Strategic Framework of Options for the CHFS Network

Transport Scotland

Reliance Restricted

16 February 2022

Building a better working world

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16 February 2022

Strategic Framework of Options for the CHFS Network

Dear Sirs

In accordance with the terms of our Agreement (Management Consultancy Services for Project Neptune) dated 9 March 2021, we have prepared this report to provide you with a strategic framework of options for the Clyde and Hebrides Ferry Services (CHFS) network, for consideration by Scottish Ministers, to help to identify the preferred corporate and governance structures for the delivery of ferry services.

Purpose of our report and restrictions on its use

This report was prepared on your instructions solely to assist Transport Scotland in considering the current arrangements and options for the future of the CHFS network only and should not be relied upon for any other purpose. Because others may seek to use it for different purposes, this report should not be quoted, referred to or shown to any other parties, unless so required by court order or a regulatory authority, without our prior consent in writing. In carrying out our work and preparing our report, we have worked solely on the instructions of Transport Scotland.

Our report may not have considered issues relevant to any third parties. Any use such third parties may choose to make of our report is entirely at their own risk and we shall have no responsibility whatsoever in relation to any such use. We consent to providing this report to other members of the Tripartite including the Scottish Government, Caledonian Maritime Assets Limited, David MacBrayne Limited and CalMac Ferries Limited. This report should not be provided to any other third parties without our prior approval and without them recognising in writing that we assume no responsibility or liability whatsoever to them in respect of the contents of our deliverables.

We only accept responsibility or liability to our client in respect of this report on the basis set out in the Agreement. We accept no responsibility or liability to any other person in respect of this report, and accordingly if such other persons choose to rely upon any of its contents they do so at their own risk.

Scope of our work

Our work in connection with this assignment is of a different nature to that of an audit. We have not sought to verify the accuracy of the data or the information and explanations provided. The report provides a strategic framework of options, for consideration by Scottish Ministers, to help to identify the preferred corporate and governance structures for the CHFS network. Our work has been limited in scope and time and highlights that further work will be required to conclude on a number of points raised within this report. If you would like to clarify any aspect of this review or discuss other related matters then please do not hesitate to contact us.

Yours faithfully

Ernst & Young LLP

Abbreviations

AT	Auckland Transport	HIAL	Highlands and Islands Airports Limited	RPTP	Regional Public Transport Plan
BC Ferries	British Columbia Ferries	JV	Joint Venture	RTP	Regional Transport Partnership
BCFA	British Columbia Ferries Authority	LA	Local Authority	SG	Scottish Government
BCTFA	British Columbia Transportation Financial Authority	LBTT	Land and Building Transaction Tax	SNF	Serco NorthLink Ferries
CAA	Civil Aviation Authority	LTMA	Land Transport Management Act	SPT	Strathclyde Partnership for Transport
C-DEL	Capital Departmental Expenditure Limit	MoD	Ministry of Defence	SRWC	Scottish Road Works Commissioner
CFL	CalMac Ferries Limited	NIFS	Northern Isles Ferry Services	SRWR	Scottish Road Works Register
CGS	Capital Goods Scheme	NR	Network Rail	STAG	Scotland Transport Appraisal Guidance
CHFS	Clyde and Hebrides Ferry Services	NSPSG	Network Strategy Programme Steering Group	TfNSW	Transport for New South Wales
CMAL	Caledonian Maritime Assets Limited	NSW	New South Wales	TOC	Train Operating Company
CMCG	Caledonian MacBrayne Crewing (Guernsey)	Ofwat	Water Services Regulation Authority	TOGC	Transfer of Going Concern
DB	Defined Benefit	ONS	Office of National Statistics	TS	Transport Scotland
DfT	Department for Transport	ORR	Office of Rail and Road	VAT	Value Added Tax
DML	David MacBrayne Limited	R-DEL	Revenue Departmental Expenditure Limit	WACC	Weighted Average Cost of Capital
EMA	Emergency Measures Agreement	ROSCO	Rolling Stock Company	WICS	Water Industry Commission for Scotland
GBR	Great British Railways				

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1 Executive Summary

Introduction to Project Neptune

This report includes benchmarking of international ferry operations and other subsidised sectors in the UK and the preliminary evaluation of a long-list of strategic options that in future could be implemented to improve delivery on the CHFS network.

Introduction

Transport Scotland (TS) seeks to deliver a safe, efficient, cost-effective and sustainable transport system for the benefit of the people of Scotland, thereby playing a key role in realising the Scottish Government's (SG) purpose of achieving sustainable economic growth with opportunities for all of Scotland to flourish. Ferry services in Scotland fulfil a critical function within the wider transport system, providing lifeline services to island communities.

The services on the Clyde and Hebrides Ferry Service (CHFS) network are subsidised by Scottish Ministers and delivered by three parties: TS, Caledonian Maritime Assets Limited (CMAL), and CalMac Ferries Limited (CFL) as a wholly owned subsidiary of David MacBrayne Limited (DML) (together "the Tripartite").

Purpose and Approach

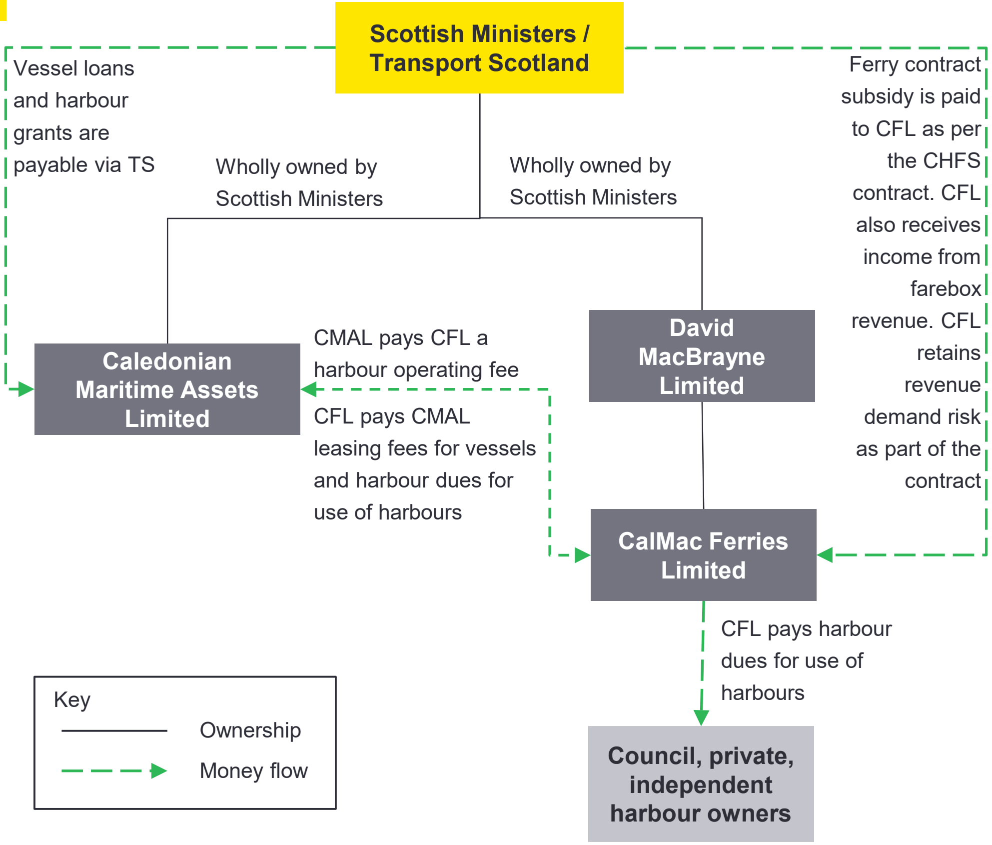
The delivery and cost of ferry services and the relationships between the Tripartite are complex and Scottish Ministers are mindful of the perception that exists of a lack of accountability among the parties.

The objective of this review is to provide Ministers with a strategic framework of options for the CHFS network.

- On behalf of Scottish Ministers our review's purpose is to help to identify the preferred corporate and governance structures for the delivery of ferry services under a range of potential future scenarios.
- This strategic framework of options provides Ministers with our views on what could be done to the CHFS network, rather than on what should be done.
- Any structure proposed for delivering ferry services on behalf of Scottish Ministers should enhance passenger experience, support local communities and be accountable, transparent and capable of achieving Best Value.

In order to inform the options we have undertaken an international benchmarking exercise of lifeline ferry services and a review of comparable subsidised industries in Scotland. The options considered draw on findings from each of these exercises and have been evaluated using an agreed set of criteria.

Illustrative diagram of Tripartite



The CHFS network is primarily delivered by three parties: TS, which acts on behalf of Scottish Ministers and is responsible for setting policy and procuring lifeline services; CMAL, which is the owner of 36 vessels (31 of which are leased to CFL) and 26 harbours (used across both the CHFS and the Northern Isles Ferry Services (NIFS) networks); and CFL, which is the operator and is responsible for the delivery of services under the CHFS2 contract.

Benchmarking

The benchmarking exercise did not reveal a predominant model for delivering ferry services. Key points of difference include the presence of a regulator; the role of the private sector; the extent of competition in the market; the scale of risk transfer; and the approach to asset ownership.

International Benchmarking

The purpose of the international benchmarking exercise was to provide an understanding of the different models adopted by ferry operators in overseas markets. We reviewed a number of ferry operations from around the world and undertook an in-depth review of four comparators: Canada (British Columbia), Norway, New Zealand (Auckland) and Australia (New South Wales (NSW)).

Strategic and Operational Control – Governments wield varying levels of strategic and operational control. To the extent that control exists, governments exercise this via a number of levers including contractual relationships, regulation, clear policy direction and / or exploiting competitive market dynamics.

Risk Transfer and Accountability – There is no uniform approach to risk transfer among the comparators. However, it was acknowledged by interviewees and in documentation that a minimum level of reputational and service level risk is always retained by the procuring authority.

	Scotland	Canada	Norway	Australia	NZ
Regulator	No	Yes	No	No	No
Operator Ownership	Public	Public	Private	Private	Private
Vessel Owner	Public	Public	Private	Public	Private
Infrastructure Owner	Public	Public	Public	Public	Public
No. of Passengers	5m p.a.	22m p.a.	44m p.a.	15m p.a.	6m p.a.
Subsidy (per annum)	£149m	£145m	[redacted]	£58m[1]	[Unknown]
No. of Vessels	31	35	203	32	30
Avg. Age of Vessels	22 years	33 years	26 years	24 years	[Unknown]
No. of Routes	29	25	120	9	24

[1]Government funding represents the net contract payments to the private operator.

Domestic Benchmarking

As well as exploring international comparators, we have considered UK sectors that share similarities with the ferries sector in order to highlight their governance and regulatory frameworks and to identify models that could be included within the long-list of structural options for the future CHFS network.

This exercise focused on a number of Scotland's key infrastructure sectors that provide services under contract with Government. These comparators were selected because they were considered most relevant to the ferries sector.

The following domestic sectors were reviewed:

- Scotland's road network
- Scotland's rail network and the proposed UK rail industry reforms
- Highlands and Islands Airports Limited (HIAL)
- Scottish Water

Regulation – In the domestic sphere, the presence of a regulator featured in all of the case studies considered. Regulators' responsibilities varied considerably from 'light touch' (roads sector) to more heavily regulated sectors, including the Regulated Asset Base model in which private investors receive a regulated return set by the regulator. In all instances the regulator provided an independent perspective on performance.

Delivery model – The degree of control across sectors varied. The roads network is segregated, with TS owning and maintaining trunk roads, whereas responsibility for non-trunk roads sits with local authorities. This differs to the rail sector where Network Rail (NR) (GBR under the new model) is responsible for the infrastructure and Train Operating Companies (TOCs) operate train services.

Private sector involvement – To varying extents private sector involvement is present in all four domestic sectors. In rail and aviation the operators are typically private. However, there are examples (such as rail) where Government has on occasion stepped in as an Operator of Last Resort (OLR).

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Future Options

When reviewing future options for the CHFS network we have considered the following: commercial contractual considerations; options relating to increased regulation; and options relating to structural reform.

Future Options

The diverse types of control and risk transfer observed in the benchmarking exercise reflect the absence of a predominant framework for delivering subsidised services.

The key points of difference between the case studies nonetheless provide a useful illustration of the characteristics that could feature in a future model for Scotland's ferry sector. These include:

- The presence of an independent regulator or commissioner
- The ability of the operator to independently raise finance
- The extent to which procurement and management of ferry services should be decentralised
- The merits of an integrated approach in which roads and ferry services are managed together
- The presence of competition and the means by which it can be stimulated
- The full range of options for owning and maintaining key assets
- The distribution of revenue demand and asset risk

These themes have been used to inform the development of the long-list of options that have been appraised in this report.

When reviewing the future options for ferry services we have sought to include:

- Commercial contractual considerations
- Options relating to increased regulation
- Options for structural reform

The matrix below includes an overview of the options considered, which will be outlined and evaluated throughout the remainder of this report.

Future Considerations

Commercial contractual considerations	Direct Award	Long-Term Contract	Management Contact
Options for increased regulation	Commissioner or Regulator	Regulated Asset Base	
Options for structural reform	Integration / Assimilation	Privatisation	Decentralisation

Commercial Considerations

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Prior to any decision on the future of CHFS, Ministers should consider their longer-term aspirations for the sector. Commercial changes, such as a Direct Award or a change to the contract length, should complement any regulatory or structural change.

Commercial Considerations

The current CHFS contract expires in 2024. Contracts of this nature typically take in the region of 18 to 24 months to procure (excluding the preparatory phase). Prior to embarking on any procurement exercise, TS should internally agree the contract's key commercial principles, ideally by summer 2022, in order to allow adequate time for the subsequent procurement exercise. TS should also identify its longer-term strategic objectives for the ferry service so that the contract procured complements any structural change that is undertaken in pursuit of these.

We have identified ways in which Ministers could amend the contractual relationship with the operator as part of the next CHFS procurement. These commercial considerations are distinct from the governance and structural changes that are the primary focus of our work, but could be considered in conjunction with any changes made to the structure of the Tripartite.

Risk Allocation

- Under a Management Contract, the transfer of risk to the operator is less extensive. A Management Contract could be preferable to the status quo if it is judged that the operator has limited means of influencing farebox revenue or controlling certain types of spend (i.e. maintenance of vessels). The operator is paid a fixed fee for delivering the services.
- This could potentially make the CHFS contract more efficient for SG and more attractive to operators. This may be desirable if TS wishes to stimulate competition in the market.
- However, a potential downside of using a Management Contract is that without exposure to revenue risk or full cost risk, the operator may be less incentivised to drive performance without an appropriate KPI regime.

Contract Length

- The CHFS3 contract could be let with a longer contract length. This could facilitate longer-term strategic thinking amongst the Tripartite.
- The merits of longer contract lengths have been recognised in British Columbia where British Columbia Ferries (BC Ferries) holds a 60 year contract. To support investment in low carbon vessels, procuring authorities in Norway have also extended the length of some contracts to 15 years
- A potential risk presented by longer contract lengths is that in the absence of regular procurements, operators become complacent and service delivery declines. As with management contracts, an appropriate KPI regime would be required to incentivise / disincentivise certain behaviours.

Direct Award

- TS could make a Direct Award to CFL for the CHFS contract rather than running a competitive procurement. In doing so, TS would need to satisfy the legal considerations from both a procurement and a UK Subsidy Control perspective.
- Direct Awards are permissible in short-term situations while a longer-term solution is sought. However, it must be demonstrated that the Direct Award represents VfM. It is under these circumstances that a number of Direct Awards have been issued during the pandemic.
- The negotiation process under a Direct Award does not benefit from the competitive tension present in a normal procurement, which may result in less competitive terms.

Prior to any changes to the corporate and governance structures that deliver ferry services in Scotland, Ministers should consider their longer-term objectives for the sector, and whether it can best achieve these objectives through commercial or structural means, or a combination of both.

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Future Options

We have developed a list of options under four themes: regulation, integration, privatisation and decentralisation. We undertook a preliminary evaluation of the options to assess whether an option had the potential to achieve or contribute towards Best Value.

Enhanced Regulation and Structural Reform

When carrying out our review of international comparators and subsidised services we identified a number of themes that captured the key variations between the case studies. As well as different commercial considerations (see previous slide), benchmarking highlighted the different approaches to regulation and delivery models.

We have presented below a long-list of options that includes both enhanced regulation and structural reform. The individual themes identified are not exclusive of one another and combinations of several options could conceivably feature in a future model for Scotland's ferries sector. They could also be implemented in conjunction with a number of the commercial considerations already highlighted. For the purposes of this appraisal we have assessed each option independently.

Enhanced Regulation

Independent regulation features in all of the sector case studies considered in this report. The scope of regulators' powers varies considerably: at a minimum the regulator or commissioner provides an independent perspective on the sector; under more expansive regulatory regimes their powers can extend to a Regulated Asset Base model (treated as a distinct option in this report).

Regulation

- Commissioner or Regulator
- Regulated Asset Base

Structural Reform

For each structural reform option we have included an overview of the corporate structure, roles and responsibilities and examples of how this option has been delivered in practice elsewhere.

Integration / Assimilation

- Assimilation of TS and CMAL
- Integration of CMAL and DML
- Integration of CMAL and CFL

Privatisation

- CMAL assets sold to the private sector
- CFL sold and any future contract is let to the private sector
- Divestment of non-core operations

Decentralisation

- Local authorities procure and manage ferry services
- Local authorities procure and manage ferry services and assets
- TS manages major routes. Local authorities manage smaller routes

The long-list of structural options has been evaluated using criteria drafted with reference to TS' mission of delivering a "safe, efficient, cost-effective and sustainable transport system". These criteria have been developed to understand whether the option has the potential to achieve Best Value.

Passenger Experience and Local Communities | **Deliverability** | **Accountability and Transparency** → **Potential to Achieve Best Value**

A qualitative assessment has been performed as to whether the impact of an option would be positive, neutral or negative on each criterion.

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Preliminary Evaluation

The preliminary evaluation exercise found merit in greater regulation and integration, but noted substantial challenges in relation to privatisation. The benefits of decentralisation are likely to be mixed according to the capabilities and objectives of each local authority.

Observations from the Preliminary Evaluation

The radar chart below visualises the findings from our preliminary evaluation and provides an indication of the priority areas that may merit further exploration.

The introduction of greater **regulation** in the form of a commissioner or regulator has the potential to increase accountability if the individual or body is equipped with appropriate powers; however, by introducing another stakeholder into an already crowded sector, there is a risk that roles and responsibilities become further confused, undermining transparency. Appropriate and considered regulation is needed to mitigate this risk.

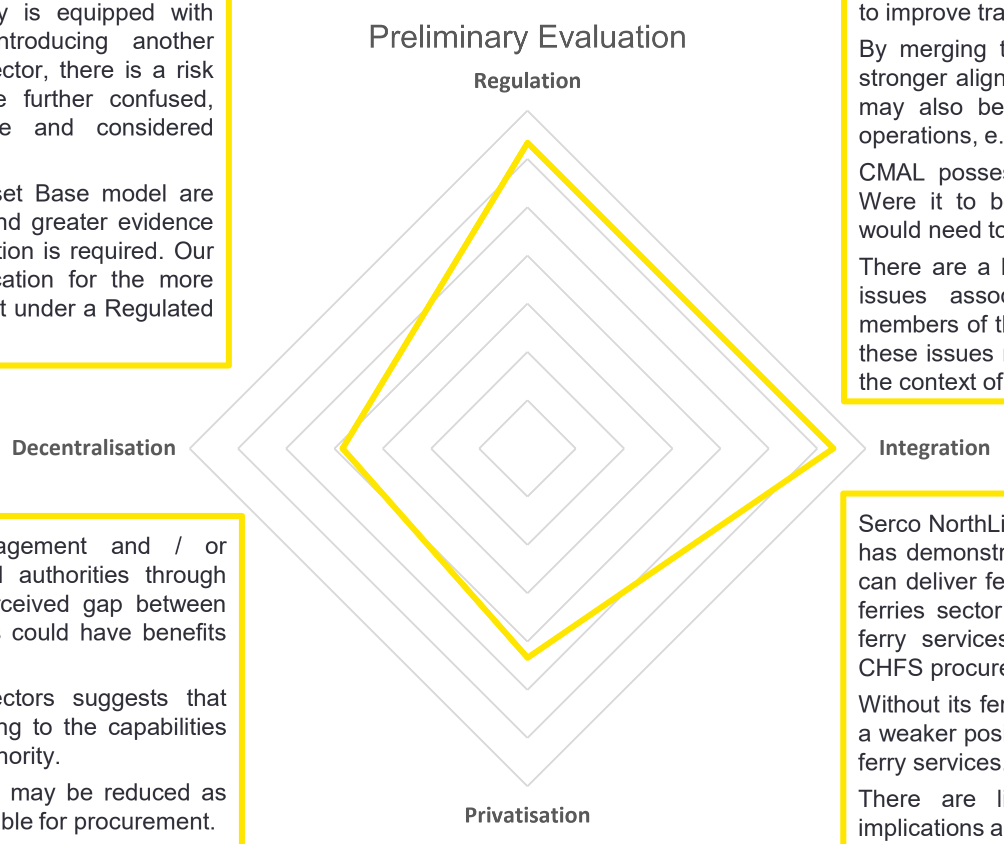
The legal barriers for a Regulated Asset Base model are higher as legislators are likely to demand greater evidence that this more expansive form of regulation is required. Our initial evaluation has not found justification for the more onerous regulation that would be present under a Regulated Asset Base model.

