

The economic benefits of public sector provision: A report commissioned by the National Union of Rail, Maritime and Transport Workers into life-line ferry services in the Clyde and Hebrides

Jeanette Findlay¹

February 2016

¹ Senior Lecturer in Economics, Adam Smith Business School, University of Glasgow.

Foreword

CalMac is a national treasure, connecting island communities to the mainland and ensuring their social and economic health, as well as preserving maritime skills at a time of decline. Yet Scotland's national ferry operator is under attack, from Serco again.

It is a plain fact that these lifeline services could not be provided without significant public subsidy, whether that's on the larger Clyde and Hebrides network or on the Northern Isles routes that were privatised in 2012 when the Scottish Government awarded Serco the six year contract.

It is also a fact that companies like Serco are attracted to these contracts by the large amounts of taxpayer subsidy required to run them and the low risk nature of these contracts, as no Government can see ferry services to the Scottish islands fail.

Serco's finances are complex and subject to commercial confidentiality but we know that since 2012, before the share price went through the floor, £145m was paid out by Serco to private shareholders. What we also know is that CalMac has returned over £10 million to the Scottish taxpayer on the Clyde and Hebrides (CHFS) network since 2008.

Privatisation would undoubtedly result in CalMac workers, passengers, communities and businesses paying for Serco's business model of service and jobs cuts to maximise profit. Furthermore, millions have been invested by CalMac and the Scottish Government on infrastructure, vessels, services and fares over the current contract, with a £36m (40%) increase in CHFS expenditure in the last two years. More investment is *guaranteed* to 2022 under the Ferries Plan, predominantly on new vessels and infrastructure work on CHFS services. This huge level of public investment should not go to prop up the ailing fortunes of Serco but should continue to refine and improve the public sector operation, CalMac.

The decision on the £1 billion CHFS contract is of vital importance to the future economic and social well-being of CalMac workers and the communities they serve and invariably live in. The Scottish Government's decision to announce the winning bid only weeks after the Holyrood elections risks disenfranchising those communities. If more time had been taken to discuss the specifications of the contract in 2013, as originally committed by the Scottish Government in 2012, then voters would be casting their votes on 5th May knowing whether CalMac had won the contract or if the entire Scottish ferry network had been privatised by the Scottish Government.

As author of two previous reports into the economics of tendering lifeline ferry services, Jeanette Findlay is an authoritative and highly respected commentator on this issue. RMT welcomes Jeanette's latest report as an important intervention, ahead of the Scottish Parliament election campaign.

We hope all candidates and voters will support the case for keeping CalMac public.

Mick Cash

General Secretary, RMT

Executive Summary

1. The current report was commissioned by the RMT in the context of the CHFS tendering process which was announced in February 2015 and for which the invitation to tender was issued in July 2015.
2. It seeks to examine the relative merits of the private and public sector bidders in this process both in relation to the fulfilment of the contract itself but also in relation to other elements which have an economic value to the island economies and to the Scottish economy.
3. It does so in the context of the Ferries Plan 2013-22 in which the then Minister outlined the Government's commitment to ferry services which are 'first class and sustainable, stimulate economic growth throughout Scotland, enable rural and remote communities to thrive, continue to make a significant contribution to Scotland's economy' and which aim to 'maximise the economic and social potential of our remote rural and island communities.'
4. The Ferries Plan signalled significant public investment in vessels, harbours and infrastructure much of which has already taken place.
5. The report notes that the dangers identified in the competitive tendering process since 2005 still pertain. The theoretical problems of moral hazard and the Principal-Agent problems are shown to have been justified in the history of ferry tendering in Scotland and remain a consideration in the current process.
6. CalMac Ferries Ltd has operated in an efficient, innovative and strategic way in the conduct of the CHFS contract and has shared with the Scottish Government all the benefits of cost savings.
7. Serco Group the owner of Serco Northlink has an extremely troubled history in relation to its public sector contracts; it has no significant experience in the maritime industry and its financial health and business model raise concerns in relation to any unforeseen aspect of the current contract as it proceeds.
8. The operation of the Northern Isles Ferry Service (a service considerably smaller and less complex than CHFS) by Serco Northlink, while not without incident, especially in the early period, has been of good standard.
9. The evidence presented here indicates that the public sector operator CalMac has employment policies and values which are fully in line with Scottish Government thinking in these matters and with the direction in which the Government wishes the

Scottish labour market to change and which contribute to its planned Future Islands policy. It has the potential to be a leader in the sector and for the economy as a whole in delivering fair work, good quality work, training and innovation as well as a good quality service to the consumer/public. Indeed, to a considerable degree, it already is leading in these areas.

- 10.** There is much less evidence that Serco Caledonian could or would wish to play that role and its motivation and focus in winning the CHFS tender is naturally based on its status as a profit-seeking entity. The experience of Serco Northlink as described above, and the activities of Serco in other markets, suggests that the overall labour market strategy of the Serco group of companies is not pointing in the same direction as that of the Scottish Government in a number of key respects.
- 11.** The economic value of a public sector provider to the fragile island economies and to the Scottish economy remains enhanced relative to that of the private sector provider examined here and, possibly, relative to that of any private sector operator.
- 12.** The estimated costs of tendering remain very high in the context of very limited scope for cost savings in the operation of the tender.
- 13.** The perverse outcome that if CalMac were to lose the CHFS tender then competition well into the future would be destroyed remains a very significant risk and a striking example of an unintended consequence of the tendering process.

1 Background and Motivation

This report is the third report^{2 3} into the competitive tendering of lifeline ferry services in the Clyde and Hebrides which the National Union of Rail, Maritime and Transport Workers (RMT) and/or the Scottish Trades Union Congress (STUC) have commissioned over the past decade. The current report was commissioned by the RMT in the context of the CHFS tendering process which was announced in February 2015 and for which the invitation to tender was issued in July 2015⁴. The decision will be announced at the end of May 2016, will take effect in October 2016 and will run for a period of up to eight years⁵.

The Scottish Government originally intended to begin the process in 2012 with the new contract taking effect in October 2013. Following concerns raised by RMT, STUC and the other CalMac unions (Nautilus, TSSA and Unite) over the Northern Isles Ferry Service (NIFS) contract and a lack of information over employment and pension protections in the CHFS contract, the then Transport Minister Keith Brown announced that the new contract would be postponed until October 2016, with the tender process starting in 'autumn 2014.' The existing contract with CalMac was extended for three years ie to 30th September 2016.

The remit of the report is to set out the background to this tender; to consider the attributes of the bidders in terms of their direct experience of running ferry services in Scotland and any other relevant experience; and to assess the extent to which the bidders might, in running the CHFS, contribute to other policy objectives set out by the current administration. Finally, the report will comment briefly on the costs associated with the competitive tendering process and consider the longer term impact of the possible outcomes.

Two participants have been selected by Transport Scotland to submit bids in this process. They are CalMac Ferries Ltd, the incumbent provider, and Serco Caledonian Ferries Limited.

² Findlay, J, (2005) The Financing of Lifeline Ferry Services to the Clyde and Hebrides: a report commissioned by the STUC

³ Findlay, J (2010) The Provision of Lifeline Ferry Services: Delivery and Tendering. A report commissioned by the STUC to inform their response to the Ferries Review by the Scottish Government

⁴ The methodology used here is largely desk-based, and involving use of secondary data, but a number of interviews were conducted with RMT national officials and with Martin Dorchester, the Managing Director of CalMac and Chief Executive of David MacBrayne Ltd. Interviews took place with a small number of seafarer employees of Serco Northlink. An interview with senior management at Serco Northlink and Serco Caledonian Ferries was requested but due to the commercial sensitivities surround the current bid this did not take place.

