimal levels of operator performance; (f) insufficient capacity; and (g) public unacceptability.

[37] Fare levels were the biggest deterrent to more travel to and from the islands. They were a potential social and economic barrier; hence the Scottish Government's policy commitment to the RET/reduced fares. This would drive up demand and cause further capacity problems. The current fares were not reasonable. There was a market failure to provide fares at a reasonable level, which met the needs of the island communities. The petitioners had advised that their fares were 30% lower than they ought to be, and would be but for the Scrabster route. Removal of the Scrabster route would result in additional barriers to travel in terms of geography, availability and price. Gills Bay had relatively poor

connectivity. The petitioners had banned the St Margaret Hope harbour trustees from their services, which called into question their suitability and reliability as providers of a lifeline service. The Churchill Barriers were subject to closure in inclement weather, when hauliers and passengers tended to transfer to Scrabster. The petitioners' service did not provide cover when the *Pentalina* was out of service.

[38] When the Scrabster route was run alongside the petitioners' service, capacity on the Scrabster route was not an issue. The *Pentalina* did not have sufficient capacity to accommodate the demand for all Pentland Firth passenger traffic throughout the year, although the *Alfred* could largely do so. The *Pentalina* could not carry all of the car traffic during the summer. The *Alfred* could not do so in the peak summer period. Some form of two vessel scenario was required. The problem would be exacerbated once the RET was introduced. Accordingly, the Scrabster route was necessary for the provision of adequate scheduled services. During the period of the NIFS (2002 to date), no economic operator has expressed an interest in operating the services without a subsidy.

[39] A PSC was necessary given the European Commission's decision on state aid (*supra*). The Commission had determined that it was appropriate to bundle the NIFS routes. There were sufficient safeguards to ensure that the compensation granted was proportionate to the PSOs. The market had not changed substantially since then. Bundling enhanced integration of the network by making it easier to combine safety, quality and environmental aspects of vessel and port operations. It provided resilience, including the substitution of vessels, crew and resources. It led to economies of scale in terms of management costs, ticketing and marketing. The petitioners had never expressed any interest in operating the Scrabster route, whether subsidised or not. The market had been tested in 2012, when there was no

interest from anyone to operate the route. No-one had requested that the routes be “unbundled”.

[40] The current contract notice had been published on 25 September 2018. Five operators had expressed an interest, with one deemed non-compliant and another failing technical requirements. The remaining three had been scored and ranked. It was hoped to evaluate the tenders in June 2019, with a contract awarded in August for service commencement in October. The respondents would retain control over fares, timetables and routes. They would, if requested, provide the three existing car ferries and the two freight boats on bare boat charters. There were provisions to allow changes to the PSC to reflect future demand and market conditions. Based on past experience, a contract with a six year length and a two year extension period had been selected. The subsidy would be calculated by reference to the difference between the costs of and revenue for the service. There were provisions for the recovery of any excess payment.

Mr Banks' affidavit

[41] Alfred Banks has been the petitioners' managing director since their establishment in 1997. In his affidavit, he expressed disappointment at the lack of support for the petitioners' services from Orkney Council. In 2017, the petitioners' Gills Bay service had carried 150,000 passengers, 52,000 cars and 90,000 lane metres of freight. It was a commercially viable, unsubsidised lifeline route. New complaints to the European Commission had been made, including one relating to the RET. It was accepted that there was a need for both the Gills Bay and Scrabster routes, especially in the summer. However, once the *Alfred* was available, both boats could be operated and meet the entire demand on the Pentland Firth. The petitioners offered a better service; being a cheaper, shorter crossing. A standard passenger

fare on the Scrabster route was between £17 and £20 whereas it was £16 on the Gills Bay crossing. The fares for cars were respectively £54-60 and £38. The crossing was calmer.

[42] In 2018, the petitioners operating costs had been about £2.9 million. In 2017, the Scrabster route had received a subsidy of £7.3 million (£20,000 per day) (cf £8.1 million (*supra*)). The market was being distorted by this level of subsidy and the petitioners struggled to pay equivalent wages and conditions. The petitioners operated inexpensive ships and built their own piers. They could run a free Scrabster route for the amount of subsidy being paid. The Scrabster route could be operated at a profit with more fuel efficiency, convenient timings and a reduction in crew. There would be no problem with there being only one provider as there would be no need for a subsidy. The petitioners' fares would not change. It was not correct to say that fares were 30% lower than they should be. The petitioners could operate between Gills Bay and Stromness. They could increase sailings by using another boat. Their performance was superior to that on the Scrabster route. The public had always been happy with the petitioners' service. The Churchill Barriers ought to be improved. They only closed at high tide and did not result in cancellations of, as distinct from delays in, sailings.

[43] The respondents had failed to take into account the availability of the petitioners' two boats. In 2010, the petitioners had proposed that the Pentland Firth crossings should be the subject of a separate tender. They would bid on the basis of a £2 million subsidy for 5 years. There was no adequate response to this. The petitioners could not take on the Aberdeen routes which, it was accepted, required a subsidy. This would be too big an operation for them. In 2011, it had been suggested by the respondents that the Scrabster route would be the subject of a separate tender. However, the conditions attached to this, which included fixed ports and ships and the same timetable, meant that the route would

continue to be inefficient. The petitioners were not interested in this. In 2015, the petitioners had expressed an interest in running a car ferry service to Burwick, on South Ronaldsay. Assurances from the respondents that this would be considered did not bear fruit.