By reducing the number of parties within the Tripartite through **integration** it may aid clarity, which has the potential to improve transparency and accountability in the sector.

By merging two members of the Tripartite there will be a stronger alignment of those organisations' objectives. There may also be opportunities to achieve efficiencies in their operations, e.g. vessel maintenance.

CMAL possesses technical expertise that TS depends on. Were it to be integrated with CFL or DML, consideration would need to be given to how TS could retain this capacity.

There are a large number of taxation, legal and accounting issues associated with integrating or assimilating two members of the Tripartite. The cost associated with resolving these issues need to be more fully understood and judged in the context of Ministerial priorities.



Passing responsibility for the management and / or procurement of ferry services to local authorities through **decentralisation** could narrow the perceived gap between communities and decision makers. This could have benefits for accountability and transparency.

Evidence from Norway and other sectors suggests that passenger experience will vary according to the capabilities and priorities of the responsible local authority.

The ability of Ministers to drive change may be reduced as they would no longer be directly responsible for procurement.

It is possible that the positives associated with decentralisation could be achieved via other means that would avoid the complexities mentioned above.

Serco NorthLink Ferries (SNF) operate the NIFS contract and has demonstrated the success with which a private operator can deliver ferry services. TS could divest its interests in the ferries sector and depend on the **private sector** to deliver ferry services on the CHFS network; however, in recent CHFS procurements there has been limited competition.

Without its ferry interests, TS / Scottish Ministers would be in a weaker position to step in as OLR, a requirement for lifeline ferry services.

There are likely to be significant tax and accounting implications associated with the sale of CMAL.

The SG's objectives with regards to DML's commercial mandate requires greater clarity to assess if this remains a desirable direction of travel.

Preliminary Evaluation

It is possible that a combination of options could deliver enhanced value for TS. It may therefore be desirable to introduce a number of these options, recognising that the timescales for each of their introductions may differ.

Evaluation Criteria	Passenger Experience	Deliverability	Accountability and Transparency	Overall potential to achieve Best Value
Enhanced Regulation				
Commissioner or Regulator	Neutral	Positive	Positive	Positive
Regulated Asset Base	Positive	Negative	Neutral	Neutral
Structural Reform				
TS / CMAL assimilation	Neutral	Negative	Positive	Negative
CMAL / DML integration	Positive	Neutral	Positive	Positive
CMAL / CFL integration	Positive	Neutral	Positive	Positive
CMAL assets privatised	Negative	Negative	Neutral	Negative
CFL does not bid on the next CHFS contract	Neutral	Neutral	Neutral	Neutral
Cease focus on non-core commercial operations	Neutral	Neutral	Positive	Neutral
Local authorities procure ferry services	Negative	Negative	Positive	Negative
Local authorities procure ferry services inc. vessels	Negative	Negative	Positive	Negative
TS manage major routes and smaller routes passed to local authorities	Neutral	Negative	Positive	Neutral

Negative – Unlikely to achieve Best Value

Neutral – Requires further research to understand whether Best Value can be achieved

Positive – Potential to achieve Best Value

The summary table adjacent presents the preliminary scores awarded to each option.

- The introduction of a commissioner or regulator could increase independent oversight of the sector and serve as a helpful interface between the Tripartite and the public. Lighter touch regulation is considered more appropriate than a Regulated Asset Base model, which may be excessive and not contribute towards Best Value due to it being ill suited to the challenges facing the sector.
- Integration of CMAL and CFL is the most attractive option from the 'integration and assimilation' grouping; it offers the opportunity to streamline the structure of the Tripartite while maintaining separation from DML's commercial activities. It would present a number of complex legal and taxation issues, which need to be more fully understood as part of the detailed evaluation.
- Limited benefits were identified in relation to privatisation. Some merit was noted in relation to the cessation of DML's non-core operations; however, in order to explore this option fully, more clarity is needed regarding Ministerial priorities for DML.
- Complete decentralisation of ferry services on the west coast of Scotland was not judged to be desirable. Partial decentralisation and de-bundling of routes may provide a more pragmatic means of bridging the gap between decision-makers and local communities. Other means by which local communities and the relevant local authorities can formally input into the sector could also be explored as an alternative to structural change.

Key Recommendations

We recommend that when considering the future of the CHFS network, communities are consulted on the proposed future options and a Business Case exercise is undertaken to further appraise the indicative preferred options with reference to Ministerial objectives.

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- In this report we have indicatively identified a number options for the CHFS network which merit further detailed evaluation by TS and its stakeholders.
- The long-list has been developed with reference to our international benchmarking exercise and a review of domestic sectors judged as being relevant to the ferries sector.
- We have set out an evaluation framework which can be used to evaluate the options in a robust and transparent manner.
- We have included below an overview of this report's key recommendations and next steps based on the evaluation we have undertaken.

Consultation	Commercials	Regulation	Structural reform
Prior to any further decisions on the contract or future regulatory / structural reform, we recommend further consultation with local communities.	The current CHFS contract expires in 2024. Contracts of this nature commonly take in the region of 18 to 24 months (excluding preparatory phase) to procure. All three of the commercial options could conceivably be introduced to the CHFS network. Prior to embarking on any procurement exercise, an assessment of the desired commercial position vis-à-vis TS' future objectives for the ferry sector should be undertaken to understand how contractual changes could support the delivery of these objectives.	Enhanced regulation could be introduced in the form of a commissioner or regulator. Implementing either would give more oversight and bring the ferries sector into line with the rail sector in the UK. A full economic assessment of the remit of a commissioner or regulator would need to be undertaken if more independent oversight is deemed a Ministerial priority.	The industry could be restructured to become more integrated, increase private sector involvement or enhance the role of local authorities. Our preliminary assessment highlights an integrated model between CMAL and CFL as an option which has the potential to contribute towards the achievement of Best Value. We recommend TS consider this framework and long-list of options as part of a Business Case and full options appraisal to help identify a preferred way forward for the future of the CHFS network.
Short-term	Short-term	Medium-term	Medium-term

At this stage of the evaluation we have sought to understand the benefits and disbenefits of a number of commercial considerations, enhanced regulation and structural reform.

The options proposed may be complementary but do not necessarily need to be implemented at the same point in time.

We recommend that when considering the future of the CHFS network, long-term objectives are factored into all key decisions, including any commercial considerations relating to CHFS3.

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An Introduction to Project Neptune

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Introduction

TS seeks to deliver a safe, efficient, cost-effective and sustainable transport system for the benefit of the people of Scotland, thereby playing a key role in helping to achieve the SG’s purpose of sustainable economic growth with opportunities for all of Scotland to flourish.

Ferry services in Scotland fulfil a critical function within the wider transport system, providing lifeline services to island communities.

Ferry services on the CHFS network are subsidised by Scottish Ministers and delivered primarily by three parties: TS, CMAL and CFL as a wholly owned subsidiary of DML (together “the Tripartite”).

The delivery and cost of ferry services and the relationships between the Tripartite are complex, and Scottish Ministers are mindful of the perception which exists of a lack of accountability among the parties.

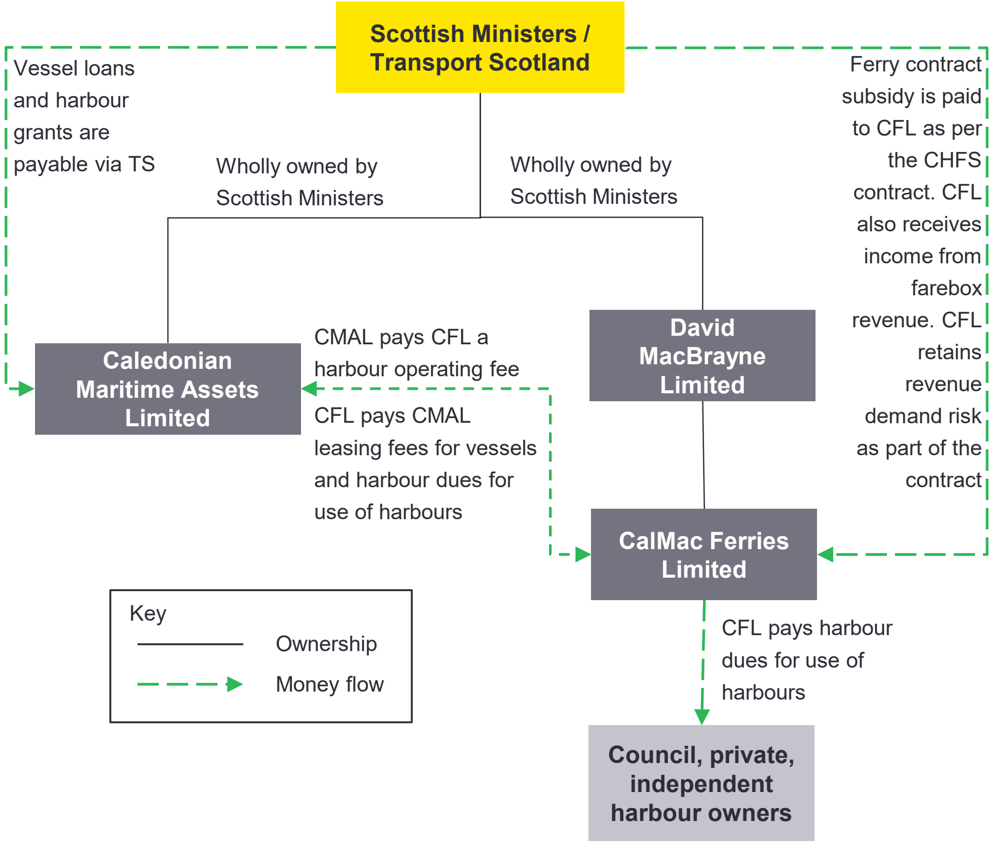
Purpose

The objective of this review is to provide Ministers with a strategic framework of options for the CHFS network.

- Our review’s purpose is to help to identify the preferred corporate and governance structures for the delivery of ferry services on Scottish Ministers’ behalf.
- The strategic framework of options provides Ministers with our views on what could be done to restructure the CHFS network, rather than on what should be done.
- Any structure proposed for delivering ferry services on behalf of the Scottish Ministers should enhance passenger experience, support local communities and be accountable, transparent and capable of achieving Best Value.

Clyde and Hebridean Ferry Network

The diagram below includes an overview of the current structure of the CHFS network.



Policy Considerations

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Policy Considerations

The current policy objectives for Scotland's lifeline ferry services are set out in the following key documents:

- The Scottish Ferries Plan (2013-2022) provides a basis for the shape of all of Scotland's ferry services until 2022 (and beyond as vessels have a 30 year design life)
- The Vessel Replacement and Deployment Plan is intended to complement the Ferries Plan by considering historical and projected customer demand and the ongoing provision of capacity to meet that demand

The latest Scottish Ferries Plan is currently being developed by Ministers and is expected to be published in December 2022. It is likely that the plan will include consideration of issues such as Scotland's low carbon agenda and how ferry services can help achieve these ambitions.

When considering the options put forward in this report, the following questions will be key:

1. What are SG's main policy objectives that are relevant to the ferries sector?
2. How could the structure of the Tripartite best help to achieve these?

Report Structure

In order to inform the options developed we have undertaken an international benchmarking exercise of lifeline ferry services and a review of comparable subsidised industries in Scotland and across the UK. The options considered draw on the findings from each of these exercises and have been evaluated using an agreed set of criteria. This section of the report is split into the following parts:

Benchmarking	Options for consideration	Preliminary evaluation
The purpose of the benchmarking exercise is to develop an understanding of the different models adopted by both ferry operators internationally and similar sectors in the UK. The information gathered as part of this exercise will enable the identification of key points of difference between markets and highlight potential 'lessons learned' that could be applied in the context of Scotland.	It is evident from our benchmarking and sector analysis that there are a number of alternative models Ministers could adopt in delivering ferry services on the CHFS network. We have reviewed commercial contractual considerations, options for increased regulation and options for structural reform.	The evaluation criteria reflects Scottish Ministers' priority that any structure for delivering ferry services in Scotland should enhance passenger experience, support local communities, be accountable and transparent, as well as capable of achieving Best Value. Deliverability has been added in recognition of the practical limitations that could preclude any given option's viability.

2 Benchmarking

Approach to Benchmarking

Introduction

The purpose of the international benchmarking exercise is to develop an understanding of the different models adopted by ferry operators internationally and what these models help to deliver. The information gathered as part of this exercise enabled the identification of key points of difference and highlight what may be desirable in Scotland.

This section includes an overview of the following:

- International benchmarking of lifeline ferry services
- Domestic benchmarking of public services that share similarities with the ferry sector

More detailed commentary on both is included as an appendix.

International Benchmarking Approach

The global ferry industry is similar in size to the commercial airline industry, transporting approximately 2.1 billion passengers each year, 250m vehicles and 32m trailers (excl. China). Operators can be publicly and privately owned, serve urban and rural communities, and function under a wide variety of structures and operating models.

We reviewed a number of ferry operations from around the world and have included in this chapter a review of four comparators. These are as follows:

- Canada (British Columbia)
- Norway
- New Zealand (Auckland)
- Australia (NSW)

These case studies were selected after being recommended as suitable options during initial discussions with the Tripartite. Their suitability is based on the presence of subsidy and, in the case of Canada, Norway and to a lesser extent New Zealand, provision of lifeline ferry services. The availability of suitable material on which to base our research was also a relevant factor.

The benchmarking exercise was informed by interviews with industry and government figures, as well as reviews of relevant documentation, including government policy papers, company annual reports and academic papers.

Source: www.Transdev.com

International Benchmarking Summary Table

The table below summarises the key statistics of the ferry services that have been considered as part of the international benchmarking exercise.

	Scotland	**Canada**	**Norway**	**Australia**	**New Zealand**
Awarding Body	Transport Scotland	Province of British Columbia	Norwegian Public Roads Administration / local authorities	Transport for NSW	Auckland Transport
Regulator	No	Yes	No	No	No
Contract Holder	CFL	BC Ferries	Multiple	Transdev	Multiple
Operator Ownership	Public	Public	Private	Private	Private
Vessel Owner	Public	Public	Private	Public	Private
Infrastructure Owner	Public	Public	Public	Public	Public
No. of Passengers	5m p.a.	22m p.a.	44m p.a.	15m p.a.	6m p.a.
Farebox	£76m	£360m	[redacted]	£21m	[Unknown]
Subsidy	£149m	£145m	[redacted]	£58m[1]	[Unknown]
Profit Before Taxation	£1m	£17m	[Unknown]	[Unknown]	[Unknown]
No. of Vessels	31	35	203	32	30
Avg. Age of Vessels	22 years	33 years	26 years	24 years	[Unknown]
No. of terminals	52	47	[Unknown]	38	21
No. of Routes	29	25	120	9	24
Contract Length	8 years	60 years	6-10 years	9 years	6-12 years
Contract Type	Farebox risk with operator	Farebox risk with operator	Multiple[2]	Operate and Maintain	Farebox risk retained by authority

[1] Government funding represents the net contract payments to the private operator. Passenger revenue is retained by the private operator.
[2] Contracts are let on both a gross and net basis

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Canada – BC Ferries

- BC Ferries carries in the region of 22m passengers per annum across 25 routes. It owns the majority of its 35 vessels, which have an average age of 33 years.
- It serves tourists and commuters, as well as providing lifeline and long-distance ferry services.
- The Province owns 75,477 non-voting 8% cumulative preferred shares in BC Ferries and receives an annual dividends payment. These shares do not provide the Province with a voting interest in BC Ferries.
- BC Ferries entered into the Coastal Ferry Services Contract with the Province of British Columbia on 1 April 2003 for a 60 year term.
- As the operator it holds farebox risk under the contract, which can be amended on a four year rolling basis following a price cap review by the commissioner.
- BC Ferries owns and operates its own vessels which it pays for via private sector finance. The Province owns the land and structures comprising most of the terminals operated by the company. This infrastructure is leased to BC Ferries for the 60 year term commencing 1 April 2003.
- BC Ferries operations are regulated by a commissioner whose responsibilities include establishing price caps, monitoring adherence to the contract and authorising major spend.

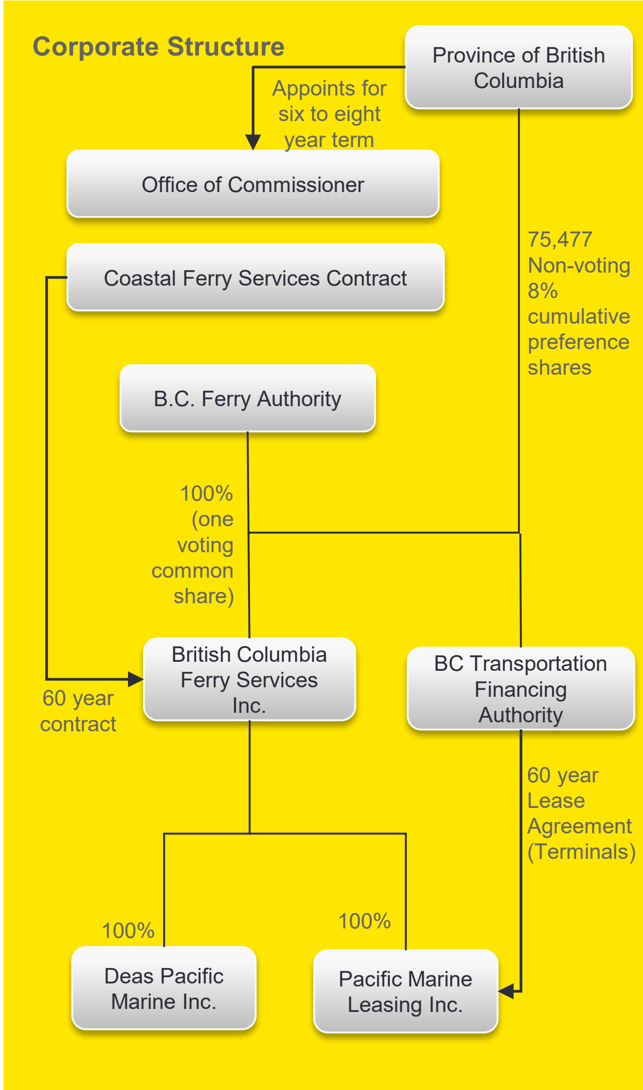
Observations for Future Options

The presence of a commissioner and the long length of BC Ferries' contract provides it with significant independence. BC Ferries employs this independence to adopt a highly commercial approach to its operations; previously this has been manifest in its executive pay (noted for being high) and vessel construction (noted for being undertaken overseas).

The independence BC Ferries has been endowed with required the Government of British Columbia to surrender a significant degree of control. However, in our engagement with stakeholders it was noted that from the perspective of the public, the Government remains responsible and perceived failings by BC Ferries continue to be associated with the Government of the day.

The Provincial Government has attempted to redress this imbalance in recent years by amending the existing legislation to reduce BC Ferries' commercial focus and encourage consideration of a wider range of socio-economic factors, including domestic shipbuilding.

The Government's limited control means BC Ferries' private debt does not sit on the Balance sheet.



Norway

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Norway

- Norway has a ferry fleet of c.200 vessels that deliver services across 120 ferry routes and carry 44m passengers each year.
- Ferry services are procured through a number of separate contracts by either the national Norwegian Public Roads Administration or by individual county municipalities' road authorities, according to whether or not the ferry service forms part of a national route.
- Of the country's 120 ferry services, 16 are currently national routes and 114 are county routes.
- The normal contract length is 6-10 years although there is often an option to extend.
- Contracts are tendered on either a gross or net basis. In recent years there has been a tendency towards gross contracts.
- Government subsidy accounts for [redacted] of the ferry sector's income, which with farebox revenue amounts to [redacted] per annum.
- Four private sector operators dominate the Norwegian ferries sector.
- In recent years operators have been required to procure low carbon vessels as conditions of their contracts, which has reduced the fleet's average age to 26 years.