⁵ Clyde and Hebrides Ferry Services Contract for Provision of Ferry Services and Harbour Operating Agreement <http://www.transport.gov.scot/ferries/clyde-and-hebrides>

CalMac Ferries Ltd⁶ is a wholly-owned subsidiary of David MacBrayne Ltd, which is wholly owned by Scottish Ministers and is the public sector bidder for this contract.

Serco Caledonian Ferries Limited was incorporated in March 2015 and is owned by Serco Group plc an international services provider which operates in thirteen separate and diverse markets grouped into five headings: Justice & Immigration, Defence, Transport, Citizen Services and Healthcare. Serco Northlink Ferries, also owned by Serco Group plc, has held the £243m contract for the provision of the Northlink Ferry service to Orkney and Shetland (Northern Isles services) since May 2012 and this contract is due to run till 2018.

Scottish Ferries Plan

The background to the plans for the provision of ferry services in Scotland is contained in the Scottish Ferries Plan⁷ which was launched by Keith Brown, the then Transport Minister, in December 2012. The Plan contains his commitment, on behalf of the Scottish Government, to providing ferry services which:

- are first class and sustainable
- stimulate economic growth throughout Scotland
- enable rural and remote communities to thrive
- continue to make a significant contribution to Scotland's economy

The introduction to the plan states that the aim, among other things, is to

'maximise the economic and social potential of our remote rural and island communities.'

The Plan outlines the future of Scottish Ferry services with respect to a number of important dimensions such as investment, procurement, harbour charges, routes, services, fares and future tenders (including the CHFS tender currently underway).

The Plan envisaged considerable increases in investment in ferries in excess of £300m over the period till 2022 in vessels, ports and infrastructure, much of it in relation to the Clyde and Hebrides

⁶ The vessels and piers are owned by Caledonian Maritime Assets Ltd (CMAL) which is also wholly owned by the Scottish Ministers. Both CalMac and CMAL were created in 2006 in order to take part in the first tender for the Clyde & Hebrides Ferry Service contract. CMAL leases the vessels and ports to whoever operates the service which, at the time of writing, has always been CalMac.

⁷ Scottish Ferry Services: Ferries Plan (2013-2022) ISBN 978 1 908181 71 8
<http://www.transport.gov.scot/report/j254579-00.htm>

routes. The actual spend in recent years was given in an answer to a written question to the Minister on 29th October 2015⁸, who provided the following table:

	2013-14	2014-15	2015-16 (forecast)
Clyde & Hebrides Ferry Services	£85,522,390	£101,071,419	£115,958,000
RET	£3,889,000	£5,034,000	£10,000,000
Sub-total (CHFS Network)	£89,411,390	£106,105,419	£125,958,000
Northern Isles Ferry Services	£37,507,196	£35,973,572	£32,268,314
Other Ferry Services	£4,299,504	£3,288,197	£3,545,281
Total (Ferry Services)	£131,218,090	£145,367,188	£161,771,595
Piers & Harbours and Vessels	£13,295,693	£20,216,321	£45,495,000
TOTAL	£144,513,783	£165,583,509	£207,266,595

It is clear from this that substantial public investment is going into both ferry services which will benefit whichever providers win the CHFS contract in 2016 and the NIFS contract in 2018.

Paragraph 30 and 31 of the Ferries Plan, sets out the Scottish Government's view on competitive tendering of ferry contracts and the role of private sector companies:

The benefits of regulated competition, in the right circumstances, were seen in the outcome of the recent tendering of the Northern Isles Ferry Services contract. Four bids were submitted – more than for any previous Government ferry contract in Scotland – and the successful bidder, Serco Ltd, has entered into a contract offering a continued and enhanced quality of service at a very competitive cost to the Scottish Government.

⁸ Written Question from David Stewart MSP S4W- 27940
http://www.scottish.parliament.uk/parliamentarybusiness/28877.aspx?SearchType=Advance&MSPIId=3806&SearchFor=AllQuestions&DateChoice=3&SortBy=DateSubmitted&MAQA_Search_gvResultsChangePage=9

We are aiming for a similarly competitive exercise – and similar financial benefits - for the Clyde and Hebrides Ferry Services contract that will commence in 2016....

The report offers no evidence to support the statement that there has been an ‘enhanced quality of service’ and as we shall see later, there are significant areas in which private sector provision and other objectives of the ferries plan are not well matched. The consideration of these other objectives is fully compliant with European law⁹.

In short, the Ferries Plan expresses the Scottish Government’s overall vision for lifeline Ferry services between the island communities and the mainland as well as their detailed objectives on almost an island by island basis.

Report Outline

Many of the issues raised with respect to the impact of tendering lifeline services in general, and ferry services in particular, are set out in detail in Findlay (2005 and 2010) referred to earlier (and from which we quote below in italics). We will not rehearse all of them in detail here but many of them remain substantively the same today. These are:

- the issues of moral hazard (in relation to the management of vessels in which the operator has no long term interest) and the completion of the contract on the original terms in the absence of a competitor:

Moral hazard (another consequence of imperfect information) also arises in this present context in so far as costly assets may be left in the hands of agents who have incentive to maintain them only for a fixed period far short of their reasonable life expectancy. (2005)

- the principal-agent problem inherent in writing time-consistent and enforceable contracts in the context of imperfect information regarding the costs and compliance of operators;

Principal-Agent problems refer to the class of economic problems in which an Agent (in this case the winner of the tender) acts for a Principal (in this case the Scottish Executive). This is usually in circumstances of asymmetric information where the asymmetry is such that the Agent knows more about its costs and its compliance with the contract than the Principal. This leads to the need for (often costly) monitoring and careful consideration and design of the contract in order to reduce costs and to try to make the contract self-enforcing, where possible.(2005)

⁹ Directive 2014/ 24, Articles 37 and 90

http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.094.01.0065.01.ENG

- the argument that public sector operators have no disincentive to provide safety standards and employment conditions which are greater than the minimum while private sector operators do

The estimates are based on data for all ferry operators (with estimates being used for Western Ferries and Pentland Ferries) therefore differences in the pay rates and the employment levels are hidden within industry averages. However, it is known that both pay rates and crewing/employment levels are higher in the public sector companies and therefore those companies have a greater impact on the communities which they serve.

- *Employment in the ferry sector clearly provides a higher level of income to employees than the average income for all the areas in which they are located – see Table 2.5 of the HIE report. This is taken to also reflect the higher number of full-time, permanent posts than in the labour market generally in Scotland.*
- *The income impacts are only the direct impacts (ie the wages and salaries received). There will also be second-round impacts ie when ferry crews spend on local goods and services this supports employment outside the ferry industry. These second round impacts are likely to be large because most of the spending activities of ferry employees (particularly in the island communities) will be carried out in their own communities and won't 'leak' out to other areas thereby diminishing the local employment effect. In these circumstances, the direct impacts of ferry sector employment are likely to be a significant underestimate of the total impact of ferry sector employment. (2010)*

- the additional social and economic benefits which a public sector operator can/does provide which are unlikely to be provided by a private sector bidder;

Cal-Mac's mission statement sets out its ethos as a public service provider. In addition to setting up a Disability Steering Group, consulting with CMUC on a regular basis and continuing to promote the Gaelic language, Cal-Mac makes a valuable contribution to the artistic and cultural life of the Highlands. Activities such as supporting the Royal National Mod, organising the 'Ceilidh to Craignure' and hosting art exhibitions on board its vessels, resulted in the company winning the Arts & Business Brand Identity Award along with the organisers of the Mod, An Comunn Gaidhealach, and being nominated for a VisitScotland Scottish Thistle Award for excellence in Scottish tourism. These activities have a value which goes beyond the day to day running of the ferry service and Cal-Mac's proactive approach to them would, in all likelihood, be a loss to the wider community. (2005)