Mr Laidlaw's supplementary affidavits

[44] Mr Laidlaw commented that the freight figures from the petitioners were new. Their passenger and car figures were inconsistent with those provided by them to the European Commission. The *Alfred*, if it were operating alone, could not meet the Pentland Firth demand in the summer, even with extra sailings. The petitioners had made no firm commitment to run two ferries. That had not been their publicly expressed intention. Considerable planning would be necessary to achieve it. It was accepted that the subsidy to the Scrabster route was "large" in comparison to the petitioners' operating costs. There were several reasons for this. First, dues, which were payable to the Scrabster and Stromness harbour authorities, were significant at £5.4 million per annum. There were higher fuel costs. The operators on the Scrabster route paid the "Living Wage". They provided training to all employees and contributed to their pension scheme. The ferry users would not be happy if the petitioners were the sole providers of Pentland Firth crossings. Consultations had stressed that the Scrabster route was a vital lifeline link.

[45] The amount of the subsidy for the NIFS in the period 2012 to 2019 had been about £41.3 million per annum. The £370 million figure in the contract notice was the total contract value. The market would determine the revenues and costs and thus the amount of the subsidy. The estimate was that the subsidy for the new contract would be about £46 million per annum over the 8 year period. However, a decrease in vessel lease costs, static harbour charges, fare levels and freight timetables had reduced this to about £40 million. All costs

and payments were strictly monitored and controlled. If the revenues exceeded the levels set out in the tender price, the amount of subsidy would be reduced. The controls were applied to individual routes, thus ensuring that the subsidy remained proportionate to the need and only ever covered the difference between revenue and costs plus a profit level which was capped in the tender process.

Lord Ordinary's reasoning

[46] The Lord Ordinary summarised the petitioners' position as being that their ability to operate a service in the same market without a subsidy showed that there was no market failure which required a subsidy for the Scrabster route. The respondents' position was that they required: first, to determine the routes which were needed in order to provide adequate maritime transport services; secondly, to assess whether each route could be provided without a subsidy; and thirdly, to decide whether to designate a given route as an SGEI.

The Lord Ordinary accepted the respondents' position. He agreed with the petitioners that the Gills Bay and Scrabster routes were in competition with one another in a market for ferry services across the Pentland Firth. He found no authority to support the proposition that, if one route across a stretch of water required no subsidy, another route across the same stretch of water could not be subsidised. *C-205/99 Analir v Administracion General del Estado* (*supra*) referred (at para 34) to the need to assess specific routes to see whether regular (unsubsidised) transport services would be adequate if there was no state intervention.

[47] The starting point was not to look at the market, but to look at the specific routes that served the market (para [48]). *C-280/00 Altmark Trans v Nahverkehrsgesellschaft Altmark* (*supra*) set the test for assessing the requirement of a subsidy for a specific route. When looking at the Scrabster route, the first issue was the adequacy of transport services to

Orkney generally (*Analir (supra)*, at para [31]); the Regulation, preamble (*supra*); the Commission Guidance (*supra* at para 5.3.1). There were four reasons, underpinned by evidence, for determining why the adequate provision of transport services necessitated a subsidy for the Scrabster route.

[48] First, both of the Gills Bay and Scrabster routes were required to provide the capacity to meet the demand. Although the petitioners had maintained that a two-vessel service on the Gills Bay route would meet that demand, they had not said, during the consultation process, that both the *Pentalina* and the *Alfred* would be in operation at the same time, nor had they said that they could take over the Scrabster route without a subsidy. Secondly, frequent and reliable ferry services were vital to the economy of Orkney; especially to attract young people. The cost of ferry services was cited as the biggest single deterrent to travel to and from the islands. The respondents' aspirations were contained in the Islands (Scotland) Act 2018. Thirdly, the desire to have two routes across the Pentland Firth was not irrational. Each had its distinct advantages. The Gills Bay route was shorter and had discount freight deals. Stromness served the west of the Orkney mainland and other islands. It had bed and breakfast facilities. Scrabster was better served by public, including rail, transport than Gills Bay. Fourthly, there was strong public support for the continuance of the Scrabster route. Issues of resource allocation and aspirations for future growth were political decisions for which the respondents were accountable.

[49] The Lord Ordinary considered whether there was a market failure on the Scrabster route. Nobody had suggested that the route could be operated without a subsidy. In the pre-Appraisal Report, PBA had asked whether the respondents should consider a cap on the extent to which they would subsidise the Scrabster route. The Scrabster route had been offered as a single route in 2012, but there had been no offers to operate it on that basis.

There was ample evidence that the route was not viable without a subsidy. Mr Laidlaw's affidavit showed shortfalls between revenue and costs of £8.1 million in 2017 and £7.5 million in 2018. He gave, as reasons for the high operating costs, the commitment to maintaining a 90 minute crossing (requiring more fuel), the obligations on the operator to meet environmental standards and commitments to staff training and conditions of employment.