Observations for Future Options

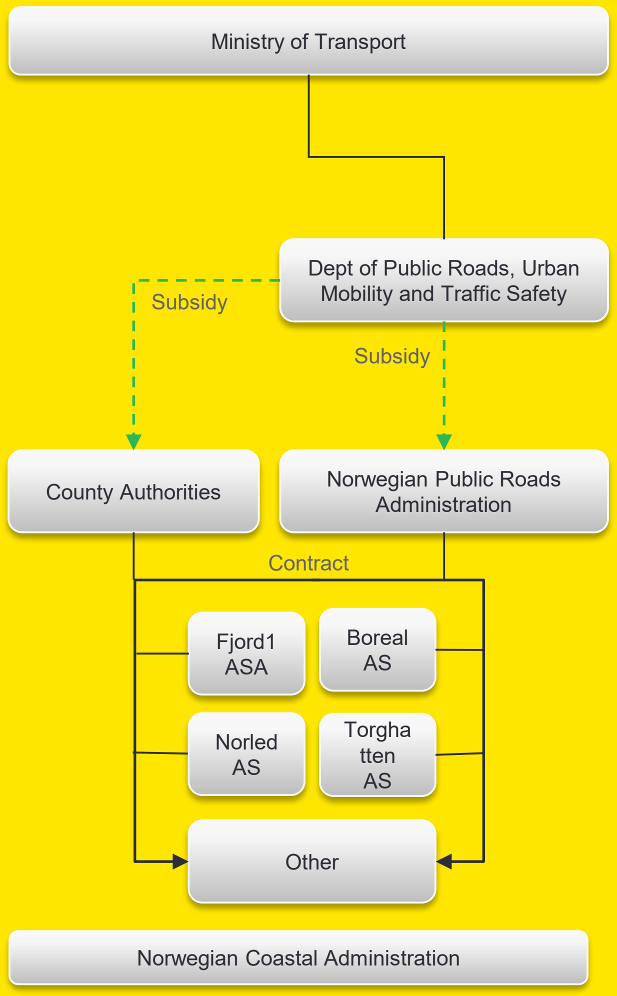
Delivery is comparatively decentralised, with a majority of contracts being awarded and managed by local authorities.

The localised nature of ferry services procurement in Norway requires the network to be tendered in small bundles. This results in a larger volume of frequently tendered contracts which helps make the market attractive to operators who are better able to manage their asset risk because vessels can more readily be redeployed elsewhere in the market if a contract is lost. A transition to gross contracts has also increased the attractiveness of the Norwegian ferries sector to the private sector.

These characteristics have contributed to a competitive market dynamic in which market participants, incentivised by the threat of competition, are more responsive to Government demands. The procuring authorities have leveraged this influence by behaving as an 'active procurer' to steer the sector. This approach is complemented at a national level by clear strategic direction in relation to Government priorities such as green vessel replacement.

Central Government has also facilitated the decentralisation of ferry services procurement by investing in the skill set of local authority staff, for example by subsidising training for procuring 'green' ferry services.

Corporate Structure



Australia – Transport for New South Wales

Australia

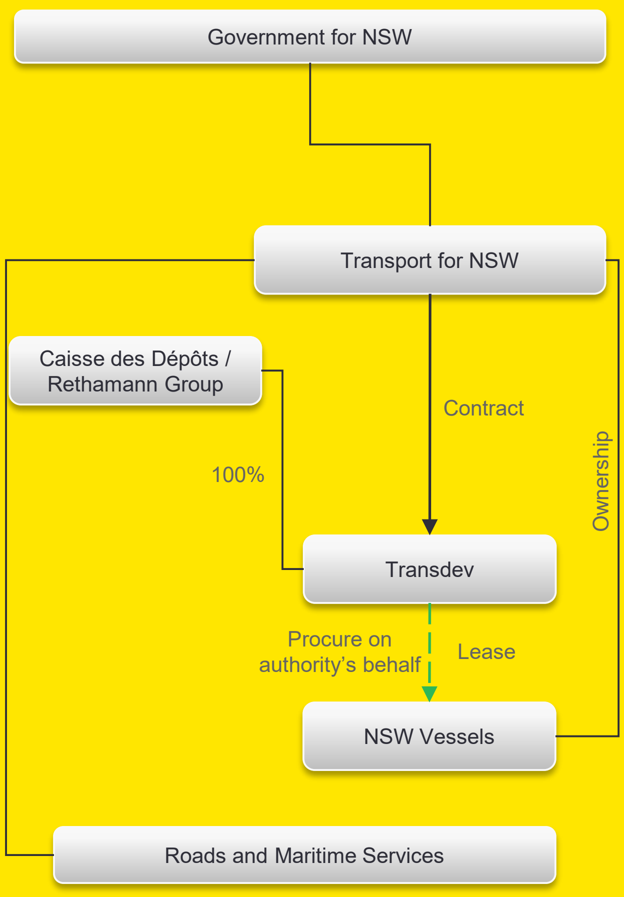
- The Sydney Ferries Network carries c.15m passengers per year and serves 36 ferry stops across nine routes. The customer base is predominantly tourists and commuters.
- Ferry services are provided under the Ferry System Contract, which is managed by Transport for New South Wales (TfNSW).
- The current operator is Transdev, which is owned by Caisse des Dépôts, an investment arm of the French Government, and the Rethamann Group, a German utilities, logistics and services group.
- TfNSW retains revenue risk and control over the fare structure, routes and timetables.
- The Government of NSW has a fleet of 32 vessels, which have an average age of 24 years. The Government also owns the wharf infrastructure.
- During the lifetime of the contract the operator leases the vessels from TfNSW and is responsible for both operational and long-term maintenance. TfNSW also owns a shipyard for maintenance and a berthing facility. Responsibility for maintaining the shipyard and berthing facility is passed to the operator for the duration of the contract.
- The annual subsidy awarded to Transdev is in the region of £58m per annum. The most recently available financial information for Transdev shows that it retained farebox revenue of c.£21m per annum.

Observations for Options Analysis

A 2016 report by the Audit Office of NSW found that contracting with the private sector has enabled cost risk to be transferred away from the public sector. It also found that elements of service risk had been transferred; however, it recognised that there is a practical limit to such risk transfer as the Government ultimately remains responsible for the delivery of public transport services.

For the duration of the contract the operator is responsible for operational and long-term maintenance of the Government's fleet of vessels. It is also responsible for the Government's shipyard. This relationship has been extended under the 2019-28 contract and Transdev is now also responsible for procuring new ferries on behalf of Transport for NSW.

Corporate Structure



New Zealand – Auckland Transport

New Zealand

- The Auckland Ferries Network consists of 30 vessels and serves 24 routes from 21 terminals.
- It carried 6.3m passengers in 2019. Ferry services predominantly serve commuters and tourists, although services to Waiheke Island are considered lifeline.
- Private sector operators provide ferry services to Auckland Transport (AT) under contracts that have durations of between 6 and 12 years. Under this arrangement AT retains farebox risk while the operators, as the vessel owners, bear the asset risk.
- Operators supply their own vessels. Fullers, the dominant operator in the market, owns 21 vessels. AT manages 21 ferry facilities on behalf of Auckland Council, the infrastructure owner.

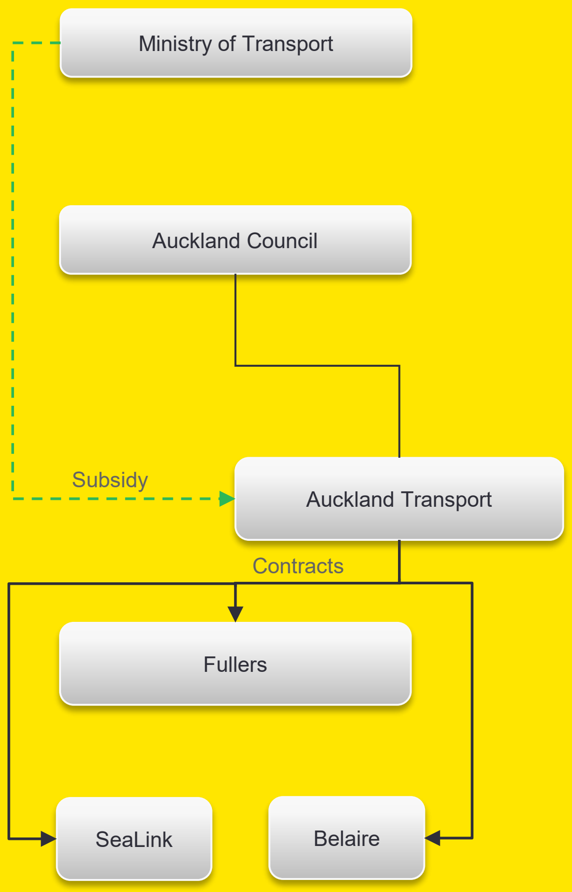
Observations for Options Analysis

AT's regulatory framework leaves key ferry routes outside of Government control. This places clear constraints on AT's sphere of influence and demonstrates the importance of an appropriately designed regulatory / legislative framework.

A procurement exercise in 2019 for ferry services was reported in the media to have failed due to AT's demand that operators invest in new vessels. Operators attributed their resistance to short contract lengths.

As well as longer contract lengths, more market participants could help to create a more responsive market. As a means of removing barriers to entry AT has considered moving to a model whereby it supplies its own vessels, as in NSW.

Corporate Structure



International Benchmarking Analysis

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Key Observations: International Comparators

The table below summarise the key observations from the international benchmarking exercise.

Key Points of Difference	CHFS	Canada	Norway	Australia	New Zealand
Commissioner	N	Y	N	N	N
Private Financing	N	Y	Y	N/A	Y
Integrated Roads and Ferries	N	N	Y	N	N
Decentralisation	N	N	Y	N	N
Competition	Y	N	Y	N	N
Operator Owned Vessels	N	Y	Y	N	Y
Operator Managed Shipyard	N	N	Unknown	Y	Unknown
Revenue Demand Risk	Y	Y	Y/N	N	N
Asset Risk	N	Y	Y	N	Y

Governance and Commercial Structures

Governments wield varying levels of strategic and operational control over their respective ferry sectors and operators. To the extent that control exists, governments exercise this via a number of levers, including:

- Contractual relationships
- Clear policy direction
- Exploiting competitive market dynamics

There is no uniform approach to risk transfer among the comparators. However, a minimum level of reputational and service level risk is always retained by the procuring authority. This is particularly true in the context of lifeline ferry services where the Government serves as the Operator of Last Resort (as per the Scottish model).

This practical limit on the transfer of reputational risk was recognised in discussions with the Government of British Columbia who found they were still held responsible for certain elements of service delivery despite control being largely transferred to BC Ferries.

This was also recognised in the Audit Office of NSW's report into ferry franchising, which found there is a "practical limit" to the transfer of service risk.

Scotland’s Roads Network

Domestic Sector Analysis – Approach

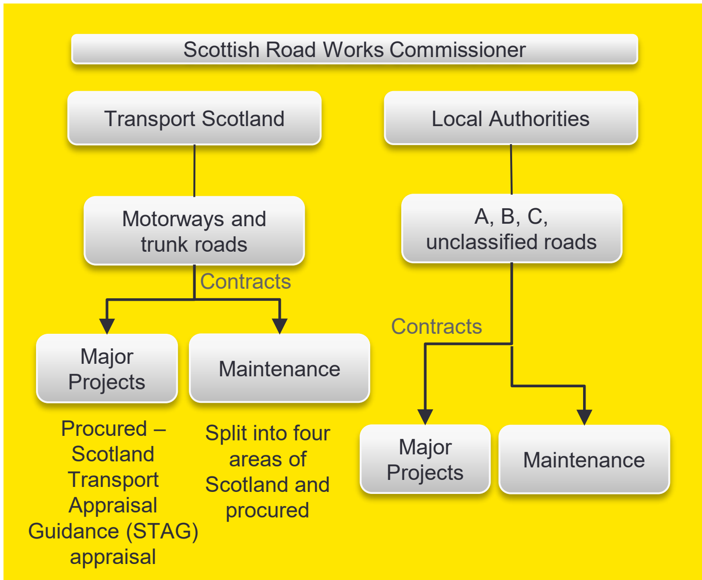
As well as exploring international comparators, we have reviewed domestic sectors that share similarities with Scotland’s ferries sector in order to understand their governance and regulatory frameworks and to identify any models that should be included within the long-list of structural options for the future CHFS network. We reviewed a number of sectors and have performed a comparison of four that we consider relevant to the ferry sector in Scotland. These are as follows:

- Scotland’s road network
- Scotland’s rail network (and proposed UK reforms)
- HIAL
- Scottish Water

This exercise was informed by reviews of relevant documentation, including government policy papers, company annual reports and academic papers, and select interviews with individuals from these industries.

Scotland’s Road Network

- The roads network in Scotland is made up of six categories of roads: motorways and trunk roads, A roads, B roads, C roads, Unclassified roads and Private roads
- Responsibility for maintaining the roads is shared between TS and local authorities in Scotland: management of the roads network in Scotland is partially decentralised, with non-trunk roads being the preserve of local authorities and trunk roads being overseen by TS.
- This devolved responsibility for roads maintenance results in variable service quality: an Audit Scotland report on roads maintenance found that 87% of those surveyed felt trunk roads were in an acceptable conditions, compared to 67% for council roads.
- Variable levels of spend between local authorities has also been noted. A similar trend was recorded in the review of Norway’s ferry network, whereby a decentralised model in which local authorities are responsible for minor routes has contributed to inconsistent service delivery across the network.
- An independent commissioner has been put in place with an aim to improve the quality of Scotland’s roads, although maintenance performance has continued to fall.



Scotland’s Rail Network

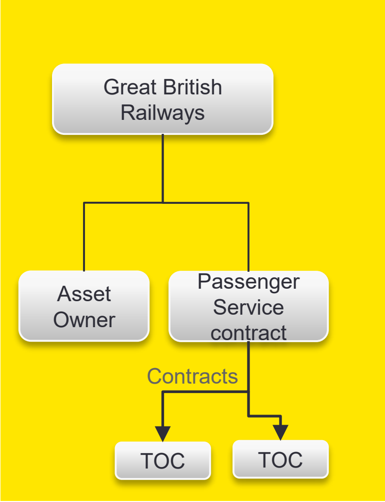
Scotland’s Rail Network

- Scottish Ministers have powers to set a strategy for railways, specify outputs which help support the delivery of that strategy and provide funding. They are able to specify rail passenger services in Scotland and do so through the ScotRail and Caledonian Sleeper franchises. The Department for Transport (DfT) is responsible for those functions transport in England and Wales, including reserved areas of safety and accessibility.
- The current ScotRail franchise contract is in place with Abellio ScotRail and is scheduled to end on 31 March 2022 following the decision not to extend the contract. ScotRail services will be operated through a wholly-owned company after the end of the current franchise in line with our Operator of Last Resort duty.
- Network Rail owns most of the UK’s rail infrastructure (tracks, signals, bridges, tunnels and stations), and receives funding from the Scottish Government to maintain and improve Scotland’s rail infrastructure. ScotRail leases the stations it manages from Network Rail and is responsible for leasing its trains from rolling stock companies (ROSCOs), and the terms of the leases include specific provisions as to who is responsible for various elements of maintenance (wet lease / dry lease). ScotRail secures the use of the network through a track access agreement with Network Rail.
- The Office of Rail and Road (ORR) is the independent rail safety and economic regulator for the railways in the UK. It sets delivery targets for Network Rail and determines its funding based on a regulatory assessment of how much the outputs should cost if delivered efficiently.
- Separating ownership of rolling stock from the operator reduces the latter’s asset risk in order to favourably impact the cost of contract delivery, and also facilitates competition as successor operators have ready access to suitable rolling stock. The fragmented nature of the rail industry has however caused challenges, which the UK Government’s Williams-Shapps Plan for Rail seeks to address via greater integration.

UK Rail Reform

The UK Government launched a review (the Williams Review) of the structure of the rail industry and the way in which rail passenger services are delivered across the UK in 2019. In May 2021, the Secretary of State for Transport announced a number of reforms to the UK rail industry, including the creation of a new public body, Great British Railways (GBR), to plan and run the railway, bring together the infrastructure and services, and receive fare revenue across the UK.

There is a presumption of the use of the private sector for the operational delivery of rail services under Passenger Service Contracts which will be competitively procured. While there is acknowledgment of the existing devolved arrangements, and a commitment to “explore options with Transport Scotland to enable the railway in Scotland to benefit from the reforms on the wider network of GB”. There is no further detail on what this means or how it is intended the structure of GBR will operate in a devolved environment and therefore it remains unclear how this will work in Scotland.



Scottish Water / Highland and Islands Airport Limited

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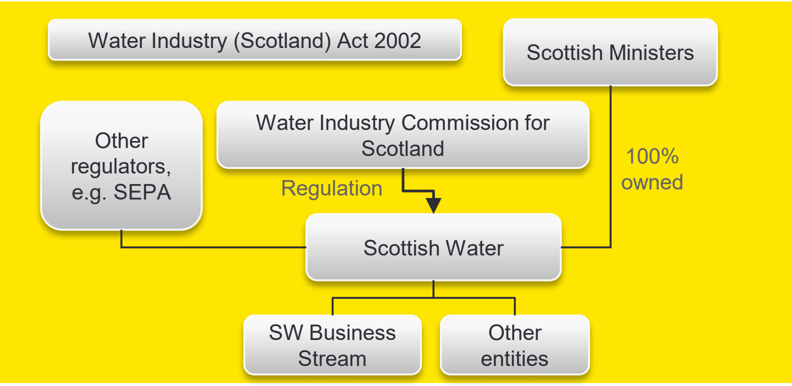
Scottish Water

- Scottish Water was founded in 2002 following a merger of three water authorities. The purpose of the merger was to make the Scottish water industry more efficient and competitive, improve VfM and harmonise charges across Scotland.
- Scottish Water is a monopoly business (except in the retail market) and supplies water to households under the relevant legislation and in line with a broad strategic framework set by the Scottish Ministers.
- Scottish Water is funded through revenue raised from customer charges and borrowing from the SG via the Scottish Consolidated Fund.
- Water Industry Commission for Scotland (WICS) is a non-departmental public body with statutory responsibilities. It is the economic regulator for the Scottish water industry and acts independently of Ministers. It is staffed by a team of c.20 people. Members of the Commission are appointed by the Scottish Ministers for a period of four years.



Scottish Water – Observations for Options Analysis

- Each six year regulatory period provides an opportunity for the WICS to independently assess Scottish Water's funding requirements and to set price caps in line with this. This helps to ensure adequate funding for the sector.
- The SG's input to the Strategic Review of Charges provides an opportunity for it to appraise and renew the policy framework that underpins Scottish Water's operation. This helps to ensure the Government assumes an active role in setting the strategic direction of the sector.
- Scottish Water maintains a commercial arm via Scottish Water Business Stream. These activities are siloed within a separate legal entity.

Highlands and Islands Airports Limited

- HIAL is wholly owned by Scottish Ministers, therefore its vision and goals can be readily aligned with those of Scottish Ministers.
- A framework document between HIAL and the SG sets out the broad context within which HIAL operates and defines key roles and responsibilities which underpin the relationship between HIAL and TS.
- HIAL receives an operating subsidy from the SG for the continuation of operations at its 11 airports. This subsidy amounts to half of all revenue received. HIAL also receives funding in the form of capital grants from the SG for investments and upgrades to the airports it operates

HIAL – Observations for Options Analysis

- As has been noted as part of the international benchmarking, retaining the capacity to influence the operator of lifeline services is important as a degree of reputational risk and service delivery risk is always retained by the Government.
- The Framework Agreement in place between HIAL and SG provides a clear foundation for the working relationship between the two parties and could serve as a blueprint for a similar framework for the Tripartite.

Sector Analysis: Key Commercial Considerations

Key Observations: Sector Analysis

The table below summarise the key observations from the sector analysis exercise.

