Strategic Framework of Options for CHFS Network | Appendices

Transport Scotland

Reliance Restricted

16 February 2022

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16 February 2022

Strategic Framework of Options for the CHFS Network | Appendices

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

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Appendix A: International Benchmarking

Introduction and background

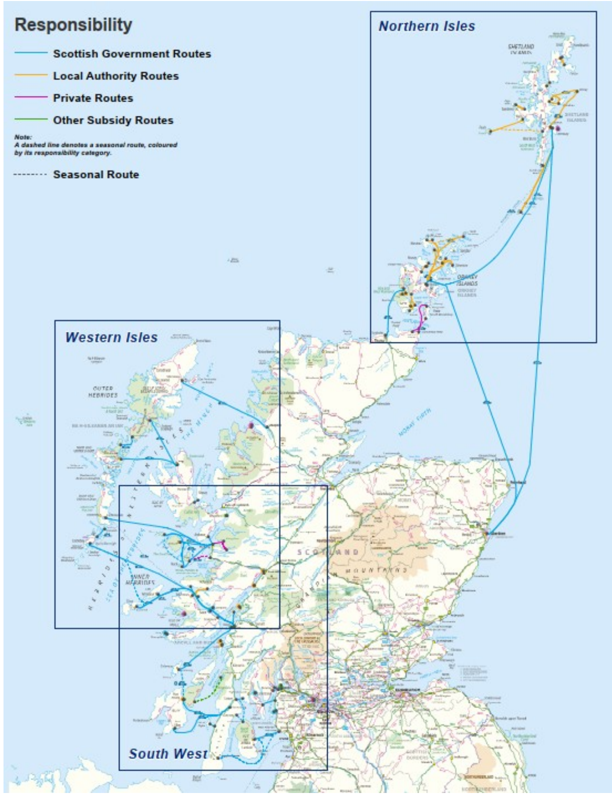
Introduction

We have explored international comparators in order to understand their governance and regulatory frameworks and to inform our long-list of options for the CHFS network. The international comparators that have been explored are: Canada (British Columbia), Norway, New Zealand (Auckland) and Australia (New South Wales).

Background

The interrelationships and responsibilities of the various parties responsible for Scotland's ferry network are complex. TS (on behalf of Scottish Ministers) currently subsidises 33 routes to the Clyde and Hebrides and the Northern Isles through separate contracts with two ferry operators: CFL and SNF.

The infrastructure supporting the routes is owned by a number of different public and private sector bodies, creating a complicated operational and funding structure. We have included more detail on the infrastructure arrangements within the table on the following page.



Contract Type

	CHFS	NIFS
Operating Contract		
Description	SG subsidises the year round passenger, vehicle and freight ferry service from the mainland to the West Coast of Scotland and the Clyde Estuary.	SG subsidises the year round passenger, vehicle and freight ferry service from the mainland to Orkney and Shetland via the Northern Isles Ferry Services contract.
Operator	CalMac Ferries Ltd	Serco NorthLink Ferries
Contract Length	CHFS2: 8 years (October 2016 to October 2024)	NIFS3: 8 years (30 June 2020 to 30 June 2028)
Contract Value/ Type	The value of the contract, based on the full-life duration of eight years, is £868.0m exclusive of VAT and inflation. CFL is responsible for the full delivery of the service and whilst it is not responsible for setting the fares, passenger demand risk sits with the operator.	The value of the contract, based on the full-life duration of eight years, is £349.6m exclusive of VAT and inflation. Serco is responsible for the full delivery of the service and whilst it is not responsible for setting the fares, passenger demand risk sits with the operator.

Subsidy

The CHFS contract is operated by CFL and serves 29 routes across the west coast of Scotland and Clyde estuary. It receives a subsidy which amounts to approximately 66% of its revenue to run the service.

The NIFS contract is operated by SNF and serves four routes to Orkney and Shetland. It receives a subsidy which amounts to approximately 50% of its revenue to run the service.

Appendix A: International Benchmarking

Introduction and background (cont.)