[50] The Lord Ordinary considered the necessity and proportionality of the subsidy (*Analir (supra)* at para [35]). The petitioners had estimated that the proposed subsidy was double that of the existing contract. This proposition had not been foreshadowed in the petition. While there was a substantial projected increase, it was impossible to say how much would be paid under the new PSC. Fears that that subsidy would be doubled were misplaced. The new PSC provided that payments were to be used solely to meet part of the costs of the NIFS. The grant for each year was the projected cumulative difference between operating costs, including an operator's return, and revenue. Alternative ways of providing a subsidy, which would not create an unfair advantage, largely ignored any notion of a reasonable profit, which was a legitimate part of the subsidy (*Altmark (supra)* at para [92]). There may have been other methods of valuing the requisite subsidy, but there had been no manifest error in the new PSC. A direct payment to the petitioners would not work. The Gills Bay route was commercially viable at present. Any payments would be classed as illegal state aid. They would require to meet the *Altmark* principles. Whereas a payment to the petitioners could be made, if the European Commission agreed, the strong expectation was that the route would be put out to tender.

[51] The Lord Ordinary was satisfied that the bundling of the Scrabster route with the other three NIFS routes was lawful. Bundling was a common practice endorsed by the

European Commission Guidance (*supra* at para 5.5.3). In 2009, it had addressed the bundling of 26 CalMac routes during the general examination of state aid for maritime transport services in Scotland. It had concluded that, given the legal framework allowed for bundling, it could not be said that it was unnecessarily unfair. The Commission had recognised the benefits of bundling. These were: the provision of relief vessels during breakdowns, maintenance and poor weather; network integration combining safety, quality and environmental aspects of vessel and port operations; economies of scale, ticketing and marketing; and combining the costs and burden of tendering each route separately. The same considerations applied here. The situation as assessed by the Commission had not significantly changed with the introduction of the *Pentalina* and the petitioners' increased market share. Unbundling would have a significant impact on resource and staffing costs within Transport Scotland. When the Scrabster route had been put out for tender on a standalone basis in 2012, there had been no bids.

Submissions

Petitioners

[52] The petitioners submitted that the legal principles demonstrated that the default position was that payment of a subsidy, which distorted or threatened to distort competition, was unlawful. It could only be lawful if the state identified a market failure. Market failure occurred when regular transport services would be inadequate if left to market forces alone. Any subsidy required to be necessary and proportionate to the market failure. Payment was only proportionate if the same objective could not be attained by measures which were less restrictive of the freedom to provide services. A subsidy could not be proportionate if it led to undue market distortion. The onus was on the state to

establish both a market failure and the necessity and proportionality of the subsidy by producing sufficiently compelling evidence. The state could not simply rely on the existence of a general interest in the broadest sense to discharge the onus.

[53] The petitioners maintained, first, that the Lord Ordinary had erred in determining that there had been a market failure on the Scrabster route. He ought to have held that there had been no such failure; the market being the Pentland Firth crossing. The legal test was market, and not route, failure. The respondents had not carried out any economic analysis of market failure. The Appraisal Report had noted that the petitioners' potential two vessel service would be transformative. This was evidence of an effective market, yet the report failed to address the questions that it had posed in relation to the justification for a continuing PSC across the Pentland Firth. The fact that the Scrabster route had been receiving ever increasing amounts of subsidy did not constitute evidence of market failure. The petitioners' profitable and unsubsidised route from Gills Bay was irrefutable evidence that the market alone could provide ferry services across the Firth.

[54] It was for the respondents to analyse why the Scrabster route required a subsidy and thereafter to consider whether this amounted to market failure. The reasons, which might be the result of mismanagement, had to be identified in order to ensure that any subsidy was necessary and proportionate. If the reasons for the market failure were not identified, it was impossible to know if the subsidy was necessary and proportionate. If the losses were the result of increased fuel and/or crew costs, any subsidy ought to be related to these costs.

[55] Secondly, the Lord Ordinary had erred in holding that the increase in the subsidy was necessary and proportionate. As the cause of any market failure had not been ascertained, there was no assessment of whether the increased subsidy was necessary and proportionate to it. There had been no explanation of why the increased subsidy was

necessary. Since it was accepted that the Scrabster route had inadequate capacity to satisfy the demand for services across the Pentland Firth, the petitioners' route was also a lifeline service. No analysis had been carried out on the potential impact on the petitioners' service. The proposed increase in the subsidy was substantial; from £223 million to £370 million for the four routes. The petitioners had a reasonable concern that this would undermine the viability of their own lifeline service. The existing level of subsidy had enabled the prices on the Scrabster route to be frozen since 2012, despite increased fuel and labour costs. The Scrabster route had introduced discounts for Orkney residents. The respondents had failed to consider whether there were less restrictive measures available. A subsidy could not be proportionate if it led to undue market distortion. Such distortion would arise where the respondents were providing a subsidy which was greater than the petitioners' operating costs. The failure to recognise the petitioners' route as a lifeline service meant that there had been no consideration of the necessity and proportionality of providing a subsidy only on the Scrabster route. There was no justification for including the Scrabster route in the same PSC. Previously, they had been separate lots. The need for a subsidy on the Aberdeen routes was not disputed. The Pentland Firth market had to be looked at separately. The consequence of the two material errors was that the decision to subsidise the Scrabster route was unlawful because it breached Article 4.1 of the Maritime Cabotage Regulation.