Key Points of Difference	Roads	Rail	Water	HIAL
Commissioner	Y	Y	Y	Y
Integration	Y/N[1]	Y	N	N
Privatisation	N	Y	N	N
Decentralisation	Y	N	N	N
Competition	Y	Y	N	N
Revenue Demand Risk	N	Y	N	Y
Asset Ownership	Y	Y/N[2]	Y	Y

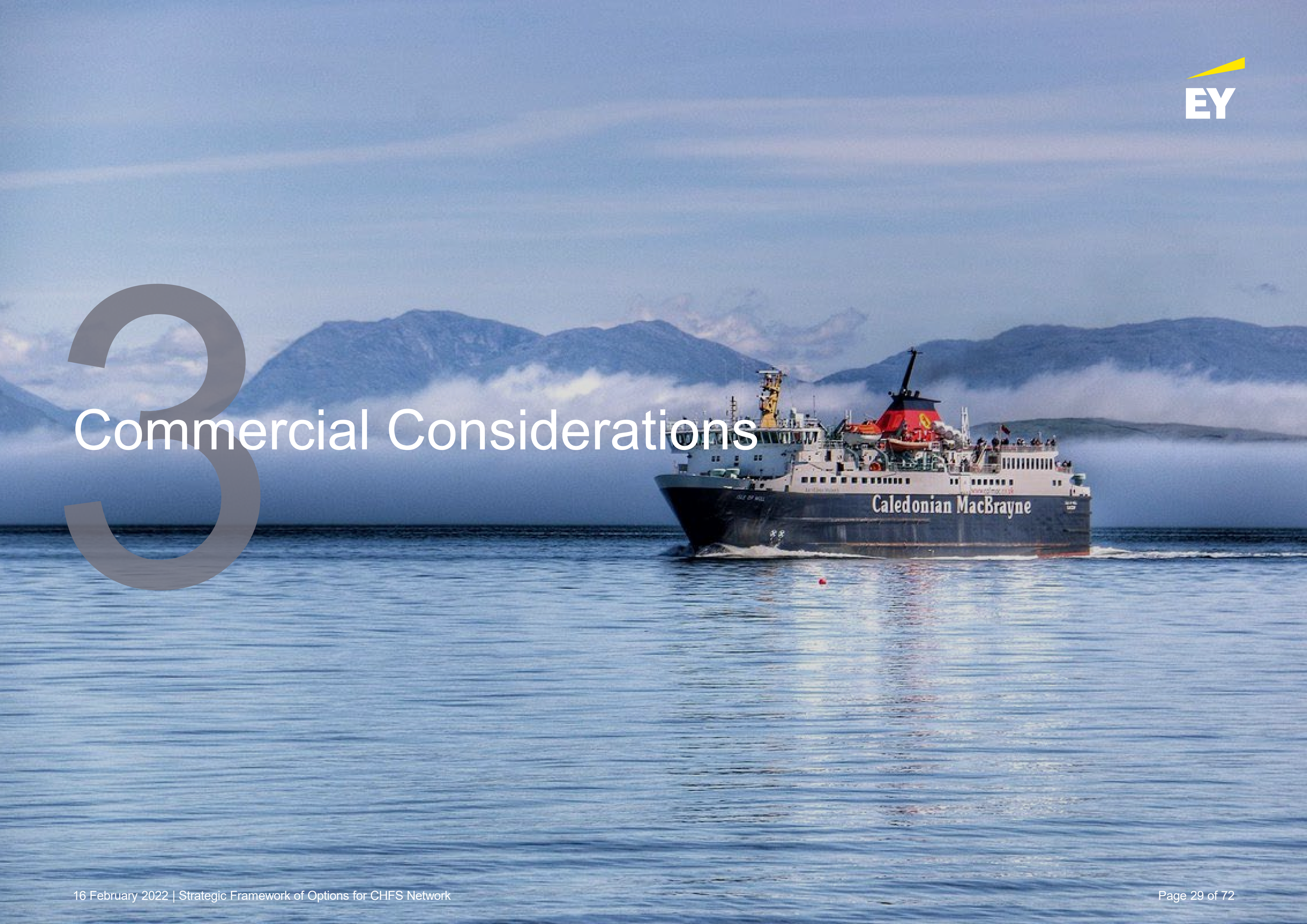
[1]Trunk roads are integrated by minor roads owned decentralised to local authorities.

[2]NR own track infrastructure and stations, ROSCO's own trains.

Governance and Commercial Structures

The sector analysis identified four key themes around the commercial structures in place:

- **Regulation** – Independent regulation features in all of the sector case studies. The scope of these regulators' powers varies considerably, with the Scottish Road Works Commissioner (SRWC) (roads) representing a comparatively light touch version of regulation compared to the economic regulation provided by the latter three bodies. In all instances the regulatory function provides an independent perspective on the performance of their respective sectors, something the ferries sector in Scotland does not currently benefit from. Regulatory powers could also extend to setting price caps to facilitate investment while also protecting consumer interests in monopolistic environments. The precise remit of any potential regulator should reflect the specific challenges faced by Scotland's ferries sector.
- **Integration** – There are differences in the way in which the ownership of assets are structured across the four sectors. Trunk roads (but not minor roads) are fully integrated within TS, which provides the latter with a great deal of control over how this service is delivered to the public. In rail, there has been more fragmentation, with the core infrastructure owned by NR and Government awarding franchises to private operators who are then responsible for service delivery. The absence of integration was a key observation in the recent Williams-Shapps Plan of the rail sector and remedying this via the establishment of GBR is one of the report's headline recommendations.
- **Privatisation** – Private sector involvement is present in all four models to varying extents. In rail and aviation, operators are typically private. Privately owned ROSCOs lease rolling stock to TOCs. The core infrastructure in rail is state owned via NR (soon to be GBR) but in the aviation sector tends to be privately owned. There are, however, notable exceptions to the above: the SG will in 2022 assume responsibility for Abellio ScotRail's operations as the Operator of Last Resort. Similarly, the SG is the owner of HIAL. The requirement for the SG to 'step-in' reflects Abellio and HIAL's status as providers of critical or lifeline services. The SG would also need to be prepared to step in as the Operator of Last Resort for ferry services under a scenario where service delivery is privatised and the operator encounters difficulties. Scottish Water has remained in public hands while the water sector in England & Wales has been privatised. This has afforded Scottish Ministers greater control over the sector and has also supported lower borrowing costs, which has resulted in lower water charges for consumers.
- **Decentralisation** – Decentralisation is present in Scotland's roads sector, with responsibility for non-trunk roads sitting with local authorities. Service delivery in the other sectors that were considered in this section were managed centrally.



3 Commercial Considerations

Introduction

The diverse types of control and risk transfer observed in the international benchmarking reflects the absence of a predominant framework for delivering ferry services. This was also noted during our interviews with industry stakeholders who commented that there was not a “single model” for service delivery.

The key points of difference between the case studies nonetheless provide a useful illustration of the characteristics that could feature in a future model for Scotland’s ferry sector. These include:

- The presence of an independent regulator or commissioner
- The ability of the operator to raise finance for shipbuilding independently
- The extent to which procurement and management of ferry services should be decentralised
- The merits of an integrated approach in which roads and ferry services are managed together
- The presence of competition and the means by which it can be stimulated
- The full range of options for owning and maintaining key assets, including vessels, ports and shipyards
- The distribution of revenue demand and asset risk

These approaches, already proven to be feasible in other markets, will help to inform the future options analysis undertaken in this report.

Future Options

When undertaking our review of international comparators and subsidised services in Scotland our principal observation related to the range of different structures adopted and the different ways in which commercial contracts are employed to achieve different objectives.

When reviewing the future options of the ferry services, we have sought to therefore include:

- Commercial contractual considerations
- Options on increased regulation
- Options for structural reform

The diagram below includes an overview of our considerations which will be outlined and evaluated throughout the remainder of this report.

Future Considerations

Commercial contractual considerations	Direct Award	Long Term Contract	Management Contact
Options for increased Regulation	Commissioner or Regulator	Regulated Asset base	
Options for structural reform	Integration / Assimilation	Privatisation	Decentralisation

The options identified are not exclusive of one another and could conceivably all feature in a future model for Scotland’s ferries sector. For the purposes of clarity though in this exercise though we have looked at each independently.

Commercial Contractual Considerations

The current CHFS Contract expires in 2024. Contracts of this nature typically take around 18 to 24 months to procure (excluding preparatory period).

Prior to any decision on the future contract, Ministers should consider their longer-term strategic objectives.

We have identified ways in which Ministers could amend the contractual relationship with the operator as part of the next CHFS procurement to strengthen the delivery of ferry services.

These commercial considerations are distinct from the regulatory and structural changes that are the primary focus of this report but could be considered in conjunction with any further change made to the structure of the Tripartite.

Commercial considerations relevant to the next CHFS procurement include:

- Changing how risk is allocated
- Changing the contract length
- Issuing a Direct Award for the operating contract.

Risk Allocation

Under the current CHFS contract farebox revenue and a majority of cost risk are transferred to CFL for the duration of the contract. Under a management contract, the transfer of risk to the operator is less extensive. TS would retain the revenue risk and potentially some cost risk where appropriate. A management contract of this nature could be preferable if it is judged that the operator has limited means of influencing farebox revenue or controlling certain types of spend (i.e. vessel maintenance). The operator is paid a fixed fee for delivering the services.

The amount payable would reflect the lower level of risk that the operator is exposed to in delivering the management contract versus the current arrangements. In addition, a performance payment can be included in the contract to incentivise certain behaviours.

As the holder of revenue risk, TS would be exposed to any rises or falls in demand. However, TS would also possess greater means by which it can influence farebox revenue due to its role in the policy making process. Analysis to understand how elastic demand is in response to policy changes may be required to understand TS' ability to manage farebox revenue risk.

The adjacent table presents types of contractual relationships observed in the sectors that have been reviewed as part of the international and domestic benchmarking exercise

Comparator	Contract type
TS Ferries	Farebox risk with operator
BC Ferries	Farebox risk with operator
Norway	Management contract and farebox risk contracts
TfNSW	Management contract
AT	Management contract
TS Roads	N/A no revenue from road passengers
TS Rail	Traditional franchise – Farebox risk with operator (pre-COVID)
UK Rail	Rail reform indicates a move to Management Contracts

Risk Allocation

Risk Allocation and the Rail Sector

In the rail sector it is increasingly recognised that the operator has limited means of influencing farebox revenue relative to its risk exposure and as a consequence management contracts are now viewed as a more sustainable means of delivering rail services.

Operators' weakness with regards to influencing farebox revenue was acute during the pandemic when passenger numbers fell by more than 90%.

In order to ensure continuity of passenger ferry services during the pandemic, the SG introduced Emergency Measures Agreements (EMAs). These arrangements were designed to maintain the financial viability of the operators and transferred revenue and cost risk back to the procuring authority. These arrangements have since been extended and are expected to be maintained in part under the reforms proposed in the Williams-Shapps Plan (see Domestic Benchmarking section), albeit with the operators taking on more risk than under the original EMAs.

CHFS Network

A benefit that may be realised as a consequence of adjusting the risk profile of the CHFS contract is that TS could attract a wider pool of bidders. If the balance of risk is viewed more favourably by the market this could increase the competitiveness of the procurement exercise and result in lower priced bids.

Greater VfM may also be attainable under a management contract if bidders are no longer required to price risks over which they have limited control into their bid.

A potential downside of using a Management Contract is that without exposure to revenue risk or full cost risk, the operator may be less incentivised to drive performance. This could lead to a decline in service quality, which would negatively impact passenger experience and farebox revenue. Poor cost management could increase the cost of delivering the service.

An appropriate KPI regime would be required to mitigate these risks. To design an effective KPI regime, TS must possess both a strong understanding of the operator's cost base and the technical capabilities to challenge the operator's costs on an ongoing basis.

Risk Allocation – Key Observations

A management contract would change the risk profile of the CHFS contract, which may be more efficient and make it more attractive to operators. This may be desirable if TS wishes to stimulate competition in the market.

Drafting and monitoring a KPI regime successfully requires TS to have a strong understanding of the operator's cost base and the technical wherewithal to challenge costs on an ongoing basis.

Contract Length

As illustrated in the below table, the eight year contract in place between CFL and TS is at the lower end of the range of contract lengths observed in our benchmarking exercise.

	Contract Length
TS Ferries	8 Years
BC Ferries	60 Years
Norway	6-10 Years
TfNSW	9 Years
Auckland Transport	6-12 Years
TS Roads	8 Years
TS Rail	7-15 Years
UK Rail	Typically eight years
HIAL	N/A - Framework Agreement
Scottish Water	N/A - Framework Agreement

Shorter contract lengths require more frequent procurements that provide an opportunity for the procuring authority to test the market and ensure the operator represents VfM. The prospect of a competition in the near-term also encourages the operator to continue delivering against the contract. There are, however, a number of disadvantages associated with shorter contract lengths:

- Operators are not incentivised to invest in the service to the extent that the return on that investment is realised after the end of their contract term. This can lead to short-term thinking and a lack of focus on long term investment. This is problematic in the ferries sector where vessels have useful lives of 25+ years and strategic planning is required to have a similar horizon.
- There is a cost associated with bidding for a contract and the cost must be recovered over the lifetime of the contract. If the contract length is shorter, the operator may be more likely to pursue short-term profits in order to recoup these costs rather than focussing on what is financially sustainable in the long-term.
- Bidding for contracts is also resource intensive. For shorter contracts, the period of time during which the operator is dividing its attention between service delivery and bidding is proportionally greater. Conversely, for longer contracts the period of time that the operator can focus exclusively on service delivery is greater.

CHFS Network

The CHFS3 contract could be let with a longer contract length. This could support more joined up strategic thinking amongst the Tripartite.

The merits of longer contract lengths have been recognised in British Columbia, where BC Ferries holds a 60 year contract. To support investment in low carbon vessels, procuring authorities in Norway have also extended some contracts to 15 years. In the UK's rail sector, the Williams-Shapps Plan noted that longer contracts may be desirable if major investment is required.

A risk presented by longer contract lengths is that in the absence of regular procurements, operators become complacent and service delivery declines. As with management contracts, an appropriate KPI regime would be required to incentivise / disincentivise certain behaviours. A commissioner or regulator could also be introduced to monitor compliance with the contract, similar to the Office of the Commissioner in British Columbia.

Contract Length – Key Observations

The procuring authority can be responsible for monitoring performance against KPIs and / or compliance with the contract. Alternatively, this responsibility can be passed to a commissioner or regulator, as happens in British Columbia. The length of the CHFS contract is noted as being at the lower end of the observed range. Its brevity relative to other contracts may become more pronounced as there is a noted trend towards longer contract lengths in the ferries and other sectors. Longer contract lengths are often deemed necessary to support capital investment. A longer CHFS contract could allow the operator to act more strategically and reduce the likelihood of short-term decision making. It may also allow the operator to align itself with TS and CMAL's asset renewal strategy, as the operator would be more likely to benefit from the realisation of that strategy. This could support vessel renewal and in the long-term reduce the average age of the fleet.

Direct Award

Direct Award of the Operating contract

A ‘Direct Award’ refers to a situation whereby the procuring authority negotiates a contract directly with a single operator (to date all Direct Awards in the UK have been made to the incumbent operator, although this does not have to be the case). No competition takes place. In making a Direct Award, there is an emphasis on the achievement of VfM and use of good commercial judgement.

Direct Awards are normally permitted when a competition is:

1. not possible for a technical reason (e.g. there is only a single supplier capable of delivering the contract)
2. is likely to cause significant disruption
3. is unlikely to deliver good value

Direct Awards are also permissible in an emergency situation while a longer-term solution is sought. However, it must be demonstrated that the Direct Award represents VfM. It is under this circumstance that a number of Direct Awards have been issued during the pandemic.

CHFS Network

TS could in the future make a Direct Award to CFL for the CHFS contract rather than running a competitive procurement. In doing so, TS would need to satisfy the legal considerations set out in the following section.

Assuming a Direct Award were made to the incumbent, it would release CFL from the resource intensive process of bidding for the CHFS3 contract. TS would also be released from having to run a competitive procurement. However, due to the stringent requirements of making a Direct Award TS may have to invest a similar level of resource in proving that these requirements are satisfied.

The negotiation process under a Direct Award does not benefit from the competitive tension present in a normal procurement. Without this pressure, the operator is less likely to offer competitive terms, which could increase the overall cost of the service for TS.

The threat of the Direct Award being removed and put out to tender is also an important incentive for the operator to deliver against the contract. If there is no viable competitor, this incentive may be absent and lead to higher costs. These factors would need to be considered as part of any evaluation of whether or not a Direct Award would offer VfM.

Direct Award – Key Observations

TS could in future make a Direct Award to CFL for the CHFS contract rather than running a competitive procurement. In doing so, TS would need to satisfy the legal considerations from both a procurement and a UK Subsidy Control perspective. In order for Direct Award of CHFS routes to proceed, the SG’s Subsidy Control Unit would need to set out how adherence to the principles set out under the Subsidy Control Bill – expected to be passed into law in summer 2022 - are being met under the Direct Award.

Conclusion

Conclusions

TS could consider making a number of reforms to enhance the delivery of services on the CHFS network. We included within this section an overview of commercial changes Ministers could consider for the CHFS3 which could be implemented when the contract terminates in September 2024, whether that be a Direct Award to the existing operator, implementing a management contract or extending the length of the contract. Each of these proposed changes could deliver on a range of objectives:

- A Direct Award in the short-term could enable Ministers to focus on future strategy, rather than resource being used to run a competitive procurement process.
- A management contract could remove the element of revenue risk from the contract and potentially increase competition.
- Extending the contract length beyond eight years could encourage longer term strategic thinking from the operator, giving them stability over a longer period and enabling them to focus on the future.

Prior to any changes on the CHFS network, Ministers should consider what it would like to achieve from any change, i.e. what are their longer-term aspirations for the sector and how they would like to achieve these objectives through either commercial change, structural change or a combination of both. Developing a long-term strategy with future goals will help aid decision making in both the short and medium-term.

In the following sections of this report we have included options and performed a preliminary assessment around enhanced regulation and structural change to the CHFS network. Each of the future options considered should be assessed along with the commercial considerations available to Ministers.

4 Options: Enhanced Regulation

Enhanced Regulation

Introduction

Independent regulation features in all of the sector case studies considered in this report:

- SRWC
- ORR
- UK Civil Aviation Authority (CAA)
- WICS

The scope of these regulators' powers varies considerably, with the SRWC representing a comparatively light touch version of regulation compared to the economic regulation provided by the latter three bodies.

In all instances the regulatory function provides an independent perspective on the performance of their respective sectors, something the ferries sector in Scotland does not currently benefit from.

We have sought to outline how the role of a commissioner or regulator, as well as the introduction of a Regulated Asset Base, could be applied in the context of the CHFS network.

This section sets out the options we have considered around enhanced regulation on the CHFS network. Each option has been assessed within section 7 of this report.

Commissioner or Regulator Model

A commissioner or regulator (the two terms are used interchangeably in this report) could be introduced to assume some of the responsibilities currently belonging to TS with regards to the ferries sector, as well as providing an independent perspective on the sector's needs.

The potential extent of the commissioner's responsibilities is wide ranging:

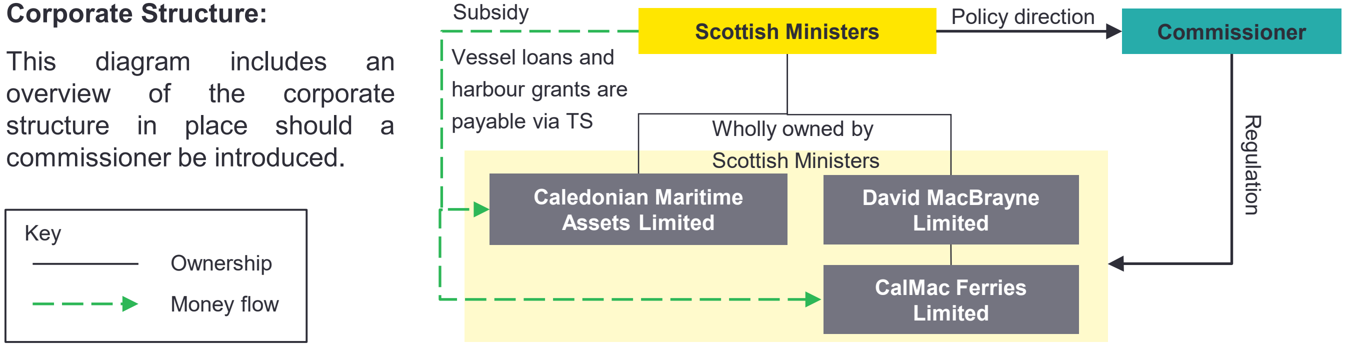
- At a minimum, the commissioner could assume responsibility for monitoring the operator's and / or CMAL's performance against Government objectives.
- The commissioner could have the power to penalise sector participants who systematically fail to deliver against these objectives.
- The commissioner could also have a co-ordinating role, facilitating information sharing for the benefit of the sector.
- The role of the commissioner could potentially be more extensive and include setting price caps and approving major capital spend, as WICS does for the water for the water sector in Scotland.

The commissioner would fulfil these functions for all 'regulated' routes, regardless of whom the operator is. Regulated routes could include those that are strategically important, e.g. lifeline, where there is an absence of competition, or where Government oversight / control is otherwise limited.

A commissioner would be appointed by the SG for a fixed term. During this term the commissioner would discharge their responsibilities in a manner consistent with the overarching policy framework set by the SG. It is important that the commissioner would be independent of the Government.

Corporate Structure:

This diagram includes an overview of the corporate structure in place should a commissioner be introduced.



Commissioner or Regulator Model

Responsibilities

The table below includes the roles and responsibilities of the Tripartite should a commissioner or regulator model be introduced. We have assumed the commissioner or regulator would have the following remit:

1. Price Caps
2. Approvement of major capital spend
3. Oversight of port infrastructure
4. Monitoring operator compliance with the contract.

	Scottish Ministers	CFL	CMAL	Com-missioner	Comments
Sets policy	✓				TS responsible for setting policy framework
Sets fares				✓	Commissioner sets price caps
Vessel procurement			✓	✓	CMAL is responsible for procurement although the commissioner could approve major spend
Vessel maintenance		✓			Operator is responsible for vessel maintenance
Vessel ownership			✓		CMAL remains the owner of the vessels
Harbour / ports ownership			✓		Ownership of ports is unchanged. Remit of commissioner could extend to oversight of port infrastructure
Harbour / ports operations		✓			Management of ports is unchanged
Procurement of operating contract	✓			✓	TS is responsible for procuring contract. The commissioner is responsible for monitoring the operator's compliance with the contract
Ferry operations		✓			Operator is responsible for operations

BC Ferry Commission

The Coastal Ferry Act established the Office of the Commissioner to regulate operators providing core ferry services under the Coastal Ferry Services Contract. Currently BC Ferries is the only operator subject to this regime. There are a further eight unregulated routes operated by independent ferry contractors that service small and remote communities.