Corporate Structure

CHFS: Scottish Ministers are the sole shareholder of both DML and CMAL. They procure lifeline ferry services through the CHFS and NIFS contract, including contract award and management. They provide grant and loan funding to CMAL for capital investments.

Asset Ownership and Management

CFL and SNF lease their vessels on a bareboat charter, i.e., they are responsible for maintenance and crewing. In 2019/20 vessel charter fees paid to CMAL by CFL and SNF amounted to £21.8m.

Harbours across Scotland are owned by a number of organisations including CMAL, local authorities and private sector owners. Harbour owners receive income in the form of harbour dues from the operators and are responsible for the maintenance and upgrade of the infrastructure.

	CHFS	NIFS
Infrastructure Arrangements		
Vessels	31 Vessels: ▸ CMAL owns all the vessels operating on the CHFS routes ▸ CMAL is owned by Scottish Ministers and leases the vessels to CFL on a bareboat charter, meaning CFL is responsible for vessel maintenance ▸ The average vessel age is 22 years	5 Vessels: ▸ CMAL owns all the vessels operating on the NIFS routes ▸ CMAL is owned by Scottish Ministers and leases the vessels to SNF on a bareboat charter, meaning SNF is responsible for vessel maintenance ▸ The average vessel age is 21 years
Harbours	52 Harbours: ▸ CMAL owns or leases 25 and pays CFL a 'harbour operating fee' to operate these on its behalf ▸ Councils – 21 harbours ▸ Independent harbour authorities – 4 ▸ Private company – 1 ▸ National Trust for Scotland – 1	5 Harbours: Orkney Islands Council – 2 Independent harbour authorities – 3

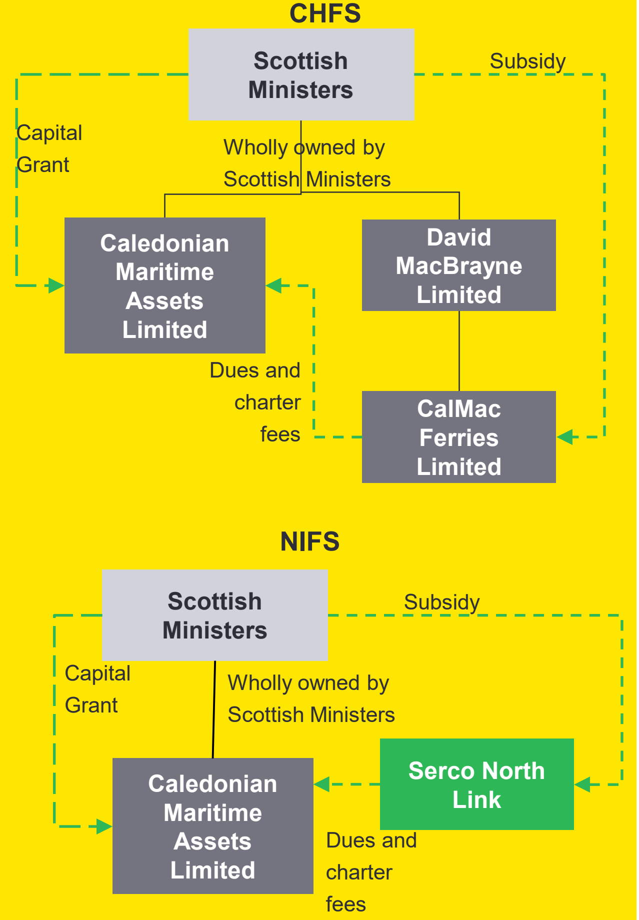
Board Appointments

CHFS: CEO is a Ministerial Appointee.

NIFS: Serco appoints a board of directors that is responsible for the management and delivery of the contract.

Legislative Context

TS is responsible for strategy, planning, policy, regulation and funding allocation for all modes of transport in Scotland. The department is administered by the Minister for Transport.



The objective of this exercise is to benchmark against international comparators in order to deliver a framework of options of structural reform.

Appendix A: International Benchmarking

Introduction and background (cont.)