- and the issue of Operator of Last Resort

There is another, potentially more serious issue which relates to the concept of the

Operator of Last Resort. Professor Neil Kay has written extensively over a long period on this very matter and it is, to date, still unresolved. The need for an Operator of Last Resort exists whether or not there is a public or private operator of a service but it is undoubtedly more crucial in the latter case, both in the tendering process (where unsuitable operators would be likely to apply in the knowledge that the absence of an OLR will give it the upper hand in future negotiations with the SG) and in the carrying out of the contract itself (where the issue of moral hazard arises both with regard to the maintenance of the vessels and, more crucially, in terms of the completion of the contract on the original terms). Specifically, the incumbent would have an incentive to simply seek to renegotiate the contract in its favour, in the knowledge that the SG would have no alternative but to comply. There is an even greater risk of this if a failure to win the contract were to lead, as it most probably would, to the demise of CalMac. In the status quo case, while there would still be a need for an OLR, CalMac and North link operate in the context of a completely different set of structural relations to the SG and face a different set of incentives to that of a private company. This, in and of itself, would make the chance of these outcomes being realised far less likely. (2010)

In the next section the Clyde and Hebrides Ferry service (CHFS) is outlined together with the distinctive features of public sector provision on those routes. In Section 3 we look at the performance and attributes of the private sector competitor in this process, Serco Group plc, and more particularly, for the purpose of comparison, at its Serco Northlink arm which currently holds the Northern Isles contract. In Section 4 we look at how the decision over the award of the CHFS contract relates to another important strand of Government policy, namely the Fair Work agenda.

In Section 5 we consider again the costs and risks of the tendering process and our conclusions are set out in Section 6.

2 Clyde and Hebrides Ferry Service: CalMac Ferries Ltd

The CHFS was first put out to tender in 2006 following a long-running debate over whether this was necessary to comply with EU rules on State Aid and EU Maritime Cabotage Regulation 3577/92. The bundle of routes (twenty-six in total) which make up the service are not profitable and require subsidy to be paid to the operator¹⁰. Under European competition regulation, in order for subsidy not to be defined as State Aid and therefore to be lawful, certain conditions¹¹ must apply. That debate, while not resolved in fact, is resolved in practice since the then Scottish Executive (now Government) took the view that competitive tendering was necessary for the subsidy to be lawful.

¹⁰ The level of subsidy expected to be paid for the CHFS contract were provided by the Transport Minister in a written answer to Elaine Smith MSP on 3/6/15 and were indicated to be between £110m and £120m for each year of the 2016-2024 contract.

¹¹ The Altmark Judgement, 2003

http://ec.europa.eu/competition/state_aid/overview/public_services_en.html downloaded 13/2/16

Notwithstanding recent legal opinion which appears to confirm that competitive tendering is not necessary on the basis of the *Teckel Exemption*¹², the current tender will proceed. The Scottish Government and the RMT have agreed to make a joint application to the European Commission on this matter and, depending on the outcome of that application, this may alter the landscape for the future.

The service was previously run by the publicly-owned Caledonian MacBrayne Ltd but in preparation for the tender the operating side was separated from the vessel-owning side. The operating side became CalMac Ferries Ltd and the vessel-owning company became Caledonian Maritime Assets Ltd (CMAL) which was set up to hold ownership of the vessels and piers and lease them to the winning bidder. The contract was won by CalMac Ferries Ltd and they have operated the route since that time¹³.

In 2013-14, the last year for which figures are available¹⁴ CalMac operated 133,477 scheduled sailings over 26 routes; carried over 4.5 million passengers (4.9 million if you include Argyll Ferries Ltd which operates the Gourock-Dunoon route); and carried just under 1.2 million cars, commercial vehicles and buses and 3000 tonnes of loose freight. CalMac charters a fleet of 33 vessels from CMAL and is responsible for their maintenance during the contract.

In response to a written question from John Finnie MSP on 3rd March 2014¹⁵ the Transport Minister provided the maintenance schedules/standards of CalMac and Serco Northlink and they are reproduced here:

Under the requirements for surveys by the Maritime and Coastguard Agency (MCA) and the Classification Society (Lloyds Register) each ship must be surveyed every year for renewal of their Passenger Ship Safety Certificate.

The 3 vessels operating on the Northern Isles Ferry Service undergo dry docking every second year with in water surveys being carried out every alternate year. These vessels were, or are planned to be, in dry dock between January 2014 and March 2014.

All the vessels operating on the Clyde and Hebrides network have been, or will be, dry docked during winter 2013-2014. The vessels which operate on the Clyde and Hebrides Ferry Service Network and are dry docked very year.

¹² <http://www.rmt.org.uk/news/scottish-government-does-not-need-to-tender-ferry-service/> downloaded 13/2/16

¹³ The original contract was from 2007 to 2013 but was extended by the Scottish Government to 2016.

¹⁴ The figures for 2014-15 are due to be released on 29/2/16

¹⁵ <http://www.scottish.parliament.uk/parliamentarybusiness/BusinessBulletin/73320.aspx>

All machinery on the vessels including the engines is maintained to the manufacturer's instructions and satisfaction of the MCA and Lloyds Register.

Albeit that the vessels used by Serco Northlink are not leased from CMAL, the response would appear to indicate that the concerns quoted above in relation to moral hazard are well-founded. The level of maintenance is clearly less rigorous than that applied by CalMac.

In any of the debates around competitive tendering there has never been any serious suggestion that the CHFS has been badly or inefficiently run. Indeed there is evidence of performance targets for reliability and punctuality being met to a considerable degree. In the Directors' Report for 2014-15 it is noted that technical reliability was 99.93% and punctuality was 99.75% (a slight drop on the previous year which they attribute to increases in the severity and frequency of extreme weather events).¹⁶ The Directors' Report also contains evidence of high performance in the award of the Best Ferry Company in the UK Transport Awards for 2015 and the Best Ferry Company in the Guardian/Observer Travel Awards for the fifth year in a row. The Head Office operation won the 'best performing large business in Inverclyde' award from the local Chamber of Commerce. In the same year, CalMac achieved 'Global Standard Accreditation for the helpfulness and professionalism of its customer operations staff.'¹⁷ This does not mean that there are no areas in which the current operations could not be improved but efficiencies are being made on continuous basis: to illustrate, in 2015 CalMac returned £1.98m of subsidy to Transport Scotland (£1.92m in 2014 and £10.35m in total since 2007-8¹⁸) as a result of efficiencies made during the year. The sharing of efficiency savings with the taxpayer is not part of the Northern Isles contract and Serco Northlink have made no such payments to the Scottish Government. However, the subsidy clawback mechanism has been built into the current CHFS contract. This is an example of how contracts must be specified in considerably more detail in order to force private sector operators to behave in ways that public sector operators do as a matter of course. Bearing in mind that contracts are six to eight years long and may become longer, there can be very long periods where there are practices in place which are not beneficial to the interests of the public.