The Commissioner serves for a six to eight year term and is appointed by the Province. They are supported in their activities by the Deputy Commissioner and rely on consultants to undertake projects. Their responsibilities include:

- Establishing price caps for designated routes (set at a level sufficient to maintain / renew vessels)
- Regulating the reduction of service and discontinuance of routes
- Monitoring adherence to the Coastal Ferry Services Contract
- Authorising major capital expenditures
- Conducting performance reviews with the support of consultants

Water Industry Commission for Scotland

WICS is a non-departmental public body with statutory responsibilities. It is the economic regulator for the Scottish water industry and acts independently of Ministers. WICS is responsible for setting price caps for each six year regulatory control period, facilitating competition in the retail water market and monitoring Scottish Water's performance with specific reference to customer service, investment, costs and leakage.

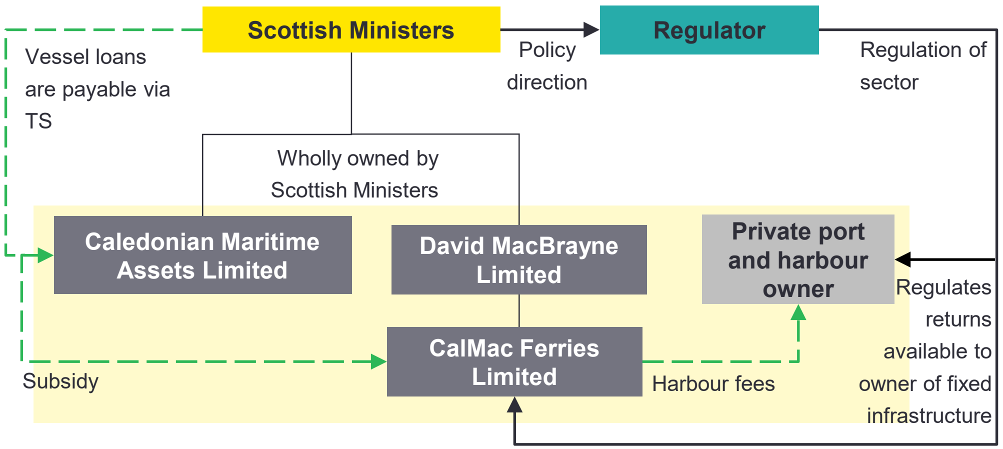
Regulated Asset Base Model

Regulated Asset Base Model

To attract private sector investment into the port and harbour infrastructure specifically, the sector could draw inspiration from utilities in the UK. In these sectors, which are characterised by significant fixed infrastructure, the regulator is responsible for estimating the value of the fixed infrastructure (the "Regulated Asset Base") and a weighted average cost of capital (WACC). This responsibility is in addition to the regulator / commissioner functions set out under the previous option. The Regulated Asset Base is multiplied by the WACC to establish a regulated return on capital that is sufficient to attract private sector investment. This return on capital is reflected in the price limits that the regulator sets for each control period.

The key consideration of the Regulated Asset Base model is the financing of current and future assets by the private sector. As such, this option would only be relevant in the event that port and harbour infrastructure were disposed of to the private sector. Ensuring a return on investment is necessary for utilities that rely on private investment and cannot draw on Government funding. (Note that under this proposed option the vessels would remain under CMAL's ownership and outside the RAB regime, whereas the port and harbour infrastructure is privately owned and subject to the RAB regime).

Corporate Structure



Responsibilities

The table below includes the respective roles and responsibilities should a Regulated Asset Base be introduced.

	Scottish Ministers	CFL	CMAL	Port owner	Regu -lator	Comments
Sets policy						TS responsible for setting policy framework. This could be via normal policy setting channels or as part of the Strategic Review process for each control period
Sets fares						The regulator sets price caps
Vessel procurement						CMAL is responsible for procurement although the regulator could approve major spend
Vessel maintenance						Operator is responsible for vessel maintenance
Vessel ownership						CMAL remains the owner of the vessels
Harbour / ports ownership						Private port owner earns regulated return set by regulator
Harbour / ports operations						Management of ports could remain unchanged (i.e. with CFL) or be held by private sector owner
Procurement of operating contract						TS is responsible for procuring contract. The regulator is responsible for monitoring operator's compliance with the contract
Ferry operations						Operator is responsible for operations

5 Options: Structural Change

Structural Reform

Future Options: Structural Reform

When undertaking our review of international comparators and subsidised services in Scotland, we identified the following key differentiating factors:

- Regulation
- Integration
- Privatisation
- Decentralisation.

We have discussed regulation within section 5. The remaining variables that were observed in the benchmarking exercise – integration, privatisation and decentralisation – will be addressed in this section of the report.

The themes identified are not exclusive of one another and could conceivably all feature in a future model for Scotland's ferries sector. However, for the purposes of clarity, for this exercise we have looked at each independently.

Integration	Privatisation	Decentralisation
Some or all of the organisations within the existing Tripartite structure could be integrated or assimilated. Examples: TfNSW, BC Ferries, Scotland's roads network.	Sell CMAL / CFL and / or DML (or their assets) and thereafter procure ferry services directly from the private sector, which would be responsible for sourcing their own vessels and operating the CHFS network under contract with the SG. Examples: Norway, New Zealand, UK rail industry.	Devolve some / all powers to local authorities who would procure some or all of their own ferry services. Examples: Norway, Roads (A, B and C roads)
Assimilate CMAL into TS	**CMAL assets are sold to the private sector**	**Unbundle and decentralise service contracts**
Scottish Ferries Co. – Integration of CMAL and DML	**CFL does not bid on the next CHFS network and Ministers relay on private sector service delivery**	**Unbundle and decentralise service contracts and assets**
CHFS Ferries Co. - Integration of CMAL and CFL	**Cease focus on non-core commercial operations**	**Major routes kept with central government and minor routes with local authorities**

We have included an overview of each of the options, including the corporate structure, roles and responsibilities and examples of how this would work in practice. In the next chapter each option will be evaluated.

Assimilation of TS and CMAL

The assimilation of TS and CMAL would bring together the strategic policy setting function of TS with the asset ownership function of CMAL.

Assimilation of TS and CMAL

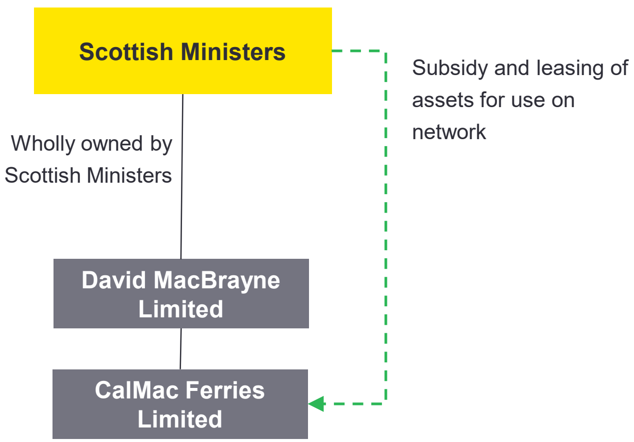
The assimilation ('assimilation' is the absorption of one Government entity by another) of TS and CMAL would bring together the strategic policy setting function of TS with the asset ownership function of CMAL. CMAL would assimilate into the TS ferries function and all staff and assets (both vessels and harbours) would transfer across.

The assimilation of CMAL into TS would mean that the oversight function currently performed by CMAL with regards to monitoring the condition of vessels leased to operators would pass to TS as the direct owner of the assets.

The CHFS contract would be tendered in line with current procurement legislation and vessels would be leased from TS rather than CMAL.

This is similar to the Scottish roads network, whereby major trunk roads are owned by the SG and maintenance is procured via four separate contracts.

Corporate Structure



Responsibilities

	Scottish Ministers	CFL	CMAL	Comments
Sets policy				TS responsible for setting policy framework
Sets fares				TS sets fares
Vessel procurement				TS is responsible for vessel procurement
Vessel maintenance				Operator is responsible for vessel maintenance
Vessel ownership				TS owns the vessels
Harbour / ports ownership				TS owns harbours and ports previously owned by CMAL
Harbour / ports operations				Management of ports is with the operator
Procurement of operating contract				TS is responsible for procuring contract
Ferry operations				Operator is responsible for operations

Transport Scotland: Trunk Roads – TS is the asset owner of the major trunk roads in Scotland. It procures both maintenance services and major capital projects from the private sector. Maintenance contracts are split into four geographic areas of Scotland and are for a duration of eight years. Major capital projects such as the A9 Duelling or the Forth Replacement Crossing were developed in line with the SG STAG appraisal process. TS appoints both technical and financial advisors when procuring major capital projects to ensure it has the relevant expertise available to procure the services.

Integration of CMAL and DML

The integration of the asset owner and operator would bring together the two commercial arms of the Tripartite into a single Government owned organisation.

Integration of CMAL and DML

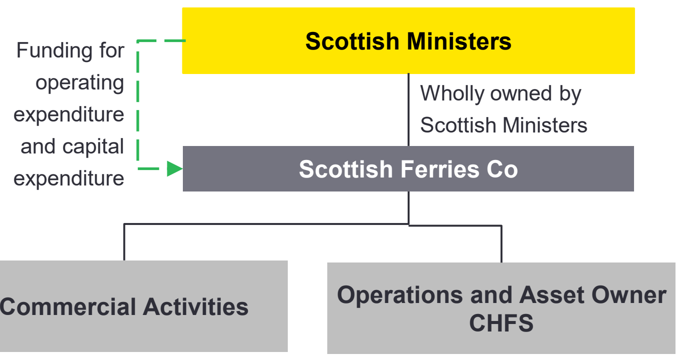
CMAL and DML could be integrated to form a single Government-owned organisation, which for the purposes of this review will be referred to as "Scottish Ferries Co". Integrating CMAL and DML could facilitate a more joined up approach to service delivery. Under this option Scottish Ferries Co could maintain a separate subsidiary for commercial activities not core to the CHFS contract.

The integration of the two organisations would remove the need for the contracts currently in place between the two bodies, including: lease agreement for vessels; maintenance agreement for vessels; harbour dues; and harbour maintenance. It would also remove the oversight function CMAL currently has over CFL with regards to the condition of the vessels.

The new company, as the asset owner, would be responsible for ensuring the assets are maintained and upgraded as required.

The new company would require the appointment of a new board of directors, a process which would be overseen by TS. The skills matrix of the board should be reviewed to ensure that it has the expertise to govern an organisation of this nature and should include representation from both TS and the island communities.

Corporate structure



Responsibilities

	Scottish Ministers	Gov Co	Comments
Sets policy			TS responsible for setting policy framework
Sets fares			TS sets fares
Vessel procurement			Scottish Ferries Co is responsible for vessel procurement
Vessel maintenance			Scottish Ferries Co is responsible for vessel maintenance
Vessel ownership			Scottish Ferries Co owns the vessels
Harbour / ports ownership			Scottish Ferries Co owns harbours and ports.
Harbour / ports operations			Management of ports is with Scottish Ferries Co
Procurement of operating contract			TS is responsible for procuring contract
Ferry operations			Scottish Ferries Co is responsible for operations

Scottish Water Business Stream – Scottish Water is the wholesaler of water in Scotland, whilst its Business Stream subsidiary is one of a number of licensed providers of water retailers. Scottish Water owns and operates the country's water infrastructure, while Business Stream provides retail water and sewerage services to the country's businesses. Although both are part of the Scottish Water group, they are legally separate companies, with Business Stream pursuing commercial ventures. The relationship between Business Stream and Scottish Water is monitored by the regulator, the Water Industry Commissioner for Scotland (WICS).

Integration of CMAL and CFL

CMAL and CFL could be integrated to form a "CHFS Ferries Co" that would focus exclusively on the delivery of the CHFS contract. DML would be separated from CFL / CHFS Ferries Co to focus on other commercial ventures and potentially prepared for sale.

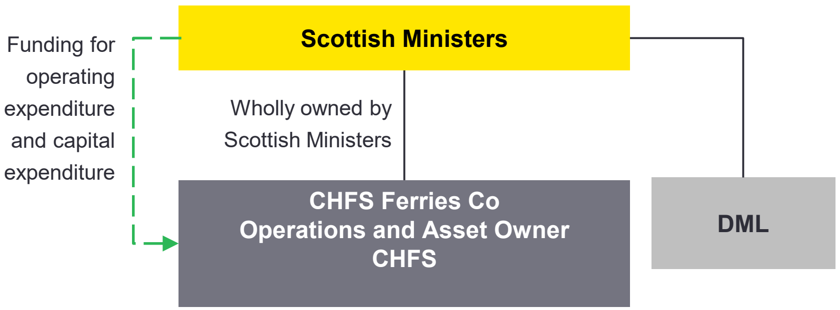
Integration of CMAL and CFL

CMAL and CFL could be integrated to form a new Government-owned organisation, which for the purposes of this exercise will be identified as "CHFS Ferries Co". Integrating CMAL and CFL could facilitate a more joined up approach to service delivery and would mean that the operator directly owns the vessels used in its operations.

The new company, as the asset owner, would be responsible for ensuring the assets are maintained and upgraded as required.

Under this option CHFS Ferries Co would focus exclusively on the delivery of the CHFS contract. DML would be separated from CFL / CHFS Ferries Co and focus on other commercial ventures. Separating CFL from DML in this way could help to facilitate the SG's divestment of DML, should there be a market and a desire to do so on the part of the SG.

Corporate structure



Responsibilities

	Scottish Ministers	Gov Co	Comments
Sets policy			TS responsible for setting policy framework
Sets fares			TS sets fares
Vessel procurement			CHFS Ferries Co is responsible for vessel procurement
Vessel maintenance			CHFS Ferries Co is responsible for vessel maintenance
Vessel ownership			CHFS Ferries Co owns the vessels
Harbour / ports ownership			CHFS Ferries Co owns harbours and ports previously owned by CMAL
Harbour / ports operations			Management of ports is with CHFS Ferries Co
Procurement of operating contract			TS is responsible for procuring contract
Ferry operations			CHFS Ferries Co is responsible for operations

International Benchmarking – BC Ferries, as well as operators in Norway and Auckland, own their own vessels. As owners of the vessels and holders of the asset risk, these operators are also responsible for procurement and maintenance.

In British Columbia, BC Ferries benefits from a 60 year Direct Award contract. If a ferry becomes surplus to its needs, due for example to a change in the contract specification, the Government is obliged to purchase the vessel at Net Book Value.

CMAL sold to the private sector

CMAL would be sold to the private sector and vessel ownership would be privatised. Sourcing vessels would become the responsibility of the operator.

CMAL sold to the private sector

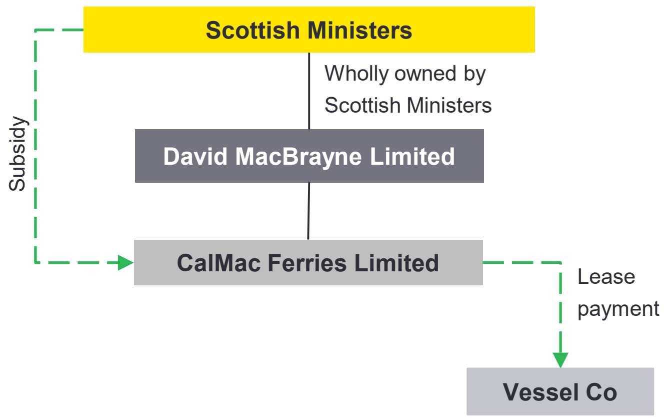
Under this model, CMAL is sold to the private sector ("Vessel Co") and vessel ownership would be privatised. CMAL's technical function would move to CFL or TS. Vessel procurement would become the responsibility of the operator. Operations of the CHFS and NIFS network would continue to be tendered in the normal way and the operator would be responsible for sourcing its vessels, either via leasing or purchase.

This model is similar to the rail industry in which ROSCOs own the rolling stock and lease it to TOCs. Leases are let on either a wet (includes maintenance) or dry (excludes maintenance) basis, and assets are maintained in line with the lease agreement in place.

In order to ensure that vessels are replaced and upgraded, TS could place requirements in the contract for vessel upgrades and provide enhanced subsidy to fund this. In Norway, procurement rules set by central government have driven investment by operators in low carbon vessel infrastructure.

CMAL also owns a number of harbours, under this option ownership for these would be passed to the local authorities or independent harbour authorities.

Corporate Structure



Responsibilities

	Scottish Ministers	CFL	Vessel Co	Comments
Sets policy	■			TS responsible for setting policy framework
Sets fares	■			TS sets fares
Vessel procurement		■	■	Private sector procures vessels and leases them to CFL. TS sets vessel specification in tender and operator inputs into design
Vessel maintenance		■	■	CFL or the vessel owner could hold responsibility for maintenance
Vessel ownership			■	Vessel Co owns vessels
Harbour / ports ownership			■	Local Authorities (LAs) / independent harbour authorities own harbours and ports
Harbour / ports operations			■	LAs / independent harbour authorities are responsible for harbour / port maintenance
Procurement of operating contract	■			TS is responsible for procuring contract
Ferry operations		■		CFL retain responsibility for operations

UK Rail – In the UK rail industry, the Government's Operator of Last Resort (OLR) function lease rolling stock from privately owned ROSCOs. This would be similar to the relationship between CFL and the ROSCO outlined in this option.

The procuring authority, in the case of rail either the DfT or TS, plays a key role alongside the ROSCOs in forming the specifications for procurement of rolling stock. For example, TS specified the class 385 carriages supporting the electrification of the Edinburgh-Glasgow route on the ScotRail Franchise.

CFL does not bid on the next CHFS contract

Ministers decide CFL will not bid on the next CHFS contract. TS would procure a contract for ferry services from the private sector through a competitive tendering process.

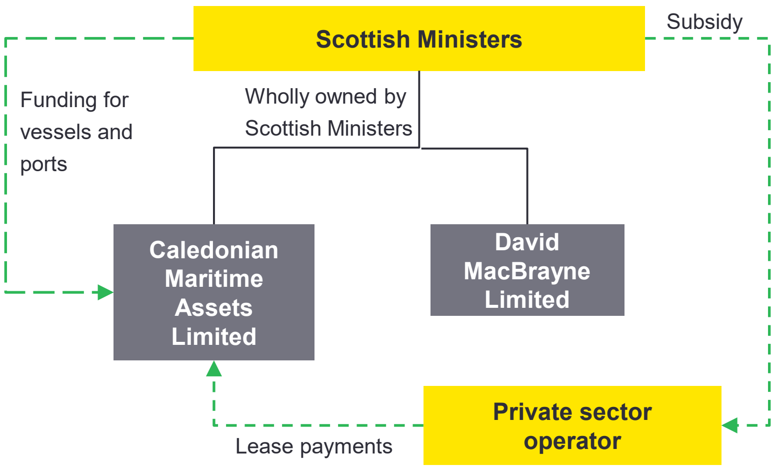
CFL does not bid on the next CHFS Contract sector

Under this model CFL would be wound down once the CHFS2 contract comes to an end. This could be the case if Ministers decide not to bid on CHFS3 or if CFL were unsuccessful in bidding for the next contract. TS would procure the CHFS contract from the private sector through a competitive tendering process.

Vessel ownership and procurement would remain with the public sector under CMAL. Harbour / ports ownership, operations and maintenance would remain with CMAL.

The operations contract would stipulate that the successful bidder must lease the required vessels from CMAL. The contract could permit the operator to feed-in to future vessel procurements, including the design specification.

Corporate Structure



Responsibilities

	Scottish Ministers	Private Operator	CMAL	Comments
Sets policy				TS responsible for setting policy framework
Sets fares				TS sets fares
Vessel procurement				CMAL is responsible for vessel procurement, from whom operator leases vessels. Operator could be granted a role in procurement
Vessel maintenance				Depending on terms of the vessel leasing contract, operator or CMAL could be assigned responsibility
Vessel ownership				CMAL remains the owner of the vessels
Harbour / ports ownership				CMAL remains the owner of the harbours / ports
Harbour / ports operations				Private sector operator is responsible for harbour / port operations on behalf of CMAL
Procurement of operating contract				TS responsible for procuring contract
Ferry operations				Successful tenderer assigned responsibility for operations on a fixed term contract

Transport for New South Wales – The Sydney Ferries Network was previously operated by Sydney Ferries, a statutory authority. Following a review in 2007 that found the operation was inefficient, responsibility for ferry services was passed to the private sector. Operations are currently contracted under a nine year franchising arrangement to Transdev. The operating contract specifies that the operator must lease vessels owned by TfNSW. The operator is responsible for maintenance of the vessels and TfNSW's berthing facility for the duration of the contract. Transdev is also responsible for procuring a new class of vessels under the latest contract.