Respondents

[56] It was accepted that any state aid which distorted or threatened to distort competition was incompatible with the internal market. State aid had four characteristics: intervention by state resources; liability to affect trade; the conferring of a selective advantage on the recipient; and distortion or threat of distortion of competition. The four

Altmark cumulative criteria had to be fulfilled to avoid the state aid classification and to constitute an SGEI. These were, first, that the recipient must have PSOs to discharge. This meant that the PSC had to comply with the Marine Cabotage Regulation. Secondly, the parameters of the compensation must have been established in advance in an objective and transparent manner. Thirdly, the compensation had to be necessary to cover the costs of the PSOs, taking into account receipts and allowing a reasonable profit margin. Fourthly, the level of compensation had to be determined in an open and transparent procurement process. The proposed PSC complied with the *Altmark* criteria and was therefore not prohibited state aid. If that was correct the subsidy would not constitute undue distortion in the market.

[57] The Marine Cabotage Regulation permitted PSCs where, for specific routes, the regular transport services would be inadequate if left to market forces alone. A PSC was lawful if it was necessary and proportionate to the need. Such a provision represented an SGEI. The respondents had a wide discretion to determine what constituted adequate regular transport services and consequently if there was a real public need for an SGEI. The respondents' assessment of that could be challenged only on the basis of manifest error. There had been no such error.

[58] Market failure was addressed by asking whether, for the specific routes, the regular transport services would be inadequate if their provision was left to the market. If that were so, there would be a failure in adequacy which would justify a PSC. A specific route which was required to ensure adequacy and which could not be met by the market alone would represent a real public service need. It was for the state to determine the need and its extent. Factors such as price, continuity and access, and public interest were all relevant to need and

adequacy. If the services were provided satisfactorily under normal market conditions, there could be no PSC.

[59] The respondents had been entitled to conclude that the Scrabster route was required to ensure the adequacy of services across the Pentland Firth. They had assessed what was needed in terms of demand, fares, continuity, access, routes, social and economic growth, prosperity and equality with the mainland. The Lord Ordinary had been correct to identify a “wealth of evidence” to support that view, *viz*: demand and capacity; the needs of the Orkney community and aspirations for future growth; the differences between the Scrabster and the petitioners’ routes; and strong public support for the Scrabster route. It was not disputed that the Scrabster route was a lifeline service. Having identified the Scrabster route as being required to ensure adequacy, the question was whether it could be provided by the market. The respondents had been entitled to conclude that it could not. There was ample evidence that the route would not be viable without a subsidy. This was all detailed in the PBA Pre-Appraisal report. The petitioners’ ability to operate their route profitably did not demonstrate that the Scrabster route could do so.

[60] There was no substantial increase in the subsidy attributable to the Scrabster route. The proposed subsidy for the Scrabster route was not materially different from the existing level at about £7-8 million. This included harbour dues of over £5 million. The fuel costs were higher. Costs were constantly monitored. The costs, and related subsidy, were a direct result of the route itself. Any reduction in costs would reduce the service and the adequacy of services. The subsidy did no more than allow a reasonable return.

[61] Necessity and proportionality were measured against the requirements of the PSC and not against any actual or hypothetical service. The fact that a PSC involved higher costs than another service did not call into question its need and proportionality. The

respondents had been entitled to specify the ports to meet the need and the nature of a suitable vessel, having regard to the demand and the likely sea conditions. They were entitled to specify the level of fares, since these were relevant to adequacy.

Decision

[62] Article 107.1 of the Treaty on the Functioning of the European Union prohibits the subsidising of undertakings where this would distort or threaten to distort competition. The European Council are entitled to provide exceptions to this (Art 107.3). Article 4.1 of the Maritime Cabotage Regulation (EEC/3577/92) provides such an exception by permitting public service contracts for the provision of maritime services to and from islands. The Preamble to the Regulation explains that PSCs may be justified in order to ensure the adequacy of such transport. PSCs can regulate the ports to be used, the timetables, capacity and crewing of vessels and the fares (Art 4.2). Article 5.5 of the European Commission Guidance (COM(2014)232) explains that any interference should be proportionate to the aim pursued and should not go beyond what is strictly needed. It is specifically stated (Art 5.5.3) that the bundling of routes, in order to achieve economies of scale and to attract operators, is not unlawful provided that it does not lead to “undue market distortions”. Any subsidies must (Art 5.6) comply with EU law, as interpreted by the CJEU, notably the rules governing aid for Services of General Economic Interest.

[63] C-205/99 *Asociación Profesional de Empresas Navieras de Líneas Regulares (Analir) v Administración General del Estado*, [2001] ECR I-1271 confirmed (paras 31-35) that the purpose of imposing PSOs was to ensure adequate regular transport services to, from and between islands. The state had, first, to determine, for specific routes, that the regular transport services would be inadequate if their provision were left to market forces alone. There

required to be a real public service need. Secondly, the relevant scheme had to be necessary in order to be able to impose the PSOs and proportionate to the aim pursued. The same objective could not be achieved by less restrictive measures.

[64] C-280/00 *Altmark Trans and Regierungspräsidium Magdeburg* [2003] 3 CMLR 12 set out the four criteria which had to be met. First, there had to be clearly defined PSOs. Secondly, the parameters for the subsidy had to be established, in advance, in an objective and transparent manner. Thirdly, the subsidy could not exceed what was necessary to cover the costs, taking into account relevant receipts and including a reasonable profit margin. Fourthly, the recipient had to be chosen under public procurement procedure or the level of subsidy had to be determined on the basis of the costs which a typical undertaking would have incurred in discharging the obligations, again taking into account relevant receipts and a reasonable profit.