¹⁶ CalMac Ferries Ltd Directors' Report and Financial Statements for the year ended 31 March 2015 file:///C:/Users/jf4z/Downloads/CalMac_Ferries_Limited_Directors'_Report_Financial_Statements_201415.pdf downloaded 13/2/16

¹⁷ <https://www.calmac.co.uk/press/calmac-secures-global-recognition-customer-service-standards> downloaded 13/2/16

¹⁸ CalMac Annual Report and Accounts, various

Major areas of customer dissatisfaction appear to be being dealt with eg customer dissatisfaction some years ago (cf Findlay, 2005) was centred to some extent around the ticketing arrangements and the performance of Head Office in Gourock. Major investment in an online ticketing system has taken place and, in addition, free Wi-Fi is being provided on board its ships.¹⁹ CalMac has spent in excess of £23m on IT since the beginning of the contract in 2006-7 with over £8m being spent since 2012 largely on IT, Wi-Fi and smart ticketing²⁰. The accolade awarded to the Head Office by Gourock Chamber of Commerce suggest that previous areas of customer dissatisfaction have also been overcome.

There is evidence, some very recent, that the operation of CalMac brings wider benefits to the local economy, the local labour market and to island tourism. The Fraser of Allander Institute at the University of Strathclyde has produced an economic impact report for CalMac Ferries Ltd²¹ which estimated that the onward effect of CalMac's turnover of £145m created turnover for other Scottish firms of £270m. We shall return to this report in Section 4 when we consider CalMac's role in the delivery of the Scottish Government's Fair Work agenda.

As noted earlier, substantial sums (in excess of £10m) have been returned to the Scottish Government over the period of the contract as their share of the cost reductions achieved by CalMac. David MacBrayne Ltd, in an innovative move for a publicly-owned company, has (jointly with GBA, a global logistics company) secured a thirty-five year contract to operate one of the biggest naval bases in the UK, Marchwood Military Port in Southampton²². This, according to Martin Dorchester²³, Managing Director of CalMac Ferries Ltd and Chief Executive of DML, opens up opportunities for increasing revenues well into the future which should go some way towards minimising the subsidy required by CalMac to run the CHFS. It is possible therefore that we shall see a continuation and possible expansion of the subsidy clawback.

¹⁹

http://www.heraldscotland.com/business/14031629.David_MacBrayne_posts_loss_after_investing_in_ticketing_system/ downloaded 13/2/16

²⁰ Written Question by David Stewart 27/3/15

http://www.scottish.parliament.uk/S4_ChamberDesk/WA20150327.pdf

²¹ <https://www.sbs.strath.ac.uk/feeds/news.aspx?id=612> downloaded 13/2/16

²² In November 2015 David MacBrayne, the parent company of CalMac, announced that it has won a 35 year MoD contract to run a military port in England in a joint venture with another company.

<http://www.bbc.co.uk/news/uk-scotland-scotland-business-34725144> downloaded 12/2/16. DML was also involved in unsuccessful bids to run ferry services in Gotland, Sweden and the Woolwich Ferry in 2014.

http://www.heraldscotland.com/news/13158639.CalMac_bid_to_run_European_ferries/ downloaded 12/2/16.

²³ Telephone interview, Friday 12/2/16

In summary, therefore, it can be argued that CalMac Ferries Ltd has operated in an efficient, innovative and strategic way in the conduct of the CHFS contract and has shared with the Scottish Government all the benefits of cost savings.

3. Northern Isles Ferry Service: Serco Group plc and Serco Northlink Ferries

Serco Group plc

As a company the Serco Group has experienced some difficult times in recent years and been subject to considerable criticism in the way that it has managed its public sector contracts. Examples of failures in its UK public sector contracts include the fact that it over-charged on its contract with the UK Ministry of Justice to operate its electronic tagging scheme and in 2013 had to pay back £68.5m to the government²⁴. As a result of this it suffered, in the words of the company Strategic Report, 'Immense reputational damage'²⁵. It was barred for bidding for government contracts for a period and is still under investigation by the Serious Fraud Office in relation the tagging contract. It has acknowledged a number of catastrophic errors in its health service contracts resulting in £17m of losses for the company and ultimately it decided to withdraw from all clinical health contracts²⁶; it faced serious allegations in terms of its operation of the Yarl's Wood immigration centre after an inspection by Her Majesty's Chief Inspector of Prisons, as a result of which a number of staff were sacked²⁷. It does, however, continue to operate the facility and other prison facilities in the UK.

More seriously and more pertinent to the current contract, Serco Woolwich Ferries were found guilty of 'failing to ensure the health and safety' of the crew of the Ernest Bevan over an incident which led to the death of teenage deckhand Ben Woollacott²⁸. They were fined £200,000 as a result. As noted earlier, Serco lost the Woolwich Ferry contract in 2012.

As a consequence of these failings and the resulting fall in profits there was an overhaul of senior management of the company in February 2014. In a Trading Update in 2015, the company reported that it is pulling out of a number of areas of operation due to their inability to make profits on them:

²⁴ <http://www.professionaloutsourcingmagazine.net/news/serco-pays-back-685-million-while-g4s-faces-fresh-sfo-probes> downloaded 14/2/16

²⁵ https://www.serco.com/Images/22000_Serco_AR14_tcm3-46422.pdf downloaded 14/2/16

²⁶ <http://www.ft.com/cms/s/0/f6816830-63e2-11e3-b70d-00144feabdc0.html#axzz409hxQVpz> downloaded 14/2/16

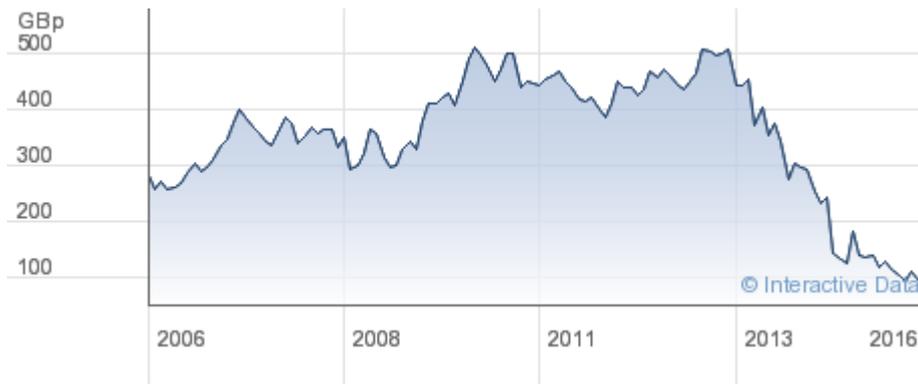
²⁷ <http://www.bbc.co.uk/news/uk-england-beds-bucks-herts-24719300> downloaded 13/2/16

²⁸ <http://www.bbc.co.uk/news/uk-england-london-34601388>

*We are making progress executing our strategy; total costs in the period were some £200m lower; we are reshaping the portfolio to become a focused provider of public services, and making good headway exiting loss-making contracts.*²⁹

The share price of Serco Group plc has collapsed dramatically over a lengthy period as Chart 1 shows.

Chart 1: Serco Group plc share price



Data source: Interactive Data

Graph source: Hargreaves Lansdown plc

As the time of writing, despite the significant fall in share prices (to a level well below the level at the time of the £550m rights issue in July 2015), there appears to be no marked increase in demand for Serco Group shares which suggests that the markets do not have confidence that the price will not fall further.

Other recent news also suggests that their troubles are not yet over. Serco's new Chief Executive, Rupert Soames, announced in December 2015 that profits for 2016 would be significantly lower (halved) than they had expected³⁰.