Key Stakeholders

The Tripartite has a number of key stakeholders that have an interest in the delivery of the CHFS contract, both directly as passengers and indirectly as businesses that rely on its infrastructure, trade unions that represent the staff in its employment and local authorities who interface with it in their capacity as public service providers.

CalMac Community Board

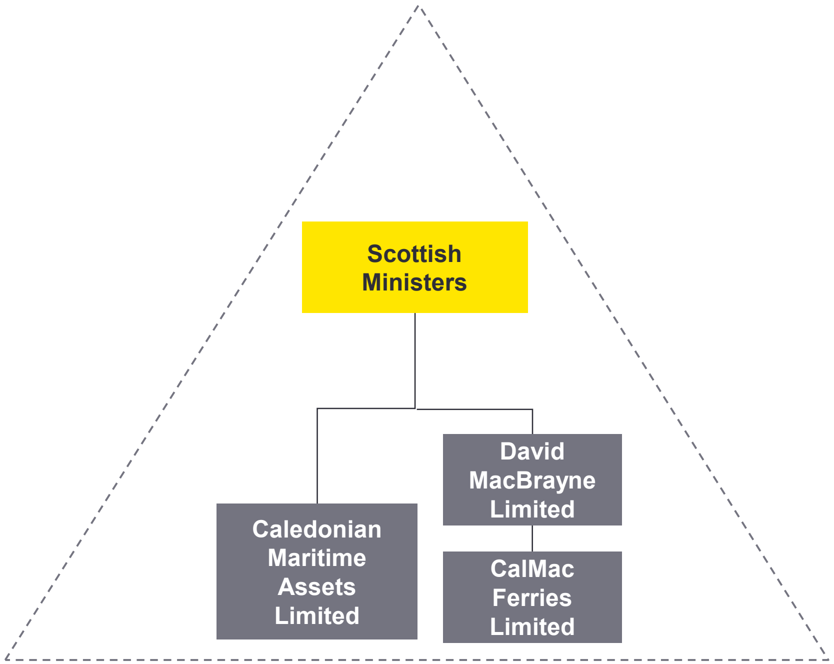
Primary purpose is to be the voice of the communities and provide the community view to CFL. It focuses on strategic issues rather than operational.

Ferry Committees

For each major island in the Hebrides there is a ferry committee that represents the users. Ferry committees are key to the Tripartite's consultations and input to operational matters such as timetabling.

Trade Unions

CFL employs 1,700 individuals, many of whom are members of trade unions who represent and negotiate on behalf of their members.



Local Authorities

Public services delivered by local authorities often interface / have interdependencies with the delivery of ferry services.

Island Businesses

Island businesses trading with the mainland and vice versa are dependent on ferry services to maintain their viability.

Appendix A: International Benchmarking

British Columbia Ferries

Background

BC Ferries and its predecessors have operated a ferry system on the British Columbia coast since the 1960s and today it is one of the world's largest ferry operators, carrying in the region of 22m passengers per annum across 25 routes.

BC Ferries was established in its current form in 2003 as an independent, regulated company under the Company Act. Previously it was a Crown corporation. Its creation as a "publicly owned but private-functioning" entity followed a review that found that, as a Crown corporation, BC Ferries was "dependent on Government for everything" causing each decision to be "directly influenced by the politics of the day".[1] A new model was deemed necessary to renew the fleet and access the requisite financing.

Large populations living and working on Vancouver Island and in Greater Vancouver, as well as the popularity of these areas as tourist destinations, are the foundation of demand for BC Ferries' services. It also provides lifeline services and long-distance overnight ferry services.

Contract Type

BC Ferries entered into the Coastal Ferry Services Contract with the Province of British Columbia on 1 April 2003 for a 60 year term, with an option to extend by 60 years subject to mutual agreement. BC Ferries holds farebox risk under the contract, which can be amended on a four year rolling basis following a price cap review by the Commissioner. Retention of farebox revenue allows for cross subsidisation between profitable (commuter / tourist) and unprofitable (lifeline) routes.