Cessation of non-core commercial operations

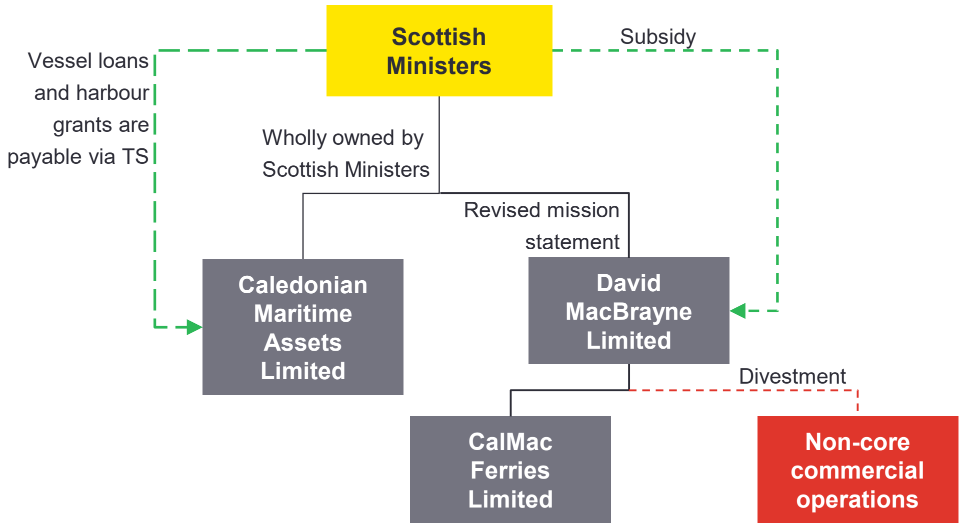
DML's commercial ventures not core to the delivery of the CHFS contract are ceased.

Cessation of non-core commercial operations

DML is 100% owned by the SG and is the parent company of CFL, which is the entity responsible for delivering the CHFS contract. DML has a wider commercial mandate than CFL, something that is reflected in its mission statement “to grow as a recognised leading international transport infrastructure and logistics services group”. This mission has empowered DML to pursue commercial activities beyond delivery of the CHFS contract, including entering a Joint Venture to operate a port at Marchwood in Southampton under a 35 year concession. The port is owned by the Ministry of Defence (MoD) and used for deployments overseas, but also has considerable commercial activity that could be grown further.

If there is no longer a desire on the part of the Scottish Ministers to sponsor DML's commercial activities that are not core to the delivery of the CHFS contract, DML's mandate could be narrowed to focus exclusively on delivery of the CHFS contract via CFL.

Corporate Structure



Responsibilities

	Scottish Ministers	CFL	CMAL	Comments
Sets policy				TS responsible for setting policy framework
Sets fares				TS sets fares
Vessel procurement				CMAL is responsible for procurement
Vessel maintenance				Operator is responsible for vessel maintenance
Vessel ownership				CMAL owns vessels
Harbour / Ports ownership				Ownership of ports is unchanged
Harbour / Ports operations				Management of ports is unchanged
Procurement of operating contract				TS is responsible for procuring contract
Ferry operations				Operator is responsible for operations

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Local authorities procure and manage ferry services

Powers are devolved to local authorities who would become responsible for procuring and managing ferry services in their geographies. CMAL retained as vessel owner.

Decentralisation Model

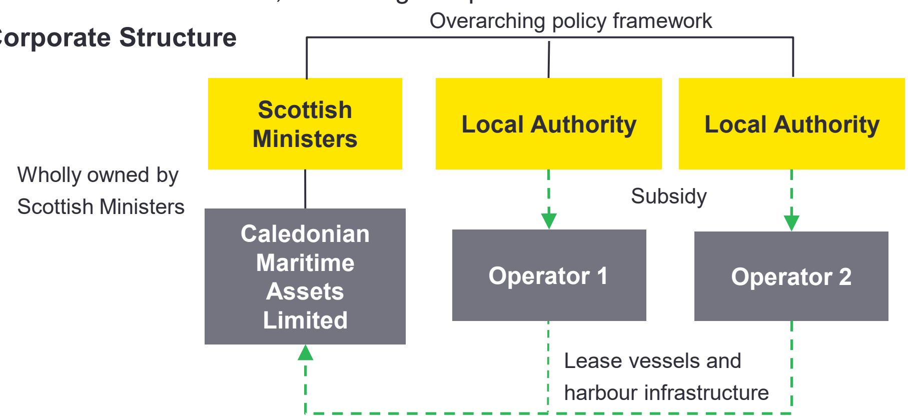
This option would see powers to procure and manage services currently delivered under the CHFS contract passed to local authorities. Routes within the CHFS contract would be 'unbundled' and repackaged according to the local authority boundaries. This would give local authorities discretion in procuring ferry services as they see fit for the local area and could lead to more targeted decision-making. The SG would be responsible for setting the overall strategic direction of the sector.

The local authorities would have the ability to alter the key commercial features of the contract, e.g. the optimal contract term length, procurement method and revenue risk allocation that best meets their needs. The local authorities would be primarily responsible for regulation and contract / performance monitoring, unless additional regulation was also established via an independent body.

CMAL would be retained and would continue to own and procure vessels. The operators would be obliged to lease these vessels and maintain them as per the contract in place with CMAL.

CFL would be maintained in its current form and could bid for the smaller bundles of routes. The smaller bundles (and contract sizes) would reduce barriers to entry and may encourage other participants, e.g. private enterprises or local authorities, to bid for these contracts, increasing competition in the sector.

Corporate Structure



Responsibilities

	Scottish Ministers	LA	CMAL	Operator	Comments
Sets policy	■				TS responsible for setting overarching policy framework. LAs would interpret / implement this in delivery of services
Sets fares		■			LA sets fares
Vessel procurement			■		CMAL is responsible for vessel procurement. Operator leases vessels from CMAL. Private sector operator could be granted a role in procurement
Vessel maintenance				■	Operator would negotiate with CMAL regarding responsibility for maintenance, but likely to be responsibility of operator
Vessel ownership			■		CMAL would own vessels
Harbour / ports ownership			■		CMAL would own harbours
Harbour / ports operations				■	Contract procured could transfer responsibility for harbour / port maintenance to operator
Procurement of contract			■		LAs are responsible for procurement of contract
Ferry operations				■	Operator delivers contract in line with LA specification, which would incorporate TS overarching policy

Scottish Local Authority Ferry Services – Orkney Ferries is owned by Orkney Islands Council (OIC) and runs 13 routes from Orkney's mainland to smaller islands using nine vessels. OIC runs the service through Orkney Ferries Limited and is the sole shareholder. The company receives funding from OIC under a Service Level Agreement to provide the lifeline ferry services. OIC is the asset owner and is responsible for procurement and upgrades to the vessels. In turn, SG provides funding to OIC, partly through the Local Government settlement and partly an additional Specific Grant, for the sole purpose of operating inter-island ferry services.

Local authorities procure and manage ferry services and assets

Powers are devolved to local authorities who would become responsible for procuring and managing ferry service. Assets currently owned by CMAL are also transferred to local authorities.

Decentralisation Model

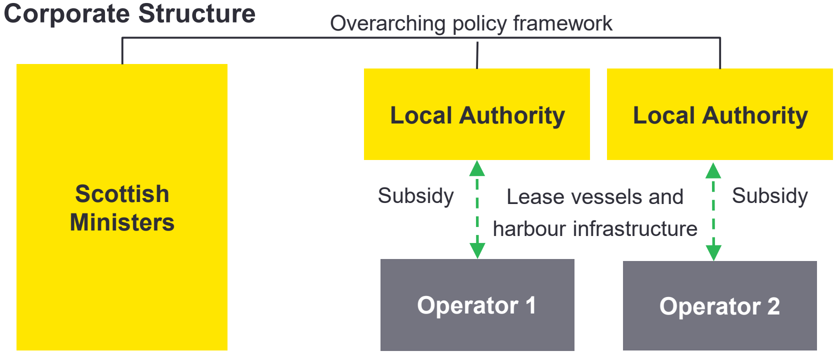
This option would see powers devolved to local authorities who would procure and manage ferry services in place of TS. Routes within the CHFS contract would be ‘unbundled’ and repackaged according to each local authority area. Local authorities would procure ferry services as they see fit for the local area, which could lead to more targeted decision-making. The SG would be responsible for setting the overall strategic direction for the sector.

The local authorities would have the ability to alter the key commercial features of the contract, e.g. the optimal contract term length, procurement method and revenue risk allocation that best fits their needs. The local authorities would be primarily responsible for regulation and contract / performance monitoring, unless additional regulation was also established via an independent body.

CFL would be maintained in its current form and could bid for the smaller bundles of routes. The smaller bundles (and contract sizes) would reduce barriers to entry and may encourage other participants to bid for these contracts, increasing competition in the sector.

Ownership of the harbours / ports would pass to the local authority based on geography. CMAL’s vessels would also transfer to the local authorities who would lease these to the operators on their local network. The local authority could include within its contract with the operator a requirement to maintain and operate these assets.

Corporate Structure



Responsibilities

	Scottish Ministers	LA	Operator	Comments
Sets policy				TS responsible for setting overarching policy framework. LAs would interpret / implement this in delivery of services
Sets fares				LA sets fares
Vessel procurement				LA would be responsible for future vessel procurement. This would be done in line with overarching policy framework and could include input of operator
Vessel maintenance				LA would negotiate with vessel owner regarding responsibility for maintenance, but likely to be responsibility of the operator
Vessel ownership				Operators would lease vessels from LA
Harbour / ports ownership				LA owns the harbours and ports based on geography
Harbour / ports operations				Contract procured could transfer responsibility for harbour / port maintenance to operator
Procurement of operating contract				LA is responsible for procurement of contract
Ferry operations				Operator delivers contract in line with LA specification, which would incorporate TS overarching policy

TS manages major routes and smaller routes passed to local authorities

Minor routes are unbundled and responsibility for management is passed to local authorities. TS would continue to procure ferry services for major routes as part of a more limited CHFS network.

Decentralisation Model

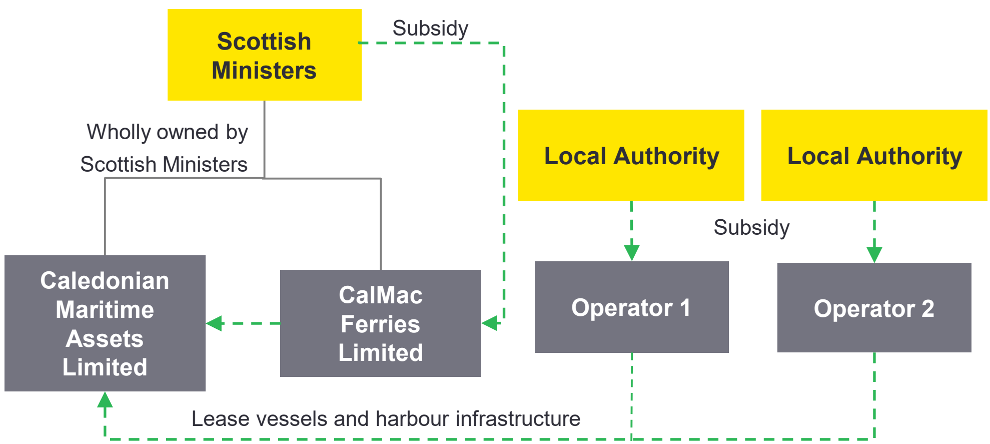
Under this option TS could consider unbundling certain 'minor' routes and passing responsibility for their management to local authorities. TS would continue to procure ferry services for major routes as part of a reduced CHFS network.

Major routes would be classified as such based on their strategic importance, which could be driven by passenger volumes or other factors, such as the extent of the island's dependence on lifeline ferry services.

The local authorities would have the ability to alter the key commercial features of their contracts, e.g. the optimal contract term length, procurement method and revenue risk allocation that best meets their needs. They would be responsible for regulation and contract / performance monitoring, unless additional regulation was also introduced that was the responsibility of an independent body.

CMAL would be retained and would continue to own and procure assets, with the operators leasing and maintaining the vessels as per their contracts with CMAL. CFL would be maintained in its current form and could continue to bid for both TS and local authority ferry contracts.

Corporate Structure



Responsibilities

	Scottish Ministers	LA	CMAL	Operator	Comments
Sets policy	✓				TS responsible for setting overarching policy framework. LAs would implement this in delivery of services
Sets fares	✓	✓			TS sets fares for those routes it is responsible for and LAs sets fares for theirs
Vessel procurement			✓		CMAL would be responsible for procuring vessels
Vessel maintenance				✓	Operator would negotiate responsibilities with CMAL, but likely to be operator
Vessel ownership			✓		CMAL owns vessels
Harbour / ports ownership		✓	✓		CMAL / LAs owns harbours and ports as is currently the case
Harbour / ports operations				✓	Contract could transfer responsibility for harbour / port maintenance to operator
Procurement of operating contract	✓	✓			LA / TS responsible for procurement of respective contracts
Ferry operations				✓	Operations delivered by ferry company successful at procurement

Norwegian Ferry Sector – The Norwegian model is a working example of the hybrid model in practice. Of the country's 120 ferry services, 16 are currently national routes (procured centrally) and 114 are county routes (procured by individual county municipalities). For contracting, routes are bundled to varying extents (typically two to five routes).

6 Options: Evaluation

Approach to Evaluation

Introduction

The long-list of options is based on observations of enhanced regulation and structural reform noted in the international and domestic benchmarking. This long-list represents a broad range of future options for delivering ferry services on the west coast of Scotland. The list of future options on regulation and structural reform is presented below:

Theme	Option
Regulation	Commissioner or Regulator
Regulation	Regulated Asset Base
Integration / Assimilation	TS / CMAL assimilation
Integration / Assimilation	CMAL / DML integration
Integration / Assimilation	CMAL / CFL integration
Privatisation	CMAL assets privatised
Privatisation	CFL does not bid on the next CHFS Contract
Privatisation	Cessation of non-core commercial operations
Decentralisation	Local authorities procure ferry services
Decentralisation	Local authorities procure ferry services, inc. vessels
Decentralisation	TS manage major routes and smaller routes passed to local authorities

In this section we will undertake a preliminary evaluation of these options using criteria that have been designed with reference to TS' mission of delivering a "safe, efficient, cost-effective and sustainable transport system".

The evaluation is intended to be high-level and focuses on drawing out key issues, that could render an option unviable. Legal and tax specialists have been engaged in this process to help identify relevant matters.

This evaluation seeks to provide a framework for identifying areas of interest that should be subject to further consideration as part of a more detailed options appraisal. The intent is not to definitively conclude on future options.

Evaluation Methodology

The below evaluation methodology has been adopted:

- A qualitative assessment has been performed as to whether the impact of an option on a criterion would be positive, neutral or negative.
- No attempt has been made to rank the options. However, options that receive an overall negative score are unlikely to be desirable.
- Options that receive a neutral overall score may warrant further consideration as part of a future evaluation and consultation exercise.
- Options that receive a positive overall score are likely to have merit and should be explored as part of a future evaluation and consultation exercise.

Our approach and indicators are intended to serve as a helpful framework that TS can deploy as it progresses towards a more detailed evaluation of future options.

Limitations of Review

NIFS – The scope of Project Neptune is limited to the three members of the Tripartite. However, it is recognised that changes to its structure could impact the holder of the NIFS contract, currently SNF. This evaluation has sought to identify instances where this may be the case, although it does not attempt to be exhaustive in doing so. A fuller evaluation of the impact of the proposed options on the holder of the NIFS contract should be undertaken as part of any subsequent evaluation.

Taxation – For comments relating to taxation, we have based our comments on a high level understanding of the group without access to detailed underlying tax computations. As part of the next phase of review, a detailed analysis of the options being considered should be undertaken which will require access to a detailed fact pattern.

Evaluation Criteria

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The evaluation criteria reflect Scottish Ministers' priorities that any structure for delivering ferry services in Scotland should enhance passenger experience and support local communities, as well as be accountable and transparent. Deliverability has been added in recognition that practical limitations may preclude an option's viability. These criteria have been developed to understand whether an option has the potential to achieve Best Value.

Passenger Experience and Local Communities

It is recognised that any changes made by the Scottish Ministers with regards to ferry services in Scotland must have the passenger at its heart and improve the experience of the end user. The island communities that depend on these services are core to this group. Passenger Experience and Local Communities is regarded as the most important criterion for this reason.

Key considerations in appraising Passenger Experience and Local Communities will include:

- Impact on service quality, resilience and reliability
- Impact on vessel quality and standards
- Impact on island communities
- Impact on passenger
- Impact on local economies of Island communities

Deliverability

The long-list of options developed in this report is wide ranging. Consequently, it is recognised that it may include options which are not deliverable in practice. The Deliverability criterion has been included to identify potential issues in this regard. As legal factors are expected to be a key limiting factor to deliverability, specialist legal input has been obtained for this criterion.

Key considerations in appraising the Deliverability of an option include:

- Ease of implementation / complexity of delivery
- Timescales for deliverability
- Improvement of access to technical knowledge
- Legal or regulatory barriers
- Impact on resources
- Stakeholder acceptance
- Accounting, tax, Value Added Tax (VAT) and pension implications

Accountability and Transparency

It has been recognised throughout Project Neptune that a key challenge for the Tripartite structure is the relative complexity of its structure. For the public, this makes it difficult to understand which party is responsible for delivering which element of the service. The Accountability and Transparency criterion seeks to identify those options that could offer improvements in this regard.

Key considerations included:

- Extent to which roles and responsibilities are clearly defined
- Optimisation of risk allocation
- Strength of governance framework
- Level of oversight
- Ability of Ministers to affect change
- Ability of island communities to input in decision making
- Alignment of objectives

Best Value considers the common framework for continuous improvement in public services, with particular reference to the effective management of resources and value for the tax payer. We have performed a preliminary assessment of each of the options against the chosen criteria to understand whether adopting these changes could improve service provision on the CHFS network.

Evaluation Overview

Evaluation Overview

We have set out in the subsequent pages our initial evaluation of the options against the three criteria identified. Within our assessment of Deliverability, we have included taxation, VAT, accounting and pensions. The table below includes an overview of our preliminary evaluation on whether the options presented have the potential to achieve Best Value. We have highlighted overleaf our key observations in relation to the four themes.

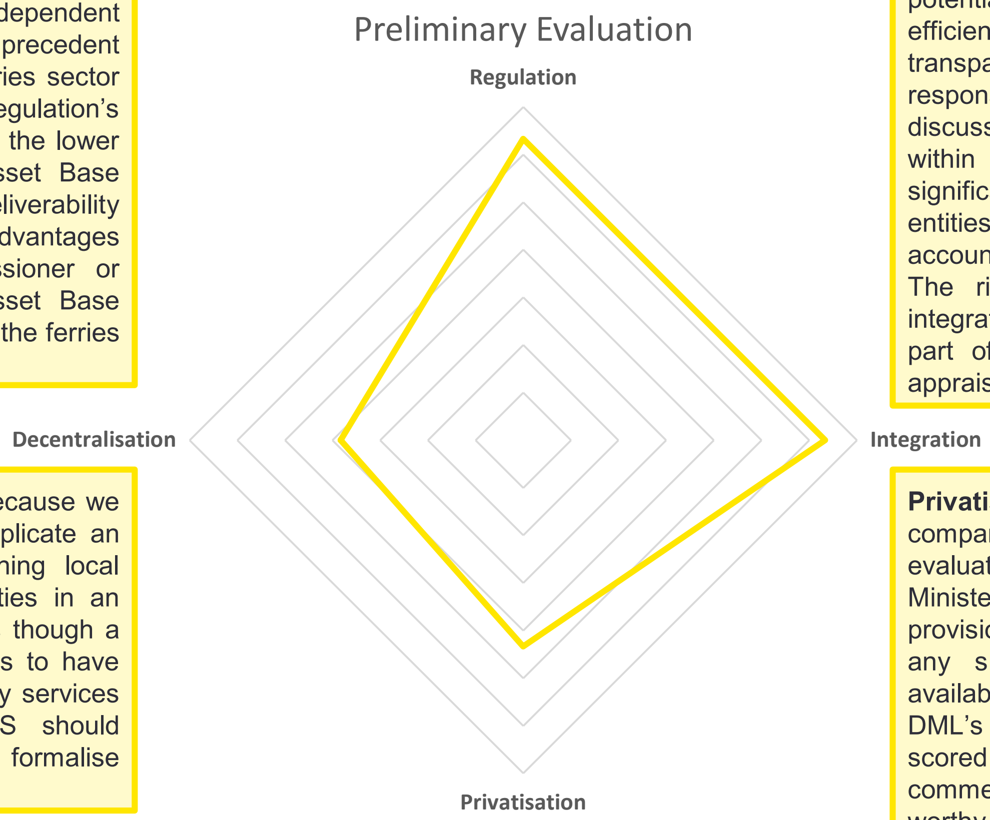
🔴 Negative	🟡 Neutral	🟢 Positive
Unlikely to achieve Best Value	Requires further research to understand whether Best Value can be achieved.	Potential to achieve Best Value

Evaluation Criteria	Passenger Experience and Support for Local Communities	Deliverability	Accountability and Transparency	Overall potential to achieve Best Value
Enhanced Regulation				
Commissioner or Regulator	🟡	🟢	🟢	🟢
Regulated Asset Base Model	🟢	🔴	🟡	🟡
Structural Reform				
TS / CMAL assimilation	🟡	🔴	🟢	🔴
CMAL / DML integration	🟢	🟡	🟢	🟢
CMAL / CFL integration	🟢	🟡	🟢	🟢
CMAL assets sold to the private sector	🔴	🔴	🟡	🔴
CFL does not bid on the next CHFS Contract	🟡	🟡	🟡	🟡
Cessation of non-core commercial operations	🟡	🟡	🟢	🟡
Local authorities procure and manage ferry services	🔴	🔴	🟢	🔴
Local authorities procure ferry services and assets	🔴	🔴	🟢	🔴
TS manage major routes and smaller routes passed to local authorities	🟡	🔴	🟢	🟡

Evaluation Radar Chart

The radar chart below visualises the findings from our preliminary evaluation and provides an indication of the priority areas that may merit further exploration as part of TS' full evaluation of future options. Each group of options is explored in more detail in the subsequent slides.