[65] In C-454/13 *Société nationale maritime Corse Méditerranée (SNM) v European Commission*, 1 March 2017, the European Commission stressed (at para 136) that the PSC had to be necessary and proportionate to a real public service need, “as demonstrated by the lack of regular transport services under normal market conditions”. The CJEU repeated (at para 133) that for a maritime cabotage service to be classified as an SGEI, it had to meet a real public service need, demonstrated by insufficient regular transport services in a situation of free competition. The scope of the SGEI must be necessary and proportionate to that need. The state had to demonstrate (para 130): first, that there was user demand; secondly, that that demand was not capable of being satisfied by the market in the absence of a PSO; and, thirdly, that simply having recourse to PSOs was insufficient to remedy that shortage.

[66] The first question is whether the respondents manifestly erred in determining that, under normal market conditions, maritime transport services to Orkney would be

inadequate without a service on the Scrabster route. The answer to that must be in the negative. At the time of the decision to offer a PSC, the only alternative car and freight route across the Pentland Firth was that offered by the petitioners between Gills Bay and St Margaret's Hope. This is a relatively (compared to the Scrabster route) short (60 minutes) journey across 15 miles of relatively sheltered waters. It is serviced by a relatively (compared to the *Hamnavoe*) modern catamaran between harbours in which the petitioners appear to have some form of monopoly or interest which keeps the harbour dues down to well below those at Scrabster and Stromness. There was no live proposal by the petitioners to operate a two ferry service on the Gills Bay, or any other, route.

[67] It is clear from the material presented to the Lord Ordinary that the Scrabster route cannot be operated commercially without a subsidy. This is not surprising. It is a significantly longer route at 28 miles which requires a sturdier vessel because of the waters. In order to be vaguely attractive to both passengers (notably those with a car) and freight, it requires to be able to cross the Pentland Firth in a not too dissimilar time (90 minutes), thus requiring a much heavier fuel load. It needs fares which are approximately competitive with those charged by the petitioner's quicker, shorter and more efficient service. Although the harbour dues at Scrabster and Stromness appear to be fixed at what might best be described as a surprisingly high price, for a local authority (public) facility serving a subsidised PSC vessel, even without such dues the Scrabster route would remain non-viable commercially without a significant subsidy.

[68] The need for a subsidy was in any event amply demonstrated by the absence of any bid for the route when it was offered as a single lot in 2012. The petitioners maintain that the Scrabster route might be run more efficiently if a more modern vessel, travelling at a

slower speed and with less crew, were used. That may be so, but the figures produced for harbour dues alone convincingly demonstrate the requirement.

[69] In these circumstances, the respondents were entitled to conclude, on the material available to them, that, if left to market forces alone, all that would exist in the Pentland Firth market (leaving aside the passenger only sailings) would be the petitioners' single car and freight service, albeit enhanced by the arrival of the *Alfred*. Its capacity might, in the off-peak season, be sufficient to meet the demand, but it could not do so over the summer months. Any sudden disruption to the petitioners' service, as a result of any problems with the vessel, could cause significant difficulties with the transport of fresh produce both to and from the island, quite apart from the general inconvenience which it would cause to commercial and tourist traffic. Similar considerations apply to the problems, albeit temporary, which would be caused by the temporary closure of the Churchill Barriers. Although perhaps not the greatest of problems in a car dominated market, it is not entirely of no moment that the petitioners' service does not connect directly with rail services. These do link to Scrabster from Thurso.

[70] It was for the respondents to determine what would constitute an adequacy of service. They were entitled, on the information available to them, to decide that an adequacy would not exist if only the service operated by the petitioners were in existence. If only the petitioners' service operated, the respondents were entitled to hold that the services across the Pentland Firth would be inadequate. The market would fail to meet the demand. There would be insufficient service to meet a real public need, especially in the peak season and if problems arose, for whatever reason, on the petitioners' route. The respondents were also entitled to take into account the advantages of the Scrabster route in terms of convenience as an alternative route. As the Lord Ordinary noted, it directly served a

different part of Orkney. After all, it was used in 2015 by almost 60,000 passengers, 34,000 cars and almost 53,000 meters of freight. It is hardly surprising that the public view is that the route should continue to operate.

[71] Once it is accepted that an alternative to the petitioners' route was required, the only option available was Scrabster. The next question is whether the proposed subsidy for that route is necessary and proportionate. As already explored, a subsidy is necessary.

Although the petitioners contend that the costs on the Scrabster route are too high for a variety of reasons, they have been demonstrated by the respondents to be real. It is not disputed that costs exceeded revenue by £7.4 million in 2017 and £6.9 million in 2018. Given the level of harbour dues, this may not be surprising once the additional fuel costs of running a 90 minute service over a 28 mile stretch of water are taken into account. The subsidy for the same years was £8.1 million and £7.5 million. The annual profit to the operator was between £600,000 and £700,000, which cannot be regarded as excessive. There is no reason, on the evidence produced by the respondents, to suspect that the new PSC will result in a substantially higher subsidy for this route. The control mechanisms in the PSC tie the level of subsidy to a figure, including reasonable profit margin, being the difference between the revenue and costs. The public procurement process ought to ensure that the resultant figure is a competitive one. The subsidy is proportionate to the aim of the provision of adequate maritime transport services to Orkney. In this context the four *Altmark* criteria are met.