The contract stipulates service levels, including a minimum number of sailings, vessel capacity and hours of service for all routes. Changes to the contract, including route or service level, are made with agreement from the Commissioner.

Subsidy

In 2019/20 BC Ferries was paid £136m (CA$232.1m) in government subsidy. This was received from both the Provincial and Federal Governments. Subsidies from the Province include Ferry Transportation Fees (CA$168.3m) for the provision of services on routes that would otherwise not be financially viable and Social Policy Reimbursement (CA$32.5m) to reimburse BC Ferries for discounts established by the Province for certain demographics, e.g. students and seniors. CA$31.3m in subsidy comes from the Government of Canada in line with the contract between the Federal and Provincial governments.

BC Ferries	£m	%
Direct Route Revenue	416	75%
Subsidy	136	25%
Total Revenue	**£552**	**100%**

Source: https://www.bcferries.com/

[1]https://www.bcferrycommission.ca/faqs/about-bc-ferries/from-2003-onwards/

Appendix A: International Benchmarking

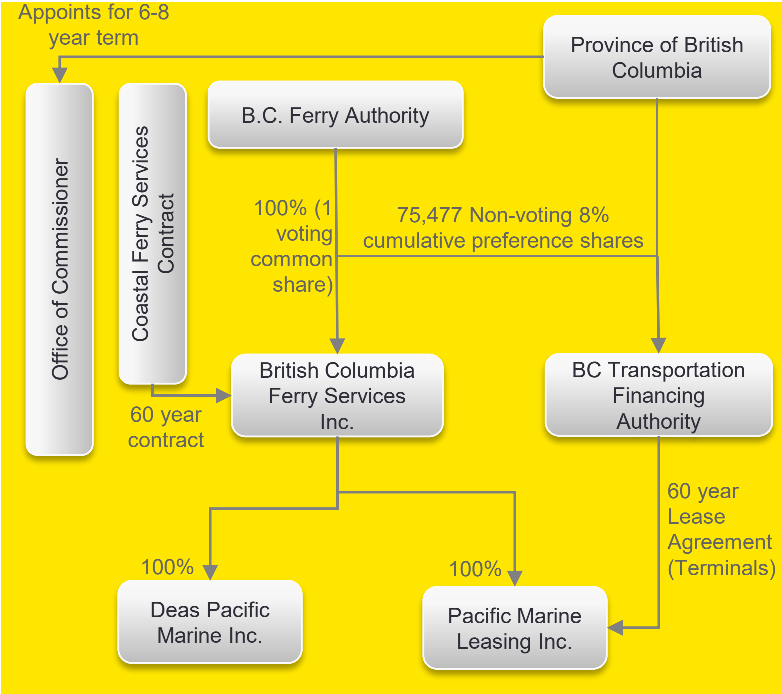
British Columbia Ferries (cont.)

Corporate Structure

Voting ownership of BC Ferries is held by the BC Ferry Authority (BCFA), a non-share capital corporation established under the Coastal Ferry Act. BCFA is responsible for overseeing the strategic direction of BC Ferries.

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 either BCFA or BC Ferries. Limiting Government control in this way means that BC Ferries' debt is not consolidated onto the Province's balance sheet. It has also supported independent decision making by BC Ferries.

Deas Pacific Marine Inc. was established to undertake a portion of BC Ferries' maintenance and refit operations. Pacific Marine Leasing was established to acquire and lease capital assets to BC Ferries.



Asset Ownership and Management

Via the BC Transportation Financing Authority (BCTFA), the Province also owns the land and structures comprising most of the terminals operated by BC Ferries. This infrastructure is leased to BC Ferries for a 60 year term commencing 1 April 2003. Under the terminal leasing arrangement, control of terminals is transferred to BC Ferries and BC Ferries has responsibility for maintaining, developing and managing the terminals at its own cost.

BC Ferries owns a majority of its 35 vessels, which have an average age of 33 years. To date BC Ferries has issued 6 bonds with a combined value of CAN$1.35bn to finance its shipbuilding programme. BC Ferries' corporate structure was designed with the intention of facilitating access to private finance in this way.