Despite what appears to be some success by Soames in dealing with systemic failures of the company, a process he rather colourfully described as

*we walked up the Serco high street saying, "bring out your dead", and rather a lot of bodies came flying out of the windows*³¹

²⁹ Rupert Soames, Chief Executive, Serco Group, December 2015 <https://www.serco.com/investors> downloaded 14/2/16

³⁰ <http://www.ft.com/cms/s/0/e25d2a0c-9cbf-11e5-b45d-4812f209f861.html> downloaded 15/2/16

³¹ <http://www.thisismoney.co.uk/money/article-2829246/Darkest-hour-Serco-chief-Rupert-Soames-depth-crisis-embattled-outsourcing-giant-laid-bare.html> downloaded 15/2/16

there remains some considerable doubt about the stability of this company, its willingness to pull out of contracts on which it fails to achieve its desired return and the suitability of its business model for handling essential/lifeline services.

Serco is explicit in its admission that it enters contracts with no previous industry knowledge and relies on acquiring that knowledge *in situ* from the existing management/workforce. In the words of outgoing Chairman, Alastair Lyons in his statement in the 2014 Annual Accounts³²

Typically, Serco inherited much of the technical capability for the diverse activities covered under our contracts, such as helicopter flight simulation or North Sea ferry operations, when it took over the contract.

Serco Group's only other experience of maritime transport, prior to it acquiring the North Sea Ferry Service contract was in running the Woolwich Ferry (a contract which it lost in 2012) and a contract to transport nuclear waste.

Notwithstanding this, it has undoubtedly acquired that knowledge to some extent in the running of the Northern Isles Ferry Service and we return to that in the next section. The advantage which Serco Group plc claims to bring to public sector contracts is the

*drive, energy and innovation of the private sector*³³

This, even to the extent which it accurately reflects reality, must be balanced against the increased cost of monitoring private sector entities due to the fact that they have an entirely different set of structural incentives to that of a public sector entity. The necessity for this is well-founded in economic theory and the necessity to monitor the activities of Serco are well-founded in the empirical evidence in relation to that company's history of mismanagement of a number of public sector contracts.

The outcome of any contract, but particularly long-term contracts of the type under discussion, rests to a considerable degree on the way that the risk is distributed between the parties³⁴. The concerns expressed by Rupert Soames regarding the increased skill of government departments in negotiating such contracts³⁵ confirms this but is also an acknowledgement that the most important 'game' here

³² https://www.serco.com/Images/22000_Serco_AR14_tcm3-46422.pdf downloaded 11/2/16

³³ 'Our Business Model', Serco Group plc, Annual Report and Accounts, 2014 *ibid*

³⁴ Walters, Jackie, and Jan Owen Jansson. "Risk and reward in public transportation contracting." *Research in Transportation Economics* 22.1 (2008): 26-30; White, Peter, and Stephen Tough. "Alternative tendering systems and deregulation in Britain." *Journal of Transport Economics and Policy* (1995): 275-289.

³⁵ <http://www.independent.co.uk/news/business/news/serco-shares-plunge-after-the-outsourcer-which-runs-everything-from-prisons-to-boris-bikes-issues-9850449.html> downloaded 15/2/16

is not between the two bidders but between the government and the private sector bidder. To the extent that the private sector bidder 'wins', the government, and therefore the taxpayer, 'loses'. This, of course, holds for any competitive tendering process and it can be argued that there is potential for the overall benefits to outweigh any potential risk. Furthermore, it is within the gift of the relevant public authority to take action to minimise financial risk by full and proper specification of the contract. However, such risk can never be removed – it has to be held by one party or the other as Mr Soames clearly indicates. Moreover, in the provision of lifeline services of the kind under consideration here, the risk on the side of the public is not confined to financial risk but to innumerable risks up to, and including, risk to life.

For the current purpose we can attempt to draw some inferences regarding the potential benefit of Serco Caledonian Ferries winning the CHFS ie in terms of the level of 'drive, energy and innovation' which could be brought to it, by examining the operation of Serco Northlink in its conduct of the Northern Isles Ferry Service.

Serco Northlink

Serco Northlink won the tender to provide essential ferry services in the Northern Isles in 2012. The contract was won following a period of difficulty with this contract involving additional payments to the service operator in 2003 and legal challenges to the tender process in 2012^{36 37}. The current contract is due to end in 2018.

In 2013-14, Serco Northlink Ferries Ltd operated 2886 scheduled sailings over 5 routes; carried 283,000 passengers and 56,000 cars. The data on commercial vehicles for the Northern Isles is no longer collected but no reason is given by Transport Scotland for this discrepancy between the data published for the two contracts.

The performance of this contract, in terms of the provision of services to the travelling public and to business users, appears to have been reasonably successful. It should be noted however that the number of sailings on the Scrabster to Stromness route have been reduced since Serco Northlink took over the contract and some concern was expressed by interviewees during the course of this research about Serco's plans for this route. The published figures for 2013-14 show reliability/punctuality figures combined³⁸ for the Aberdeen routes and the Pentland Firth route of 99.8% and 92.1% respectively. The relatively low figure for the latter can presumably be explained

³⁶ <http://www.gov.scot/Publications/2010/06/17134612/7> downloaded 14/2/16

³⁷ <http://www.bbc.co.uk/news/uk-scotland-scotland-business-18251727> downloaded 14/2/16

³⁸ These figures are presented separately for the CHFS and there are no notes to explain this difference or what the combined figures mean

by the breakdown of the Hamnavoe referred to below. Serco Northlink has not published more recent figures as CalMac has done but they will become publicly available by the end of this month (see footnote 14).

The Chairman of the Shetland Council Transport Committee and of ZetTrans, the regional transport body, Cllr Michael Stout, indicated in a telephone interview with the author³⁹ that 'overall Serco's performance is pretty good' and that they were 'good at responding to complaints'. He also indicated that he believed they had a degree of transparency in their dealings with the community which he felt was an improvement on that of previous operators of the service. There appears to be some dissatisfaction with service levels and capacity at certain peak times throughout the year (albeit this is disputed by MD Stuart Garrett⁴⁰) but these were not attributed to any fault on the part of Serco Northlink by Mr Stout. Indeed there appears to have been some effort by Serco Northlink to deal with this issue and to try to expand capacity with the use of 'sleeper pods'. This has been met with varying degrees of satisfaction. The company received heavy criticism early on in the contract when the Hamnavoe, the vessel on the Scrabster to Stromness route, broke down and was out of service for a period of weeks.⁴¹ They were perhaps saved from more serious local reaction by the provision of additional passenger services by the private operator Pentland Ferries which operates an adjacent ferry service on the Pentland Firth.

As mentioned above, Serco Northlink's dry docking maintenance schedule for vessels is less frequent than that conducted by CalMac on CHFS vessels and that is a concern for the future both of this service and for intended practice should Serco win the CHFS contract.

In summary therefore, it appears that the operation of the Northern Isles Ferry Service by Serco Northlink, while not without incident, especially in the early period, has been of good standard and indeed, there appears to be a degree of satisfaction of island communities with the willingness of senior management to respond to difficulties reported to them. It should be noted however, that the lack of recent figures (which should be rectified by the time of publication of this report), the combined nature of the reliability/punctuality figures and the lack of data for commercial freight make a direct comparison with the performance of CalMac less than straightforward. The latter issue is particularly relevant in that the interview data with Northlink employees contains a

³⁹ The telephone interview took place on Friday 12/2/16

⁴⁰ <http://www.shetlandtimes.co.uk/2015/06/12/figures-disprove-ferry-capacity-claims> downloaded 14/2/16

⁴¹ <http://www.johnogroat-journal.co.uk/News/Serco-faces-fresh-criticism-over-lack-of-a-plan-B-09052013.htm> downloaded 14/2/16

suggestion that at busy times freight is given more priority than passengers on the Northern Isles routes.