[72] Apart from the harbour dues on the Scrabster route, there must be some concern about the bundling of the Pentland Firth route with what appears to be regarded as the separate, although related, Aberdeen routes, not only to Orkney but to Shetland. However, bundling is a recognised mode of producing economies of scale and to attract operators

(*Commission Guidance (supra)* para 5.5.3). It is not unlawful if it does not produce “undue market distortions”. The bundling does not appear to do that. The reality is that the unbundling of the Scrabster route in 2012 had produced no bidders. Although the petitioners maintained that they would have considered making a bid, that was only on the basis that they could change the route as well as the timetables, both of which the respondents were entitled to determine to be necessary to provide adequacy. If the Scrabster route, as a single PSC, could attract no bidders, there was little choice but to bundle it in with the other NIFS, just as this is done with the multiple island routes off the west coast.

[73] For these reasons, the court should adhere to the Lord Ordinary’s interlocutor of 26 April 2019 and refuse the reclaiming motion.



FIRST DIVISION, INNER HOUSE, COURT OF SESSION

**[2019] CSIH 41
P1291/18**

Lord President
Lord Menzies
Lord Drummond Young

OPINION OF LORD MENZIES

in the Reclaiming Motion by

PENTLAND FERRIES

Petitioners and Reclaimers

against

THE SCOTTISH MINISTERS

Respondents

**Petitioners and Reclaimers: Lindsay QC; Macroberts LLP
Respondents: Crawford QC, E Campbell; Scottish Government Legal Directorate**

23 July 2019

[74] I am in complete agreement with the views expressed by your Lordship in the chair,
and there is nothing further that I can usefully add.



FIRST DIVISION, INNER HOUSE, COURT OF SESSION

[2019] CSIH 41
P1291/18

Lord President
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OPINION OF LORD DRUMMOND YOUNG

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23 July 2019

[75] I agree with the opinion of your Lordship in the chair. I have decided to write a short concurring opinion, however, for two reasons. First, I have not found the issues that arise in this case to be easy to resolve. State aid is generally prohibited under Community law, on the basis that it is liable to distort competition and to favour one business at the expense of another. An exception exists for public service contracts and public service obligations under the Maritime Cabotage Regulation, but that exception is subject to important controls in accordance with the *Altmark* criteria; the state must establish that a

public service contract or public service obligations are necessary, and such contract or obligations are subject to the requirements of proportionality. Secondly, although the court has concluded that those requirements are concluded in the present circumstances, the proposed public service contract will necessarily run for a number of years, and it will in all probability be replaced by another similar contract. Throughout that period, on the assumption that the existing rules governing state aid continue in existence, it is important that the proposed contract or any successor should be regulated according to the *Altmark* criteria as those have been interpreted by the courts. That will require Scottish Ministers to ensure that the subsidy arrangements, in particular, do not give the operator of ferries on the Scrabster to Stromness route an unfair or disproportionate advantage over private enterprise competitors such as the present petitioners.

[76] The starting point, which is accepted by the respondents, is that state aid that threatens to distort competition is incompatible with the internal market; that is established by article 107 of the Treaty on the Functioning of the European Union. The reason for this is obvious: free competition among businesses that compete on an equal basis is the most effective way of ensuring that goods and services of high quality are provided at a reasonable price. In respect of certain categories of coastal shipping and shipping serving offshore islands, however, that is subject to the exceptions contained within the Maritime Cabotage Regulation (Regulation EEC/3577/92). Article 4 of the regulation permits member states to conclude public service contracts with, or impose public service obligations as a condition for the provision of cabotage services on, shipping companies that provide regular services to, from and between islands. That power has been extensively used in practice, and it is clearly potentially available in respect of shipping services between the Scottish mainland and Orkney.

[77] Before a public service contract or a contract imposing public service obligations can be concluded, however, it is necessary that the state should establish market failure: European Commission guidance (COM (2014) 232). This means that, before public service contract or obligations can be used on a particular route, it must be established that commercial operators would not provide adequate services on that route. The primary requirement is thus necessity: without state intervention or state aid adequate shipping services would not be provided. In addition, if compensation is to be provided in respect of a public service contract, it must meet a set of criteria laid down and repeatedly reaffirmed by the Court of Justice and General Court, generally known as the *Altmark* criteria: Case C-280/00. *Altmark Trans and Regierungspraesidium Magdeburg*, *supra*; reaffirmed in cases such as Case T-454/13, *Societe nationale maritime Corse Mediterranee v European Commission*, *supra* (“*Corsican Ferries*”). I propose to consider each of these requirements in turn.

[78] In relation to the necessity of concluding a public service contract along the lines proposed by the respondents, two questions are critical: first, whether the Scrabster – Stromness route is required to ensure adequate regular transport services between the Scottish mainland and Orkney; and secondly, whether that route is viable without a subsidy. In this connection it must be borne in mind that travel between the mainland and Orkney is also available on the petitioners’ service between Gills Bay and St Margaret’s Hope; in general terms, it appears that comparable amounts of traffic are carried on the two routes. It was suggested in argument that the petitioners, who are about to bring a new, larger ferry into operation, the MV *Alfred*, could use that vessel together with their existing vessel, the MV *Pentalina*, to cater for all travel between the mainland and Orkney, without any form of state aid. That argument was not put to Scottish Ministers at the time when consultation was carried out as to transport between the Scottish mainland and Orkney,

however, and for that reason I consider that it is not open to the court to take it into account at this stage.