The **commissioner or regulator** option scores strongly as, depending on its form, it presents a comparatively straight forward opportunity to introduce added oversight and an independent perspective to the sector. There is also precedent for a body of this type in both the ferries sector and comparable domestic sectors. Regulation's strong overall score partially disguises the lower score awarded to the Regulated Asset Base which presents far greater deliverability challenges while offering limited advantages versus a more light touch commissioner or regulator. Further, the Regulated Asset Base model may have limited applicability in the ferries sector.



The options that include **integration** (but not **assimilation**) have scored well because they present an opportunity to streamline the Tripartite. This is advantageous and has the potential to achieve Best Value through efficiencies as well as provide greater transparency (lack of clarity around roles and responsibilities has featured heavily in our discussions with stakeholders). The assets held within CMAL have the potential to generate significant tax liabilities if moved between entities. There are also wider legal and accounting issues associated with integration. The risks and opportunities associated with integration should be more fully understood as part of the proposed detailed evaluation and appraised in light of Ministerial priorities.

Decentralisation has scored poorly because we have judged that it could further complicate an already complex sector while burdening local authorities with additional responsibilities in an era of constrained resources. There is though a demonstrable need for local authorities to have more opportunity to influence how ferry services are delivered. To facilitate this TS should consider the means by which it can formalise local authorities' input into the sector.

Privatisation of CFL and CMAL has scored comparatively poorly in our preliminary evaluation because these options would deprive Ministers of assets that are critical to the provision of lifeline services, without providing any significant benefit beyond that already available in the market. The option to cease DML's focus on commercial interests has been scored more favourably on the basis that its commercial mandate requires clarity and is worthy of exploration. However, in the context of future options for the CHFS network this is considered a relatively immaterial point.

Key Observations

The boxes below summarise the key themes and findings observed as part of our preliminary evaluation of the regulation and integration / assimilation groups of future options.

Regulation

- The introduction of greater regulation to the sector has the potential to increase accountability if the individual or body is equipped with appropriate powers; further, it would bring the ferries sector into line with similar sectors that often have a commissioner or regulator.
- Regulatory oversight has the potential to instigate some efficiencies in the sector although these are unlikely to be material.
- By introducing another body into an already crowded sector, there is a risk that roles and responsibilities may become further confused, undermining transparency. Appropriate and considered regulation is needed to mitigate this risk.
- Legislators are likely to require evidence of a need for regulation and consequently deliverability challenges may increase with the proposed level of regulation. This initial evaluation has not found justification for the more expansive regulation that would be present under a Regulated Asset Base, particularly if the desired outcomes can be achieved with more limited regulation. As such a lighter touch commissioner or regulator model is considered a more viable future option for the ferries sector.
- As this group of future options does not lead to changes in the legal statuses of the Tripartite, no impediments relating to taxation are anticipated. However, from a public accounting perspective, if the Public Corporation status of CMAL were to change due to reduced income under a RAB regime, all of its revenues and spending could in future impact the SG Revenue Departmental Expenditure Limits (R-DELs).

Integration / Assimilation

- The delivery and cost of ferry services and the relationships between the Tripartite are complex, and the Scottish Ministers have noted that they are mindful of the perception which exists regarding a lack of accountability among the parties.
- The challenge of holding the Tripartite to account has its origins, in part, in confusion regarding each members' respective roles and responsibilities. By reducing the number of parties within the Tripartite it may aid clarity in this respect, which has the potential to improve transparency and accountability.
- By merging two members of the Tripartite there will be a stronger alignment of those organisations' objectives. There may also be opportunities to achieve efficiencies in their operations, e.g. vessel maintenance.
- CMAL possesses technical expertise that TS depends on. Were it to be integrated with CFL or DML, consideration would need to be given to how this function could be preserved.
- There are a large number of taxation and accounting issues associated with integrating or assimilating members of the Tripartite. The challenge this may present becomes greater if it is CMAL's assets that are moved, due to the potentially high market value of its assets. There are also a number of legal considerations that become relevant under these future options. The cost associated with resolving these issues needs to be more fully understood and judged in the context of Ministerial priorities as part of a full evaluation.

Key Observations

The below boxes summarise the key themes and findings observed as part of our preliminary evaluation of the privatisation and decentralisation groups of future options.

Privatisation

- SNF, current holder of the NIFS contract, has demonstrated the success with which a private operator can deliver ferry services on behalf of TS and Scottish Ministers. Successful privately run ferry operations have also been observed in Norway.
- It is feasible that TS / Scottish Ministers could divest its interests in the ferries sector and depend on the private sector to bid for and deliver the CHFS contract; however, in recent procurements there has been little or no competition and there is a risk that future procurements would attract limited interest under commercial terms similar to those currently in place. Without its ferry interests, TS / Scottish Ministers would be in a weak position to step in as Operator of Last Resort, a requirement for lifeline ferry services.
- There are likely to be significant tax and accounting implications associated with the sale of CMAL, particularly due to the potentially high market value of its assets.
- The contractual relationship that TS / Scottish Ministers would have with the holder of the CHFS contract is likely to be less influential than the shareholder relationship it currently benefits from.
- Although current accounting rules may permit lease payments to a private asset owner to be treated as R-DEL, IFRS 16 will become effective from 1 April 2022, which will have a Capital-Departmental Expenditure Limits (C-DEL) impact equal to the present value of lease rentals, i.e. there may be limited benefits from a budgeting perspective.
- The SG's objectives with regards to DML's commercial mandate require greater clarity to assess if this remains a desirable direction of travel.

Decentralisation

- Passing responsibility for the management and / or procurement of ferry services to local authorities could narrow the gap between the communities served by the CHFS network and decision makers. This could benefit accountability and transparency.
- Local authorities may be more able to take a holistic approach to the delivery of ferry services due to their involvement in other public services. This could lead to more joined up policy making with better outcomes for the communities on the west coast of Scotland.
- A decentralised model would require contracts to be let as smaller bundles, which may attract more competition into the market and have a positive impact on pricing; however, the loss of economies of scale may undo some of these efficiencies.
- Evidence from Norway and other sectors that adopt a decentralised approach suggests that passenger experience will vary according to the capabilities and priorities of the local authorities.
- The ability of Ministers to drive change would be reduced as they would no longer be directly responsible for procurement.
- Introducing multiple new procuring authorities to an already crowded arena could further undermine transparency.
- It is possible that the positives associated with decentralisation, namely enhanced transparency and joined up policy making, could be achieved via other means that would avoid the pitfalls mentioned above. This could include the introduction of a more formal role for local authorities via which they can input into the sector.

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Commissioner or Regulator

This option would introduce a commissioner or regulator who would provide an independent view on matters critical to the sector, including operator performance, price caps and capital spend.

Passenger Experience	Deliverability	Accountability & Transparency
▸ An independent commissioner or regulator could be responsible for monitoring operator performance and have the power to impose penalties for short comings. This could help the operator to improve its performance, which would positively impact passenger experience. However the practical limitations on the impact of regulators should also be noted in light of faliings in the UK's energy supplier market in 2021. ▸ If the commissioner is required to approve major capital spend, it could increase the likelihood that commissioned vessels are fit for purpose which would positively impact vessel quality. ▸ Island communities and passengers would benefit from a clearly identifiable body that is responsible for overseeing service quality and potentially pricing.	▸ British Columbia, which has a ferries commissioner, is frequently cited by Scottish stakeholders as a successful model for ferry services. Existing stakeholder support for a commissioner should ease implementation. ▸ A commissioner's office would increase the sector expertise available to TS. ▸ Legal advice should be sought on the legal implications of introducing a commissioner model as legislation may be required. ▸ Establishing and maintaining an office for the commissioner would incur a cost. Further VfM analysis is required to understand the value of introducing a commissioner. ▸ However, an effective commissioner should be capable of driving efficiencies in the sector that are greater than its operating costs. If this is achieved, then the net impact should be positive.	▸ Providing the remit of the commissioner is clearly defined, their introduction should not undermine accountability or transparency. ▸ The commissioner would be responsible for monitoring performance in the sector, which could improve accountability in the sector. ▸ Ministers may have to relinquish certain powers to the commissioner, which could reduce their influence over the sector and their ability to affect change. ▸ As a dedicated resource, the commissioner should enhance oversight of the sector, particularly if it is able to fulfil this function more effectively than the current structures that are in place.
Summary	An independent commissioner or regulator has the potential to drive enhanced passenger experience and accountability. Limited deliverability issues are noted providing the commissioner or regulator's remit is limited to the CHFS network. No accounting or tax issues were noted in relation to this option although legislation may be required.	

Regulated Asset Base

The Scottish Government could legislate to make the port and harbour infrastructure a Regulated Asset Base. This would help to ensure adequate capital investment in the sector’s fixed infrastructure (ports and harbours). Note that while this option would require the port and harbour infrastructure to be disposed of to the private sector, the appraisal of this option only considers the consequences of the RAB regime itself. For the purposes of clarity, privatisation of CMAL’s assets are appraised under a separate and distinct option.

Passenger Experience	Deliverability	Accountability & Transparency
▸ The Regulated Asset Base would regulate returns for investors in the fixed infrastructure (ports and harbours), which could lead to increased investment in ports and harbours, which could improve the quality of the infrastructure and support enhanced service delivery.	▸ Scottish Ministers would need to undertake the administrative steps to establish a Regulated Asset Base. This process would be more intensive than that required for introducing a commissioner or regulator with lesser powers. ▸ In order to introduce a RAB model, legislation may be required. Further investigation is needed to understand if SG would have the devolved competence to enact such a piece of legislation. ▸ In order for the private investor to earn its regulated return, habour fees may need to increase. This would ultimately be borne by SG via the payment of higher subsidy to the operator that would be liable for the harbour fees. ▸ If the Public Corporation status of CMAL changes due to reduced income under a RAB regime, all of its revenues and spending would impact the SG Revenue Departmental Expenditure Limits (R-DELs). ▸ Excessive regulation has the potential to undermine the efficient operation of the CHFS network and wider sector. As part of the detailed evaluation, TS should consider if lighter touch regulation, e.g. a commissioner, would be sufficient to achieve its desired objectives.	▸ Regulation in excess of that required to achieve Ministerial objectives has the potential to introduce unnecessary complexity to the sector, which could undermine accountability and transparency.
Summary	Legislation may be required, which has the potential to introduce deliverability challenges if a RAB model is judged to be excessively burdensome versus a more light touch regulatory model. If this renders the option unviable it could move the overall score to red. Depending on impact of RAB regime on CMAL’s income, its Public Corporation status could also change, which could cause all of its revenues and spending to affect the SG’s R-DELs.	

Assimilation of TS and CMAL

The assimilation of TS and CMAL would bring together the strategic policy setting function of TS with the asset ownership function of CMAL.

Passenger Experience	Deliverability	Accountability & Transparency
▸ If during assimilation key CMAL personnel leave the organisation due to concerns about change (e.g. impact on pay), TS will lose access to expertise, which could impact vessel and service quality in the long-term. Both could negatively impact passenger experience. However, there is a potential option for this expertise to be accessed via contractors or external recruitment. ▸ Streamlined Tripartite structure should be more easily understood by key stakeholders, including island communities. There should be less confusion regarding the respective roles of CMAL and CFL as a consequence.	▸ Transfer of CMAL staff and vessels to TS likely to be complex with significant accounting, tax, pension and HR implications. ▸ Members of Tripartite may resist if it is felt that assimilation will not be in their interests. ▸ Assimilation would move CMAL's activities from a Public Corporation to within General Government. This would move all of CMAL's revenue spending into the SG R-DELs. This would be in addition to its current capital impact which is less likely to change. ▸ Transfer of business from CMAL to TS may meet the VAT Transfer of Going Concern (TOGC) requirements, which would allow CMAL to transfer its business and assets without the need to charge VAT. ▸ Transfer of vessels / harbours to TS will result in a cessation of the CMAL trade, with disposal values required to be brought into account in final period. Chargeable assets would be deemed to transfer at market value which may give rise to chargeable gains. Asset values and tax attributes should be considered further to quantify any tax exposures. Relief from land and buildings transaction tax (LBTT) should be available subject to satisfying necessary conditions. ▸ CMAL is the principal employer for the CalMac Pension Fund, and has a legal responsibility to financially support it. We expect the transfer of business and assets from CMAL to TS will require a new principal employer. ▸ Statutory basis for assimilation needs to be considered. ▸ Significant TUPE / asset transfer / risk considerations.	▸ Fewer organisations within the Tripartite should help to clarify the respective roles and responsibilities of TS and CFL. ▸ As the asset owner, TS should have greater oversight over the vessels, including their condition. Fulfilling this oversight function successfully would depend on technical capabilities within TS. ▸ TS would be directly responsible for vessel procurement.
Summary	Simplified Tripartite structure may enhance accountability and transparency, although limited reason to believe passenger experience will be materially improved, especially if CMAL's capabilities are weakened during the process of assimilation. Significant number of legal issues that may prevent delivery of option. CMAL would be classed as General Government, which would have budgeting implications. Chargeable gains, which have the potential to be significant depending on the market value of CMAL's assets, may be payable on the transfer of CMAL's assets.	

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Integration of CMAL and DML

The integration of the asset owner and operator would bring together the two commercial arms of the Tripartite into a single government owned organisation.

Passenger Experience	Deliverability	Accountability & Transparency
▸ The integration of the operator and asset owner could lead to more streamlined decision-making and a better alignment of objectives, which should have a positive impact on service quality and reliability.	▸ The integration of CMAL and DML may bring efficiencies and streamline operations. An example of which would be in relation to the maintenance or upgrades to vessels or harbours. ▸ The integration of CMAL and DML is likely to be complex with legal, tax, pension and HR implications. ▸ SNF may not be content to lease vessels from an organisation that is also a competitor. This would need to be explored further as part of a stakeholder engagement exercise. ▸ VAT status of the new entity to be considered. Would require VAT registration for TOGC. Transfer of businesses into a single entity may meet TOGC requirements. Capital Goods Scheme (CGS) implications need to be considered. ▸ Merging a Public Corporation (CMAL) with an NDPD entity (DML) results in a new entity that Government controls. Its new classification will depend on whether the new body's commercial revenues exceed 50% of its operating and financing costs (referred to here as the 'Market Test'). ▸ Tax consequences will depend on how integration is achieved. Where relevant conditions for a transfer of trade without a change in ownership are satisfied, transfers can be effected at tax written down value with existing trading losses transferred to new company. Chargeable gains may arise on transfers of chargeable assets as transfers will be deemed to take place at Market Value. ▸ Further legal advice should be sought on the implications of the integration of the two organisations.	▸ Streamlined Tripartite arrangements may increase clarity around roles. Objectives of CMAL and DML will be integrated and aligned. ▸ TS oversight capabilities may be weakened as TS would no longer have access to CMAL expertise to challenge DML perspective or vice versa. To mitigate this the CMAL technical function could be subsumed within TS. ▸ DML would bear greater asset risk than under the current structure as it would own rather than lease vessels. DML would expect to be compensated for assuming this risk via the contract. ▸ A simplified Tripartite model should be better understood by island communities. Communication with key stakeholders should also be clearer as ferry services on the west coast of Scotland would have 'one voice'. ▸ CMAL and DML objectives will be aligned.
Summary	Potential for an improved passenger experience in the longer term once initial challenges of integration are overcome. The new body may also benefit from greater alignment of objectives and be more easily understood by users. The subsidy control position would require further analysis. Potential for change in classification of CMAL, with associated implications for budgeting. Chargeable gains may arise on the transfer of CMAL's assets, which could be significant depending on the market value of CMAL's assets.	

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Integration of CMAL and CFL

CMAL and CFL could be integrated to form a “CHFS Ferries Company” that would focus exclusively on the delivery of the CHFS contract. DML would be separated from the CHFS Ferries Company to focus on other commercial ventures and potentially prepared for sale.

Passenger Experience	Deliverability	Accountability & Transparency
▸ Better alignment of CMAL and CFL objectives under umbrella of “CHFS Ferries Co” could improve service delivery. ▸ Process for vessel management / renewal should be easier to manage from within a single organisation, which should have positive repurcussions for vessel quality. ▸ If during integration key personnel leave the organisation, TS may lose access to expertise, which could impact vessel and service quality over the long-term. Within a recent Audit Scotland report, it was recommended TS build on its ferry expertise, and whilst this is ongoing, TS recongises further work is required. Losing further expertise could undermine this effort. However, there is an option for this expertise to be accessed via contractors or recruitment.	▸ The integration of CMAL and CFL may bring efficiencies and streamline operations. An example of which would be in relation to the maintenance or upgrades to vessels or harbours. ▸ The integration of CMAL and CFL is likely to be complex. There would be legal, tax, pension and HR implications. ▸ DML / CFL may resist being separated. SNF may not be content to lease vessels from a competitor. This should explored via consultation with stakeholders. ▸ New entity would require VAT registration to qualify for TOGC. Transfer of businesses into a single entity may meet TOGC requirements. CGS implications would also need to be considered. Under new structure, VAT compliance burden is simplified and reduced with only one VAT registration required. ▸ Merging two Public Corporations (CMAL and CFL) results in a new entity that Government controls. Given that both bodies currently meet the Market Test, since they are both Public Corporations, the net budgetary impact is unlikely to change significantly. ▸ Chargeable gains may arise on transfers of chargeable assets as these will be deemed to take place at market value. Impact of integration on beneficial tonnage tax election would require further consideration. Public bodies relief from LBTT may be available on the reorganisation of CMAL subject to satisfying necessary conditions. ▸ Further legal advice should be sought on the implications of the integration of the two organisations.	▸ Delivery of ferry services in Scotland will be streamlined, with a single organisation responsible for operations and the supply of vessels on the west coast of Scotland. This could improve clarity around responsibilities within the Tripartite. ▸ CMAL and CFL objectives will be aligned. ▸ Simplified Tripartite model should be better understood by island communities. Communication with key stakeholders should also be clearer as ferry services on the west coast of Scotland would have ‘one voice’. ▸ TS oversight capabilities may be weakened as TS would no longer have access to CMAL’s expertise to challenge DML perspective or vice versa. To mitigate this, potential for CMAL technical function to be subsumed within TS.

Summary	
	Potential for an improved passenger experience in the longer term, once initial challenges of integration overcome. The new body may also benefit from greater alignment of objectives and be more easily understood by users. There would be clearer accountability to customers and stakeholders and the potential to improve VfM by removing duplication and interfaces. Subsidy control position would require further analysis. Chargeable gains may arise on the transfer of CMAL’s assets, which could be significant depending on market value. Legal and tax considerations should be explored further as part of detailed evaluation to fully understand and analyse risks and opportunities.

CMAL assets are sold to the private sector

CMAL would be sold to the private sector and vessel ownership would be privatised. Sourcing vessels would become the responsibility of the operator.