Crucially for the current purpose it is not straightforward to conclude that good performance on the North sea routes will necessarily transfer over to the Clyde and Hebrides routes given the huge disparity in the size and complexity of the two sets of services and the limited other experience which Serco has.

4 Scottish Government objectives: Fair work

In October 2014 the then First Minister, Alex Salmond announced at an STUC conference that a Fair Work Convention would be established by the Scottish Government⁴². The working definition of fair work that the Convention uses is

Fair Work is work that provides opportunity, fulfilment, security, respect and effective voice. Fair work balances the rights and responsibilities of employers and employees and can generate benefits for individuals, organisations and for society.⁴³

The key themes that the Convention is considering are opportunity, fulfilment, security, respect and effective voice, and these will be incorporated into a forthcoming Fair Work Framework for Scotland. In moving this work forward and making the changes to the Scottish labour market that this would require, the Scottish Government has committed the Convention to working closely with unions, employers, public sector bodies and Government.

Running alongside this policy, indeed you might say chiming with it, is the Scottish Business Pledge which was introduced in May 2015⁴⁴. The Pledge, part of the Scotland's Economic Strategy, is a voluntary code of business practice which includes a number of elements such as the Living Wage, no zero hours contracts, investment in youth, innovation and a number of other practices which are designed to produce fair work and boost 'productivity, competitiveness, sustainable employment, workforce engagement and development'⁴⁵. Employers are asked to pay all employees over 18 (excluding Modern Apprentices) the Living Wage as a minimum; to show that they are already delivering two other elements of the Pledge and to commit to moving towards the rest within some unspecified timeframe. Underpinning this initiative is the idea that 'prosperity, innovation, fairness and opportunity' are mutually reinforcing.

⁴² <http://news.scotland.gov.uk/News/Fair-Work-Convention-created-115d.aspx> downloaded 15/2/16

⁴³ <http://www.fairworkconvention.scot/index.html> downloaded 15/2/16

⁴⁴ <http://scottishgovernment.presscentre.com/News/Scottish-Business-Pledge-191f.aspx> downloaded 15/2/16

⁴⁵ <https://scottishbusinesspledge.scot/#> downloaded 15/2/16

Such is the weight that the Scottish Government gives to the notion of fair work that they have designated it a Cabinet responsibility with Roseanna Cunningham, the Cabinet Secretary for Fair Work, Skills and Training currently taking the political lead. A Scottish Government Directorate for Fair Work, Skills and Training has also been established.

The Final Tender⁴⁶ document for the CHFS contains reference to HR policies which are based on these principles. It states

We expect those who deliver public contracts to adopt fair employment practices for all workers engaged on delivering the contract. This includes not only workers they directly employ but workers who they will engage with through, for example, employment agencies and/or "umbrella" companies

and requires bidders to

provide an initial Human Resources Strategy to describe how they propose to commit to being a best practice employer in the delivery of this contract.

As part of the remit of this exercise, we have looked at the practices of both CalMac and of Serco Northlink, on the basis that Serco's operations in the North Sea will be a good indicator of the values of the, yet untried, Serco Caledonian Ferries Ltd.

Wages, pensions and security

In terms of its employment practices, CalMac and its predecessor companies have a long-standing record of above average wages, a generous pension scheme and excellent training and career progression opportunities⁴⁷. CalMac employees have an average length of service of fourteen years, reflecting the attractiveness of CalMac as an employer.

CalMac is an accredited Living Wage employer⁴⁸ (having already met the criteria before accreditation became possible) and its parent company DML signed up to the Business Pledge⁴⁹. Announcing the decision, CE Martin Dorchester outlined the nature of the DML pledge:

"Unequivocal commitment to no zero hour contracts, the living wage, industry leading investment in skills and training, including more modern apprenticeships, and building closer relationships with communities we serve are what sets David MacBrayne apart from other transport operators," (ibid)

⁴⁶ Final CHFS ITT, 15/02/16, pge 126, Vol 2, Instructions to Participants

⁴⁷ Findlay (2005, 2010)

⁴⁸ <http://www.bbc.co.uk/news/uk-scotland-highlands-islands-34047420>

⁴⁹ <https://www.calmac.co.uk/press/calmac-take-scottish-business-pledge> downloaded 15/2/16

Serco Northlink became the employer of those members of staff who were TUPE-transferred from the publicly-owned operator Northlink when it lost the Northern Isles contract in 2012. The terms and conditions of such workers remain the same in those circumstances. However, there appears to have been a deterioration in aspects of the terms and conditions since that time⁵⁰. Very early in the contract, Serco introduced changes to working practices and announced 36 redundancies. The reduction in staffing did not involve compulsory redundancies but nevertheless the knock-on effect of this has remained to this day. The biggest changes are in what is known as the hotel department, where employees are having to take on additional tasks that were previously either done by other staff or for which they were paid overtime. The Managing Director of Serco Northlink, Stuart Garrett, was quoted in the press as saying that the staffing changes would require the use of ‘more seasonal and temporary labour’⁵¹. There also appears to be increasing use of agency labour (mainly in catering). These workers are paid a daily rate which was described by the interviewee as the seafaring equivalent of a zero hours contract. Attempts by Serco Northlink to move its employees to its own, less generous, pension scheme were successfully resisted by union action in 2012.

One interviewee talked of the inexperience of many of the staff brought on (both foreign and local) who were ‘hanging off the stanchions’ due to their inability to cope with the movement of the ship. Serco Northlink also employ a number of shore-based staff whose terms and conditions are not covered by a collective agreement. This together with the replacement of secure work with seasonal and temporary work raises concerns over inconsistency with Scottish Government objectives in relation to fair work⁵². This Scottish Government has a very strong record of working closely and cooperatively with trades unions and is on record as regarding them as partners in the pursuit of fairer, more innovative and productive workplaces⁵³.

All of this, to some extent, is evidence to support the thesis, made in respect of the earlier tenders, that the only area in which a private sector operator could do better in terms of cutting costs is in

⁵⁰ The material in this section is based on interviews with Northlink staff members. Senior Management at Serco Northlink felt unable to be interviewed in the current context but they have been given the opportunity to correct any factual inaccuracies before publication of this report.

⁵¹ <http://www.shetnews.co.uk/news/6026-northlink-dismayed-and-surprised> downloaded 15/2/16

⁵² Although it should be noted that the foreign seamen employed on the vessels chartered from Seatruck and operated under the contract by Serco Northlink do not have the same terms and conditions as either Serco Northlink or CalMac employees. Some are paid below the UK Minimum Wage. Hopefully this will be rectified at the next tender.

⁵³ Memorandum of Understanding between SG and STUC

http://www.stuc.org.uk/files/Document%20download/Memorandum%20of%20Understanding/375794_SGand_STUC_Memo_WEB.pdf

cutting the terms and conditions of workers in an industry where labour costs are the biggest element of running costs.

The interviewees did however have more positive things to say about Serco Northlink in relation to the relationship between management and workers. Managers were said to come on board to observe the 'happiness' of the ship and there is a system of open meetings where managers take questions and 'always provide an answer'. Some changes to the way the ships are operated were observed to cause more work for the crew but they were accepted as being good for the customers, such as the practice of allowing passengers to board on a B&B basis when a ship is tied up. Management were seen to be particularly accommodating to freight customers but often at the expense of creating more work for the crew. The impact, if any, of this last element is hard to judge as no figures are published regarding the number of commercial vehicles carried by Serco Northlink.