[79] I have ultimately come to the conclusion that the respondents were entitled to conclude that the ferry service between Scrabster and Stromness is necessary to ensure adequate regular transport services between the Scottish mainland and Orkney. In view of that factor, once it is established that the service is necessary, I think it clear that a subsidy is necessary in order to maintain the service. The Court was referred to extensive documentation arising from the consultation exercise carried out on behalf of the respondents at the point where they were considering concluding a new public service contract for the Scrabster to Stromness route. It seems clear from the results of that exercise that this route is markedly more expensive to operate than the petitioners' route between Gills Bay and St Margaret's Hope. The difference in costs arises out of a range of factors. Two of these seem particularly important. First, the petitioners' route is shorter and more sheltered, and they are able to use a catamaran that is economical in terms of fuel. The Scrabster to Stromness route, by contrast, goes into the open sea to the west of Hoy. This requires a monohull vessel that is more expensive to operate. Furthermore, because the route is substantially longer, to achieve a journey time that is acceptable to the public the ferry requires to travel at an especially high speed, which means that it has much higher fuel consumption. Secondly, the harbour charges at Scrabster and Stromness appear to be especially high; the petitioners, by contrast, are able to use modern custom-built facilities at both terminals which are under their own control.

[80] In conditions of normal competition, expensive routes and ports should lose business and routes and ports that can operate more cheaply should gain business at their expense. The respondents' consultation exercise, however, demonstrates that Stromness has certain

advantages for the Orkney community. It serves the western part of the Orkney Mainland, which is one of the most populous parts of Orkney and contains many of its most popular tourist attractions. It is, moreover, well-positioned for services linking the Mainland with other islands in the archipelago. St Margaret's Hope, by contrast, is on an outlying island, South Ronaldsay, and it is linked to the Orkney Mainland by means of the Churchill Barriers. Occasionally these are impassable, although that does not appear to be a major problem. Gills Bay has been developed fairly recently as a ferry port. Scrabster is long-established as a port, and has traditionally been one of Orkney's two main ports; its historical links include matters such as its long-running connection with the Hudson's Bay Company. Transport links to Scrabster, especially by public transport, appear to be better than those to Gills Bay. Public opinion clearly cannot be decisive in determining whether a ferry service is necessary, but the report commissioned by the respondents indicates that the public and Orkney Islands Council strongly supported the retention of the Scrabster to Stromness service as a "lifeline" ferry service.

[81] I am further of opinion that the respondents are entitled to conclude that it is not possible to operate the Scrabster to Stromness ferry service under normal market conditions without a public subsidy. The report commissioned by them and the affidavit of Mr Graham Laidlaw narrate the history of the route at some length. It is apparent from that narrative that subsidies have been paid since the mid-1990s and continue to be paid. These subsidies are at such a level that it seems an inescapable conclusion that some form of subsidy is required if the route is to operate. It was suggested for the petitioners that they could operate a service to Stromness from Gills Bay without a subsidy, using the two vessels that they will shortly have available. Nevertheless, as I have already noted, this possibility was not put to the respondents at the time when they were considering the future of the

Scrabster to Stromness service, and for that reason I think that the possibility must be discounted for present purposes, although it could conceivably be relevant at a future date.

[82] I further consider that the respondents were entitled to bundle the Scrabster to Stromness services with the services from Aberdeen to Kirkwall, Aberdeen to Lerwick and Kirkwall to Lerwick. It is apparent from the case law of the Court of Justice and the General Court that bundling is regarded as acceptable. It can have obvious practical and economic advantages, in enabling a service to be maintained even when a vessel is out of commission for a time. It also enables administrative savings to be made, for reasons that are obvious.

[83] For the foregoing reasons I conclude that the Scrabster to Stromness route is not economic under normal market conditions, without a subsidy, and that accordingly the necessity for a public service contract, or conceivably public service obligations, is established. Under a public service contract, the respondents are entitled to regulate matters such as the ports to be used, timetables and, most importantly, the fares charged. They must also determine the amount of subsidy that is paid, and in the form of compensation for undertaking a public service contract or public service obligations. As already noted, that is a question dependent on the application of the *Altmark* criteria.

[84] These involve four propositions (*Altmark, supra*, at paragraphs 89-93; *Corsican Ferries, supra*, at paragraphs 86-90).

- (i) First, the undertaking receiving compensation must actually have public service obligations to discharge, and those obligations must be clearly defined. In the present case, these must appear from the agreement concluded between the respondents and the undertaking that provides the Scrabster to Stromness ferry service.

(ii) Secondly, the parameters on the basis of which the compensation is calculated “must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings”. Payment of such compensation by other means will constitute state aid which contravenes the European Treaties.

(iii) Thirdly, “the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations”. Such a condition is necessary to ensure that the recipient undertaking is not given an advantage that distorts or threatens to distort competition by strengthening its competitive position.

(iv) Fourthly, where the undertaking which is to discharge public service obligations is not chosen using a public procurement procedure which allows selection of the tenderer capable of providing the services at the least cost to the community, the level of compensation must be determined on the basis of an analysis of the costs which a typical undertaking, properly run, would have incurred in discharging the obligations.

[85] For present purposes the fourth of these requirements is not of great significance, as a competitive tendering process is being used. Nevertheless, the method suggested in the fourth criterion may form a useful cross-check against amounts tendered, especially when, as typically occurs with ferry services, the market is fairly restricted and the number of tenderers is limited.