Passenger Experience	Deliverability	Accountability & Transparency
▸ Vessel quality would depend on what the operator is able to source from the private sector. SNF vessels now leased from CMAL were previously owned by RBS, indicating private asset owners can supply vessels of a similar quality to CMAL. ▸ Freed from the obligation to use CMAL vessels, there is a risk that the operator could source lower quality vessels at a reduced cost. An appropriate vessel specification in the contract would be required to avoid this. ▸ Ferry services in Scotland would no longer benefit from a guaranteed source of vessels, but would instead be reliant on the private sector's appetite to meet the needs of market.	▸ Sale of CMAL is likely to be complex. There would be legal, tax, pension and HR implications. ▸ The loss of CMAL's technical knowledge could weaken TS' capabilities as a procurer of ferry services. CMAL's technical function could be moved to CFL or TS to avoid this. ▸ There may be limited appetite to buy CMAL as a legal entity due to the liabilities this may entail, in which case the only viable option may be for the assets of CMAL to be sold separately. This is likely to have different and less favourable tax consequences. ▸ VfM assessment required to understand merit of sale. Private sector vessel operator is likely to charge CFL a higher lease. Illustrative of this, the ROSCO model in the rail sector is not judged as VfM. ▸ Transfer of CMAL business and assets into the new private entity may meet TOGC requirements. While the new entity will require to be VAT registered, VAT compliance burden should be reduced. CGS implications should be considered. CMAL VAT registration could be de-registered. ▸ A sale of trade and assets would give rise to chargeable gains / cessation of trade implications for CMAL that would require further analysis. ▸ This assessment assumes that CMAL receives the sale proceeds and then remits these to the SG. The requirement for CFL to lease from the private sector vessel owner rather than CMAL will cause an initial Capital Departmental Expenditure Limit (C-DEL) reduction from the disposal, followed by subsequent C-DEL impacts from the leases, i.e. there is little C-DEL benefit from a sale and lease back (this treatment applies to leases commencing after 1 April 2022 when IFRS 16 takes effect; it is presumed that no sale and lease back would occur before this date). ▸ To preserve the continuity of CMAL employees' defined benefit (DB) pension benefits, the associated assets and liabilities related to CMAL's 38 active members could be transferred to the buyer's DB scheme. The assets and liabilities related to CMAL's inactive members could also be transferred to a buyer – however, we expect buyers to have a strong preference against this. A lump sum "exit" contribution to the CalMac Pension Fund or "top-up" contribution to facilitate the transfer of any assets and liabilities may also be required.	▸ Sale of CMAL would simplify Tripartite structure by removing one party. ▸ Asset risk would be transferred away from the public sector (maintenance risk could be retained by CFL). ▸ As assets would no longer be owned by public sector, Scottish Ministers would have less capacity to govern how these assets are managed. This is problematic as they are critical to the provision of lifeline services. ▸ Influence over vessel design could only be achieved via contract specification and not via the SG's role as shareholder.
Summary	Unclear what impact of CMAL sale would be on passenger experience; likely to be dependent on quality of vessels that can be sourced from the market. Chargeable gains may be payable on the sale, which could be significant depending on market value. Operator is likely to suffer higher vessel leasing costs due to margin required by a private sector operator. There is unlikely to be a material C-DEL benefit from a sale and lease back arrangement. Tripartite structure would be simplified although TS will have less influence over new asset owner. There will be potential for greater risk transfer to the private sector.	

CFL does not bid on the next CHFS contract

Ministers decide CFL will not bid on the next CHFS contract. TS would procure a contract for ferry services from the private sector through a competitive tendering process.

Passenger Experience	Deliverability	Accountability & Transparency
▸ SNF provides evidence that the private sector can run a high quality / reliable ferry service efficiently in Scotland. ▸ However, a private operator would also be obliged to act in the interests of its shareholders, which could lead to excessive cost cuttings in pursuit of profit, which could detrimentally impact service quality / reliability. ▸ In NSW the Government has leveraged the commercial expertise of its private sector operator to procure new vessels. Similar arrangement in Scotland could aid the vessel renewable programme. ▸ If the private sector can deliver an improved service, local businesses could become more efficient and prosper as a consequence, benefiting local economies. Conversely, if the service declines, so could local economies.	▸ Stakeholder concern regarding CFL choosing not to bid on the next contract due to its important role as an employer and provider of lifeline services. ▸ Institutional knowledge of ferries sector within TS may decline as it will no longer be the owner of an operator. ▸ Uncertain what market appetite there would be to bid on the next contract.	▸ Operations would more clearly be the responsibility of the private sector operator and not the SG. A large degree of reputation risk would continue to rest with SG. ▸ Financial risks transferred to the operator under the contract could genuinely be transferred away from the SG, whereas currently risk transferred to CFL is still ultimately the SG's risk, as the owner of CFL. ▸ As OLR for the ferries sector, there will always be a possibility that risk allocated to the private sector could be transferred back to the SG in the event of an operator's failure or withdrawal. ▸ The SG would have reduced oversight as the private sector operator would only be obliged to share information in line with the contract. ▸ As SG would no longer be the operator's shareholder, it may have less capacity to affect change within the sector. ▸ Private operator's objectives are less likely to be aligned with those of Scottish Ministers.
Summary	Unlikely to be material impact on passenger experience providing contract continues to be followed. However, it is unclear what the appetite is among the private sector to bid on the next CHFS3 contract. The governance structure would benefit from being streamlined and there will be opportunity to transfer greater risk to the private sector; however, SG will be less able to influence the operator and ensure it serves the purposes of Scottish Ministers.	

Cessation of non-core commercial operations

DML's commercial ventures not core to the delivery of the CHFS contract are ceased.

Passenger Experience	Deliverability	Accountability & Transparency
▸ Narrower DML scope post-divestment could increase the human resources available for delivering the CHFS contract, which may improve service quality and reliability, thereby contributing to passenger experience. ▸ In the medium- to long-term, DML may suffer a loss of commercial knowhow, which could have a negative impact on how successfully it manages its CHFS operation.	▸ The ease and speed with which DML's commercial ventures could be ceased would depend on the market's appetite for those businesses. This is untested and would need to be explored. ▸ The Scottish Ministers would no longer benefit from any profits earned via DML's commercial ventures; however, Ministers would also be protected from any losses incurred in pursuit of these. ▸ TOGC conditions may be met. Consideration would need to be given to any CGS assets. ▸ Tax implications of divestment following a sale to a third party would require further analysis, including impact on any existing tax attributes. ▸ Since DML is a General Government entity, divestment of non-core activities causes a budgetary impact matching the net effect of those activities before divestment. If those activities require DML to borrow, the divestment reduces C-DEL by the amount of that borrowing, while any revenue spending or income foregone will cause corresponding R-DEL impacts. There will be further budgetary impacts from any sale proceeds from the divestments. ▸ CFL, CMGC and DML HR are participating employers for the Calmac Pension Fund. As these employers are expected to remain after the divestment there is no direct impact on the fund.	▸ DML's roles and responsibilities should be clearer as there will no longer be any confusion regarding its commercial mandate. ▸ The SG will no longer be exposed to any risk assumed by DML in relation to its commercial operations. ▸ The narrower scope of DML's objectives should enable a better alignment with the Scottish Ministers' objectives. ▸ The governance framework should be simpler as it will only need to account for delivery of the CHFS contract.
Summary	Unclear what the impact on passenger experience will be although possible that more focused operation will improve performance. The tax implications of any sale would require further analysis. Limited legal barriers to deliverability noted. A streamlined DML operation should facilitate greater transparency. The loss of DML's commercial 'know how' gained via other ventures is, however, a key disadvantage of this option. Option should be explored as part of detailed evaluation and assessed in context of Ministerial priorities for DML.	

Local authorities procure / manage ferry services

Powers are devolved to local authorities who would become responsible for procuring and managing ferry services in their geographies. CMAL retained as vessel owner.

Passenger Experience	Deliverability	Accountability & Transparency
▸ Potential improvement across passenger experience metrics as there should be greater understanding of local services and needs within local authorities (LAs); although engagement with LAs suggests this could also be achieved via other means, e.g. improved lines of communication. ▸ Evidence from comparators suggests there is likely to be significant variance in standard of service achieved across LAs based on the capabilities and priorities of the LA. ▸ Capacity of LA to improve passenger experience will heavily depend on funding made available from the SG.	▸ Represents a fundamental restructuring of the industry and therefore is likely to be complex. ▸ Uncertain what appetite exists among LAs to assume responsibility for ferry services. Likely that there would be some hesitance due to additional resource requirements. ▸ Smaller contracts could increase competition in market, lowering contract cost. ▸ Uncertain that LA with limited experience of procuring ferry services will be able to achieve better value outcomes. ▸ Reduced VAT compliance and registrations. LAs are subject to a different VAT regime; VAT treatment and recovery may differ. ▸ How devolvement of activity is achieved may require further consideration. Restructuring of Caledonian MacBrayne Crewing (Guernsey) (CMCG) likely to be required under this option. ▸ The only SG budgetary impacts arise from reductions in CFL's activities to the extent that those activities affect SG budgets given CFL's Public Corporation status. This is because LA activities do not effect any SG budgets. Further changes will however occur if as a result of these changes, CFL no longer meets the Market Test and so becomes a General Government entity. ▸ No material impact on the CalMac Pension Fund is expected on the assumption that no CFL employees transfer to LAs.	▸ Decentralisation should provide island communities with more opportunity to input into decision making process and hold procuring authority to account. ▸ Governance within individual LAs will depend on competency of each LA. ▸ Ability of Ministers to influence change is reduced as they will no longer be directly responsible for procurement. Central oversight of ferry network will be reduced. ▸ The 'Roles and Responsibilities Working Group', which was set up as part of a wider review of Scotland's National Transport Strategy, previously recognised in its recommendations the need for future transport governance arrangements "to be on the basis of some form of regional model" to allow for variations in approach between different geographic regions. This option would be consistent with this recommendation.
Summary	LAs may leverage knowledge of local community needs to enhance passenger experience, although results likely to be mixed. From a legal perspective further consideration is required to understand the implications of changes to flow of funds. LA role should bring service delivery 'closer' to communities, enhancing accountability.	

Local authorities procure / manage ferry services and

Powers are devolved to local authorities who would become responsible for procuring and managing ferry service. Assets currently owned by CMAL are also transferred to local authorities.

Passenger Experience	Deliverability	Accountability & Transparency
▸ Potential improvement across passenger experience metrics as there should be greater understanding of local services and needs within LAs. ▸ However, evidence from comparators suggests there is likely to be significant variance in standard of service achieved across LAs based on the capabilities and priorities of the LA. ▸ Vessel ownership will pass to local authorities. Highly technical function and unlikely that at present LAs will possess capabilities to deliver service to equal standard as CMAL. With appropriate training, it is possible that this could be achieved, although outcomes likely to be variable. ▸ Potential for disruption in short-term as new contracts are embedded. ▸ Unbundling would mean ferries being split up among the routes and local authorities. If one route only has one ferry and the ferry breaks down, the whole route is disrupted with limited flexibility.	▸ Represents a fundamental restructuring of the industry and therefore is likely to be complex. ▸ Uncertain what appetite exists among LAs to assume responsibility for ferry services. Likely that there would be some hesitance due to additional resource requirements. ▸ Unlikely that all LAs have access to technical skill set required to procure / manage ferry contracts and vessels. Investment in training likely to be required. ▸ TS would no longer have access to hub of expertise within CMAL. ▸ Reduced VAT compliance and registrations. LAs are subject to a different VAT regime, VAT treatment and recovery may differ. Transfer of CMAL business to the private sector may meet the TOGC conditions. CGS implications should be considered. CMAL could be de-registered for VAT. ▸ Restructuring of CMCG likely to be required under this option. Transfer value of vessels / harbours by CMAL to LAs will give rise to balancing adjustments and chargeable gains / losses which require further investigation. ▸ The main SG budgetary impacts arise from any proceeds from sale of CMAL assets, along with reductions in CFL's activities to the extent that those activities affect the SG budgets given CFL's Public Corporation status. Any CFL lease for a route it successfully bids for will affect the SG C-DEL. Further changes will occur if CFL no longer meets the Market Test. ▸ As the LA's will procure and manage ferry services in place of TS, the employer will transfer members from the CalMac Pension Fund to the LA pension scheme. To preserve the continuity of employees' DB pension benefits, the associated assets and liabilities related to the employers' active members' could be transferred to the LA pension scheme. The assets and liabilities of the deferred and pensioner members of the CalMac Pension Fund could also be transferred; however, the LA may not wish to take on inactive member liabilities. If they do not wish to take on inactive member liabilities, a solution would need to be found (e.g. liabilities assumed by Government, liabilities bought out with an insurance company, etc.). A 'top-up' contribution to facilitate the transfer of any assets and liabilities to the local authorities' pension schemes may also be required.	▸ Decentralisation should provide island communities with more opportunity to input into decision making processes and hold procuring authority to account. ▸ Governance within individual LAs will depend on capability and capacity of each LA. ▸ Ability of Ministers to influence change is reduced as they will no longer be directly responsible for procurement. Central oversight of ferry network will be reduced. ▸ 'Roles and Responsibilities Working Group', which was set up as part of a wider review of Scotland's National Transport Strategy, previously recognised in its recommendations the need for future transport governance arrangements "to be on the basis of some form of regional model" to allow for variations in approach between different geographic regions. This option would be consistent with this recommendation.
Summary	LA may leverage knowledge of local community needs to enhance passenger experience, although results likely to be mixed. From a legal perspective further consideration is required to understand the implications for subsidy control. Various budgeting implications noted. LA role should bring service delivery closer to communities, enhancing accountability. Sector may become more competitive due to larger volume of smaller contracts.	

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TS manages major routes and smaller routes passed to local authorities

Minor routes are unbundled and responsibility for management is passed to local authorities. TS would continue to procure ferry services for major routes as part of a more limited CHFS network.

Passenger Experience	Deliverability	Accountability & Transparency
▸ May offer the 'best of both worlds' as major routes are procured centrally allowing 'joined up' ferries strategy, while smaller routes are devolved and able to benefit from LAs better understanding of local needs. ▸ Improved passenger experience on smaller routes is dependent on access to adequate technical expertise at the procuring LA. ▸ Island communities should have more opportunity to influence service delivery on minor routes. ▸ Retention of CMAL means vessel quality likely to remain unchanged.	▸ Represents a fundamental restructuring of the industry and therefore is likely to be complex. ▸ There will be an increase in the overall resource required to deliver ferry services as a result of the need to procure and monitor a greater number of contracts. There would also be a loss in network efficiencies in crewing cover, vessel cover and legislative compliance as a result of separation. ▸ CFL / operators may resist restructuring of CHFS network as it would reduce revenues, although they would still have opportunity to bid for smaller contracts directly with LAs and to bid for major routes. ▸ Sector may become more competitive due to larger volume of smaller contracts. ▸ The SG budgetary impacts arise from reductions in CFL's activities to the extent that those activities affect SG budgets given CFL's Public Corporation status. Further changes will occur if as a result of changes CFL no longer meets the Market Test and so becomes a General Government entity. ▸ LAs are subject to a different VAT regime; VAT treatment and recovery may differ. There will be an increase in VAT compliance with additional parties being added to the structure. TOGC conditions and CGS implications to be considered – specific fact pattern for each contract will be determinative. ▸ Limited tax implications, although how devolvement of activity is achieved may require further consideration. Restructuring of CMCG may be required under this option depending on level of activity devolved to LAs. ▸ No material impact on the CalMac Pension Fund is expected on the assumption that no employees transfer to LAs.	▸ Introduction of additional parties likely to further complicate governance structures and understanding of roles and responsibilities. ▸ Uncertain if LAs will be able to achieve better risk allocation on minor routes due to more limited procurement experience may be impediment to this. ▸ Ministerial oversight and ability to affect change will be more limited with regards to minor routes. ▸ Island communities will have more ability to influence service delivery on minor routes and hold procuring authority to account. ▸ Alignment of objectives likely to be unchanged on major routes. Uncertain if new operators delivering minor routes will share objectives of the Scottish Ministers. ▸ 'Roles and Responsibilities Working Group', which was set up as part of a wider review of Scotland's National Transport Strategy, previously recognised in its recommendations the need for future transport governance arrangements "to be on the basis of some form of regional model" to allow for variations in approach between different geographic regions. This option would be consistent with this recommendation.
Summary	LAs may leverage knowledge of local community needs to enhance passenger experience, although results likely to be mixed. From a legal perspective further consideration is required to understand the implications for subsidy control. LA role should bring service delivery closer to communities, enhancing accountability, but overall oversight may be impaired due to introduction of new procuring authorities. There may be alternative, more efficient means by which the issues this future option seeks to address can be resolved. This could include a more formalised role for LAs via which they can input into the sector.	

7 Summary Observations and Key Recommendations

Summary Observations

Report Overview

In recognition of the challenges associated with delivering ferry services on the CHFS network, EY was commissioned to develop a framework that would aid Transport Scotland in understanding the range of options that could be implemented to improve service delivery. Preferred options should be capable of enhancing passenger experience, supporting local communities and be accountable, transparent and capable of achieving Best Value.

Benchmarking

To develop a long-list of options for consideration, we completed a benchmarking exercise that focussed on two groups of comparators:

- Overseas ferry operations delivering similar types of services (i.e. lifeline) to those being delivered under the CHFS contract; and
- Other domestic infrastructure that provide critical services, often under contract with the Scottish Government.

The benchmarking exercise was informed by interviews with industry and government figures, as well as reviews of relevant documentation, including government policy papers, company annual reports and academic papers.

Framework of Strategic Options

No predominant approach was identified during the benchmarking. Rather, a broad range of regulatory models and corporate structures, as well as contractual arrangements, were observed.

The various attributes of each case study were used to develop a long-list of options. These options, not mutually exclusive of one another, can be categorised within one of the following four groupings:

- Regulation: The introduction of greater regulation to the ferries sector
- Integration: The integration or assimilation of certain members of the Tripartite
- Privatisation: The sale of either CMAL or CFL (or their assets)
- Decentralisation: The transfer of responsibility for delivery of some or all ferry services to local authorities.

As well as providing an overview of each option, this report provides an indication of the responsibilities of each Tripartite member under each of the long-listed models.

Evaluation of Strategic Options

Having established a framework of strategic options for consideration, we developed an evaluation methodology with reference to TS' mission of delivering "a safe, efficient, cost-effective and sustainable transport system". Specific criterion relating to the following were identified:

- The impact of an option on Passenger Experience and Local Communities
- The extent to which an option is Deliverable
- The impact of an option on Accountability and Transparency

Our qualitative assessment set out to identify those options that could have a favourable impact on the above criteria versus the status quo. Options that scored well across the range of criteria were judged as having high potential to contribute towards Best Value.

Outcome of Evaluation

The preliminary evaluation found merit in greater regulation and integration, but noted substantial challenges in relation to privatisation. The benefits of decentralisation were judged to be mixed according to the capabilities and objectives of each local authority.

Introducing a commissioner or regulator scored favourably in our evaluation because, depending on the precise form, regulation presents a comparatively straight forward opportunity to introduce added oversight and an independent perspective on the sector. Integration also performed well because of the potential to streamline the sector and realise efficiencies, although potential deliverability challenges were noted regarding any transfer of CMAL assets. This issue would need to be understood fully as part of a detailed assessment before proceeding.

Decentralisation scored poorly because of the potential to further complicate an already complex sector. With the exception of divesting DML's non-core operations, which may have merit depending on Ministerial priorities, privatisation was viewed poorly because it would deprive Ministers of direct control over assets critical to delivering lifeline services.

Key Recommendations

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Short-term Recommendations

► *Engage local communities on their preferences for reform of the ferries sector*

While structural decentralisation was not favoured in our assessment, key merits noted in our appraisal of the decentralisation options were the opportunity to improve transparency around the Tripartite's decision making processes and to develop policy that is more aligned with that of local authorities. Decentralisation was not deemed as essential in the effort to achieve this; however, regular engagement and consultation with local communities is likely to be. As a next step, TS should consult with local communities to understand their views on the options for reform as set out in this report.

► *Identify the optimal commercial arrangements for delivery of the CHFS3 contract*

In addition to the range of regulatory models and corporate structures presented in this report, in completing the benchmarking exercise, a wide variety of contractual arrangements were noted. These related to the transfer of risk, the length of contracts and the means by which contracts were awarded (by Direct Award or competitive tender). The contractual arrangements complement the wider delivery model. Taken together these are the means by which the sector can successfully deliver against Ministerial priorities.

The current CHFS contract terminates in September 2024 and EY suggests that preparations for CHFS3 commence 18 to 24 months in advance of this date. Before this TS should give consideration to the optimal commercial arrangements for CHFS3. To do this TS should seek maximum clarity from Ministers on their policy objectives for the ferries sector so that it can begin to formulate a coherent plan for how it will achieve these objectives via its commercial relationship with the operator and the overriding delivery model for the sector.

Medium-term Recommendations

► *Undertake a full economic assessment of the impact of introducing a commissioner or regulator*

Our preliminary assessment of the long-list of options found strong grounds for considering in more detail the introduction of either a commissioner or regulator. A commissioner or regulator could provide greater independent oversight and would be consistent with trends observed in ferry operations overseas and in similar domestic sectors, such as rail. It should be understood if there is Ministerial appetite to introduce more independent oversight of the sector and if so a full economic assessment of such a model should be undertaken. This exercise should include an exploration of the commissioner / regulator's remit.

► *Complete a Business Case for the CMAL and CFL integration option*

This preliminary assessment also found that the integration of CMAL and CFL could support Best Value by a) improving the efficiency of service delivery; and b) enhancing transparency via clearer roles and responsibilities. As a next step, it is recommended that TS undertake a fuller appraisal of this option via a Business Case exercise. This should support progression towards a preferred way forward for the future CHFS network.