Overall there appears to be a clear, albeit small, deterioration in terms and conditions of employees – some to a greater extent than others. Perhaps of more concern for the current purpose are the comments of the Serco Caledonian bid team, who were in Skye in January discussing their plans should they win the bid. The leader of the team was described in the West Highland Free Press article (22/1/16) as hinting that 'too many CalMac ships were carrying crew members which weren't required.' This has raised fears that more redundancies might follow should Serco Caledonian win the bid. We shall return to this in the next section when we discuss safety and later in the concluding section.

Training and Safety

CalMac, as indicated earlier, has a good record in both training and safety. In terms of training, there are examples of employees coming in at ratings grade and rising to become ship's masters. There are examples of staff being seconded across the business between ship and shore to bring their experience to different projects, such as port staff working in Head Office on technical projects and seafaring staff working on the current bid.

CalMac has a Learning and Training Academy which has been up and running for eighteen months and which provides a range of learning opportunities for employees across the board. Employees are encouraged to choose things they are interested in and also courses which would allow them to 'move on'. CalMac's proactive approach to training and safety were outlined in the 2005 and 2010

reports. A recent example of this is in terms of the 2010 Manila Amendments⁵⁴ to the Standards of Training Certification and Watchkeeping (STCW) which is required for all seafarers. This was to be phased in from that time but CalMac began putting their staff through it immediately. Some five and more years later, the employees of Serco Northlink are facing a deadline to complete the training by the end of this year.

In terms of the long-run sustainability of the industry and the provision of skilled labour, CalMac makes an effective contribution in terms of taking on six to ten cadets each year. Most of those apprentices will move on to other companies and indeed will necessarily do so for at least a period in order to do the 3-6 month deep sea training that is required as part of their Officer of the Watch certificate.

The following information was given by the Minister in reply to a written question by David Stewart MSP on 29th October 2015.⁵⁵

Since January 2006, including the most recent intake from August / September this year, CalMac Ferries Ltd have sponsored a total of 118 Deck, Engine and Electro Technical Officer Cadets, details of which are outlined in the following table:-

	Current	Previous
Deck Officer Cadets	23	42
Engineer Officer Cadets	24	24
Electro Technical Officer Cadets	3	2
	50	68

For Officer Cadets, CalMac are in a tri-partite arrangement with Clyde Marine Training Limited and Northern Marine Management Limited. For the duration of their cadetship, Officer Cadets are employed by Clyde Marine Training Limited and sponsored by CalMac Ferries Ltd. The majority of the Officer Cadets' sea phases are spent on deep sea voyages with Northern Marine Management Limited, in-filled with some time at sea with CalMac ferries Ltd.

Of the 68 previous Officer Cadets, 17 failed to complete their training. Of the remaining 51 Officer Cadets, 6 have been given permanent employment with CalMac Ferries Ltd. In addition, 1 Officer Cadet who did not complete his cadetship has been given permanent employment by CalMac Ferries Ltd, as a rating rather than an officer. Of the remaining 44 Officer Cadets, CalMac do not hold records of their current employment status.

⁵⁴ <https://www.gov.uk/guidance/manila-amendments-and-how-they-affect-seafarer-training-and-certificates> downloaded 15/2/16

⁵⁵ Written Question from David Stewart MSP (S4W-27942) http://www.scottish.parliament.uk/S4_ChamberDesk/WA20151029.pdf

Since January 2006, CalMac Ferries Ltd have recruited a total of 26 Deck and Engine Rating Trainees, details of which are outlined in the following table:-

	2006	2010	2013	2014
Deck Ratings Trainees	4	2	6	6
Engine Rating Trainees	0	0	4	4
Permanently Employed	3	2	8	0
Still Completing Training	0	0	1	9

Of the 26 trainees recruited, 13 have been given permanent employment, 10 are still completing their training and 3 have left the Company. Of the 3 who moved on, 2 left after being given permanent employment elsewhere and 1 during the course of their training.

This contribution to training the next generation of seafarers for the whole industry is not matched by the private sector. Serco Northlink, do, of course, put all their employees through the necessary training procedures and all have the minimum level of qualifications to be at sea. They also, of course, comply with the Tonnage Tax Scheme⁵⁶ which requires that

‘the company or group must enter into a “Training Commitment” with the Department for Transport. Broadly, this requires:

- The training of one trainee per year for each 15 officers, or
- Payment in lieu to the Maritime Training Trust.
- The trainees must be British or EEA nationals and ordinarily resident in the UK.’

Serco Northlink have trained twelve officer cadets under this scheme which is the minimum required over that period to qualify for the Tonnage Tax scheme⁵⁷.

⁵⁶ hmc.gov.uk/manuals/ttmmanual/ttm01010.htm

⁵⁷ The Tonnage Tax regulations have recently been amended to allow UK ratings to be included in the mandatory proportion of UK officers that qualifying companies must train. This adjustment to the scheme allows companies to train 3 UK ratings for every 1 UK officer. However, this is only a three year pilot scheme to 2018 and will expire if there is no take up by the shipping industry which, to date, has been slow.

http://www.legislation.gov.uk/ukxi/2015/1607/pdfs/ukxiem_20151607_en.pdf

Currently at Northlink, there is said to be a gap in the age profile of qualified engineers/ABSs with no training provision to ensure continuity when the current group in their 40s and 50s retire. This problem is said to be more acute in terms of motormen, three of whom have retired in the last year. The company have hired 4th engineers because there are no qualified motormen coming through. This is a UK wide problem with the number of UK engine ratings down last year by 13%⁵⁸ but it is a problem to which Serco Northlink do not appear to be part of the solution.

One interviewee suggested that use by Serco of a private security company on board ships means that cabin space is used up which therefore cannot be used by trainees. This lack of urgency about the long term training needs is typical of both the short-time horizon of the private sector (no longer than the term of the contract) and the unwillingness to do anything beyond what is strictly required in the contract. As outlined here, the public sector operator has a different set of values which embody the continuing nature of the state of which it sees itself as part.

There is no suggestion that Serco Northlink is operating unsafe ships and, indeed, one Northlink interviewee described there being a 'good safety consciousness' on board ship and found management to be responsive when requests for equipment to make the workplace safer were made. However, the issue of safety, which has been raised in the earlier reports is crucial in this context. Hotel and catering staff play a role in emergency situations and cutting their staffing levels to what is strictly necessary for their normal functions, or requiring them to play dual roles at times, could, in an emergency, impact on the safety of the ship and its passengers.

The Scottish Government is currently consulting on a Future Islands Bill⁵⁹ which seeks to provide a 'more prosperous and fairer future' for the islands. In that context, ferry policy is crucial. The Fraser of Allander Institute report referred to earlier outlined the way in which the operation of CalMac on the Clyde and Hebrides routes contributes hugely to the economy and culture of the islands. Part of their calculation does of course relate to the operation of the ferry services and these benefits would accrue regardless of who the operator is. However, there is undoubtedly an additional benefit to the island communities in there being good quality, well-paid jobs with the opportunity of career progression and stability of employment. The report outlines that the average wage at CalMac is 12% higher than the average wage in Scotland, and that the 1476 CalMac jobs support 5883 other jobs in Scotland. Many of these jobs are on the islands themselves (the report gives a detailed

⁵⁸ <https://www.gov.uk/government/statistical-data-sets/sfr01-seafarers-active-at-sea>

⁵⁹ <http://www.gov.scot/Publications/2015/09/5388>

breakdown by community) and the numbers supported would be much lower if average wages or employment fell for any reason. The report confirms the average length of service of CalMac staff as just short of 14 years and calculates that CalMac staff have a total of 20,000 years of experience. The knock-on effect on what the report describes as ‘fragile’ island economies of any degradation of the quality of jobs would be extremely serious and the impact specifically on young people entering the labour market would be particularly harsh.