[86] The first criterion is plainly important. The obligations that will be imposed on the successful tenderer are found in the draft Contract Agreement prepared by Transport

Scotland, a copy of which was available to the Court. This does appear to meet the first criterion, as the obligations incumbent on the operator of the Scrabster to Stromness service are set out using the framework in clause 4 of the draft agreement, dealing with Services.

[87] The second and third criteria are likewise important. These are concerned with ensuring that, notwithstanding the payment of a state subsidy, the successful tenderer is not given an advantage that places it in a favourable position as against other operators of comparable services. That is of fundamental importance in the present case, because the petitioners provide a comparable service between the Scottish mainland and Orkney, albeit between different ports. For this purpose, it is accepted by the respondents that the relevant market is the Pentland Firth market, and both the petitioners and the successful tenderer will operate in that market. That means that the respondents must take care to ensure that the levels of compensation paid to the operator of the Scrabster to Stromness service do not give it any significant advantage over the petitioners by, for example, enabling it to undercut the petitioners' fares. Furthermore, the compensation paid to the successful tenderer must, in accordance with the third criterion, be no more than is necessary to cover the costs incurred in the discharge of public service obligations, including a reasonable profit. That means in my opinion that the respondents must check, on a regular basis, that the amount of compensation that they are paying to the successful tenderer is no more than is required to meet the public service obligations.

[88] The parameters on the basis of which compensation is calculated are set out in the draft Contract Agreement, in three principal clauses. First, in clause 13.2, the purpose of the grant is stated:

“The Grant must be used solely to meet part of the costs and expenses of provision of the Services in accordance with this Contract and for no other purpose whatsoever”.

Secondly, in clause 14, the method of calculation of the Grant payable to the operator is set out (clause 14 being read in conjunction with the subsequent clauses that deal with matters such as payment, annual reconciliations and Grant adjustment). The Grant is defined (clause 14.4) as the projected cumulative difference between Operating Costs (including Operator's Return) and Revenue for a particular Service Year, as shown in the Base Case (in an original or revised version) together with the Projected Fuel Liability and any Capital Supplement. The Projected Fuel Liability reflects the fact that the costs of fuel in operating the Scrabster to Stromness service are markedly higher than in other services, because of the need to use a monohull vessel in the open sea and the need to maintain high speeds to reduce the journey time to a level that is considered acceptable. Thirdly, the level of fares charged is regulated by clause 5 of the agreement, which requires the Operator to publish a tariff scheme for its services that will apply during each calendar year. That requires the respondents to monitor the level of fares charged by the operator of the Scrabster to Stromness route.

[89] It is in my opinion of great importance that this responsibility should be properly performed, and this level of fares kept under regular review, for the following reasons. In a case where a subsidized service competes with an unsubsidized service, the danger is that the subsidy will enable an inefficient route or inefficient operator to drive an efficient route or operator out of business, by enabling the former to charge unduly low fares.

Alternatively, the subsidy inherent in a public service contract may promote inefficiency, at public expense, to the detriment of both the public interest and an efficient competitor. Care must be taken to avoid these risks. In doing so, what is involved is essentially an application of the principle of proportionality. The level of subsidy paid must be related to the discharge of the public service obligations and should not be sufficient to give the

subsidized operator an unfair advantage over unsubsidized operators. The essential point is made by the General Court in *Corsican Ferries*, at paragraph 120:

“It cannot be disputed that the granting of financial compensation to a particular service provider that is, the public service concession holder, is liable to impede or render less advantageous the provision of those same services by operators not benefiting from the same compensation. The amount of the compensation allows its recipient to enjoy a decisive advantage over its competitors and, consequently, to dissuade them from offering the services concerned”.

[90] In the present case this can be achieved in two ways. First, it is possible to test the fares charged for the Scrabster to Stromness route against the fares charged by the petitioners on their route between Gills Bay and St Margaret’s Hope. The petitioner’s fares are an obvious comparator, as they are charged by a private operator in essentially the same market, ferry services across the Pentland Firth. If the subsidized fares on the Scrabster to Stromness route are significantly lower than the petitioners’ fares, that is a clear indication that the subsidy is excessive and is operating in an anti-competitive manner. Secondly, the compensation paid to the operator of the Scrabster to Stromness route is intended to compensate it for the obligations inherent in a public service contract. These consist in large measure of the higher costs required to operate the route, in particularly in the form of greater fuel consumption and higher port charges. These costs can be ascertained, and used to check that the compensation paid to the operator is not having anti-competitive effects by giving it an unfair advantage over the petitioners.

[91] Using those two methods, and possibly others, the respondents should be able to check the effects of the subsidy paid to the operator of the Scrabster to Stromness route to ensure that it is kept at a level that can reasonably be said to do no more than compensate the operator for undertaking public service obligations, that is to say, by operating a route that has higher costs than its main competitor, principally as a result of higher fuel costs and

harbour charges. That is essential if the criteria laid down by the Court of Justice in *Altmark* and the General Court in *Corsican Ferries* are to be observed. Doing so is essential to keep the operation of the route within the Maritime Cabotage Regulation and to prevent the compensation paid to the operator from amounting to unlawful state aid. At this stage, however, this Court must rely on the respondents' observing their legal obligations in a proper manner. Provided that they do so, any risk to the economic viability of the petitioners' own ferry service should be kept as a minimal level or eliminated. In all the circumstances I agree that the petitioners' appeal should be refused.