The report also gives updated information on the ways in which CalMac contributes to the cultural life of the islands. This non-core aspect of CalMac’s activities has been commented on before (Findlay, 2005) and should not be dismissed lightly. The report’s author estimates that the Royal National Mod with which CalMac has a long association has itself created jobs in the areas in which it is held. The direct sponsorship of musical and other cultural events itself brings tourism to the islands. These are elements of what is currently provided to island communities which would be at risk in the context of a profit-maximising private sector operator.

In summary, there is ample evidence that the public sector operator CalMac has employment policies and values which are fully in line with Scottish Government thinking in these matters and with the direction in which the Government wishes the Scottish labour market to change and which contribute to its planned Future Islands policy. It does therefore, have the potential to be a leader in the sector and for the economy as a whole in delivering fair work, good quality work, training and innovation as well as a good quality service to the consumer/public. Indeed, to a considerable degree, it already is leading in these areas. There is much less evidence that Serco Caledonian could or would wish to play that role and its motivation and focus in winning the CHFS tender is naturally based on its status as a profit-seeking entity. That is not to say that private sector firms cannot and do not have the potential to be fair, innovative and progressive employers but the time-limiting nature of a contract such as this tends to mitigate against the pursuit of such goals. Moreover the experience of Serco Northlink as described above, and the activities of Serco in other markets, suggests that the overall labour market strategy of the Serco group of companies is not pointing in the same direction as that of the Scottish Government in a number of key respects.

5 Costs and risks of tender

Costs

Many of the costs associated with tendering are not publicly known until after the process is complete. Some of the costs attached to the previous CHFS contract in 2006 were revealed in 2007⁶⁰. The one-off tax bill consequent on the separation of CalMac and CMAL turned out to be £11m which was just outside the estimated range given in Findlay (2005) of £5-10m. The additional cost of £4.3m presumably related to both civil service time and consultancy fees although no finer breakdown is given.

In March 2015 in Written Answers^{61 62} to David Stewart MSP the estimated tendering costs to the Scottish Government between October 2014 and November 2016 were given as between £900,000 and £1m. Figures were also given by the Transport Minister for consultancy fees for CalMac, CMAL and DML. Not all of these figures will relate to the tender process, indeed the figures for CMAL will include engineering consultancies. However, the figures for CalMac for the period 2014-15 (up to the end of February 2015) of £3.9m and the corresponding figure for DML of £1.36m (£2.8m and £1m respectively for 2013-14) are striking. Especially in light of the significant increase from the equivalent figures for 2012-13 (£157,000 and 285,000 respectively) and the unknown expenditure in the remaining twenty-two months to November 2016. Leaving aside any consultancy fees relating to the online ticketing upgrade and the introduction of on-board Wi-Fi, these are most likely to be related to the current bid. One can only assume that the other bidder, Serco Caledonian has incurred similar if not higher costs. The total costs associated with tendering therefore remain extremely high and are particularly hard to justify in the light of almost no potential for cost savings.

Risk

The Scottish Ferries Plan reiterates the long-held view of the Scottish Government that tendering is necessary in order to comply with European competition regulations. This is a view which has been disputed in some quarters such as Kay (2009, 2010)⁶³ and is discussed in detail in Findlay (2005, 2010). The view of the Scottish Government expressed in the Ferries Plan is that

'EU rules require tendering of all subsidised ferry services'

⁶⁰ <http://www.scotsman.com/news/bill-for-calmac-tender-is-163-15m-1-685024>

⁶¹ Written Answer to David Stewart MSP S4W-24956

<http://www.scottish.parliament.uk/parliamentarybusiness/BusinessBulletin/87910.aspx>

⁶² Written Answer to David Stewart MSP S4W-24957

http://www.scottish.parliament.uk/S4_ChamberDesk/WA20150327.pdf

⁶³ Kay, Neil (2010) Scottish ferry policy and the Commission Decision, Quarterly Economic Commentary, Vol 33, pp 61-66

but, somewhat contradictorily, it also states that it

'would prefer the decision on whether or not to tender to be taken by the accountable public authority'.

Whether or not it is, strictly necessary in law, the notion that competitive tendering is the best means to achieve economic efficiency carries some weight among regulators and academics. In circumstances such as those outlined here, however, the perverse result may arise that the tendering of services actually reduce competition and thereby produce long-run inefficiency. This arises because if at any point CalMac loses the CHFS contract then they would cease to exist and the private sector operator, Serco, would face no competition at all. The point is put very clearly by Kay (2010)⁶⁴ when he says:

CalMac will have to defend its right to run the network every six years and if it loses just once in the tendering process this will effectively eliminate it once and for all as an operator - or at least as an operator with the resources and capabilities necessary to run such a network.

This remains the position today despite attempts at diversification out of Scotland by David MacBrayne, and is a striking example of an unintended perverse and negative consequence of competitive tendering.

6 Conclusion

The remit of this report was to set out the context and background of the current tender for the Clyde and Hebrides Ferry Service and to comment on aspects of the two bidders', their capacity and experience to handle a service of such size and complexity and to consider how, in doing so, they might contribute to other important strands of Scottish Government policy and Scotland's Economic Strategy.

The evidence, such as is available, leads to the conclusion that there are distinct differences in the likely outcome under the two possibilities before us.

These differences do not lie, necessarily, in the performance of the contract as specified in the final tender document, although it is clear that CalMac is by far the more experienced of the two and that there is considerably more doubt in relation to the Serco Caledonian bid. This is based on the relatively limited experience of the Serco Group in running ferry services in Scotland and with such experience as they have being in the much smaller and less fragmented Northern Isles. The ethos, history and financial position of its parent company is also a consideration which should not be ignored.

In the period of the contract it is also likely, in addition to meeting the precise terms of the contract in all respects, that the public sector option, CalMac would provide a performance, direction and ethos which is more in tune not only with the Scottish Government's Ferries Plan but also with their Fair Work agenda which is integral to the delivery of inclusive growth as outlined in the current Programme for Government. Its contribution to the maritime skills base is also crucial and would not, on all the evidence before us, be replaced by equal provision from the private sector.

While it would undoubtedly be an unintended consequence of the tendering process, an outcome which saw the end of CalMac on the CHFS routes would be the loss to Scotland and the Scottish economy of an important champion of fair work practices at a time when the Scottish Government is urging collaboration across the business community, union and other labour market stakeholders to deliver fair work as a driver of inclusive growth.

A further consequence, also unintended, might be a direction of change within the service, which turns away from the 'fairer and more prosperous future' which the Government claims it desires for fragile island communities.

Moving beyond the next tender period, and reiterating previous warnings, the outcome of this tender process could irreversibly change the circumstances that Government would face and irrevocably constrain the options available to them. Should CalMac lose the CHFS there is very limited likelihood that there would be any competition on this route at all. Perversely, the deployment of competitive tendering could, in this instance, destroy competition completely and the Scottish Government, and the island communities which it seeks to protect and develop, would be left at the mercy of a private sector monopolist. Such a monopolist would have a significantly strengthened hand in setting the terms of any new contract. This dilemma is not new or, indeed, unforeseeable. Indeed, in a different context, Audit Scotland described this very problem when

reviewing the actions of the then Scottish Executive in relation to the Northern Isles contract in 2004⁶⁵ when it was forced to make additional payments to keep the ferries running. In the scenario outlined above, a future Scottish Government would have no choice at that point other than to do what the Scottish Executive did in 2004 – to pay whatever was demanded.

⁶⁵ http://www.audit-scotland.gov.uk/docs/central/2005/nr_051222_northlink_ferry.pdf downloaded 15/2/16