Previously BC Ferries was explicitly empowered by the Commissioner to adopt a commercial approach which led to shipbuilding activity being concentrated overseas. However, in 2019 the Coastal Ferry Act was amended to remove as a regulatory principle the requirement for the Commissioner to encourage BC Ferries to adopt a commercial approach. This was done with the intention of enabling BC Ferries to consider domestic shipbuilding even if it does not represent the most commercially advantageous option.

If a vessel becomes surplus to requirements due to a route discontinuance, BC Ferries can require the Province to purchase the vessel at net book value.

Board Appointments

BCFA appoints BC Ferries' Board of Directors. BC Ferries' board appointments are 'at large', i.e. based on merit, and are drawn from a range of professions. Eight years is the maximum term that can be served.

Appendix A: International Benchmarking

British Columbia Ferries (cont.)

Board Appointments (cont.)

BCFA has its own Board of Directors composed of nine directors, four of whom are appointed by the Province of British Columbia. The remaining five are appointed by the BCFA board but must be drawn from nominees from coastal regional districts (4) and trade unions (1). The maximum term that can be served is six years.

Legislative Context

The Provincial Government of British Columbia is made up of ministries, Central Government agencies and Crown corporations. Within its remit are also independent boards, to which it is entitled to appoint at least one representative. The BC Ferry Authority and BC Ferry Commission both fall within the latter grouping.

Regulatory Regime

The Coastal Ferry Act established the office of the Commissioner to regulate operators that provide 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 6-8 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.

Source: https://www.bcferries.com/

Observations for Options Analysis

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 has required the Government of British Columbia to relinquish a significant degree of control. However, from the perspective of the public, the Government has not relinquished responsibility 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 consider a wider range of socio-economic factors, including domestic shipbuilding.

The Government's limited control means BC Ferries' private debt is not accounted for on the Government's balance sheet.

Appendix A: International Benchmarking

Norway

Background

Norway has an internationally leading maritime industry and one of the world's longest coastlines. The latter accounts for the significant ferry fleet in the country, numbered at c.200 (with a further 74 high-speed vessels). These vessels deliver services across 120 ferry routes and carry 44m passengers each year.

Since the late 2000s all ferry services have been subject to competition via regular tenders. Before this most ferry companies were publicly owned by local authorities. Competitive tenders were initially introduced on a limited basis in response to rising subsidies and were later expanded to meet European Economic Area competition requirements.

Contract Type

Ferry services are procured by either the national Norwegian Public Roads Administration (Statens Vegvesen) 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. Due to a majority of contracts being managed at a local level, there is a greater risk of variable service standards across the network.

The normal contract length is 6-10 years although there is often an option to extend. In recent years a government procurement rule requiring investment in new zero carbon vessels has led to an increase in the length of contracts (up to 15 years) as operators seek to secure their return on investment.

During the contract period the operator holds an effective monopoly on the route.

Contracts are tendered on either a gross or net basis:

- Under gross contracts the procuring authority retains farebox risk. The operator receives a fixed annual price-index adjusted fee from the procuring authority and the authority retains farebox revenue, i.e. revenue risk.
- Under a net contract the operator assumes farebox risk. The operator receives a fixed fee from the procuring authority in addition to farebox revenue.

In recent years there has been a tendency towards gross contracts. This has been done to mitigate the impact of new fare structures on operators. It is understood operators view the transition as an attractive opportunity. Also contributing to the attractiveness of the market is the small size of route bundles, which leads to a greater volume of contracts that can be competed for.

Norway Ferries sector	£m	%
Farebox Revenue	[redacted]	[redacted]
Government Subsidy	[redacted]	[redacted]
Total Revenue	[redacted]	**100%**

Norway's coastline, the second longest in the world, is served by 120 ferry routes.

Source: www.visitnorway.com

Appendix A: International Benchmarking

Norway (cont.)

Contract Type (cont.)

In discussion with the Norwegian Government it was also noted that a longer tendering period, with structured dialogue throughout, contributed to a competitive environment.

Subsidy

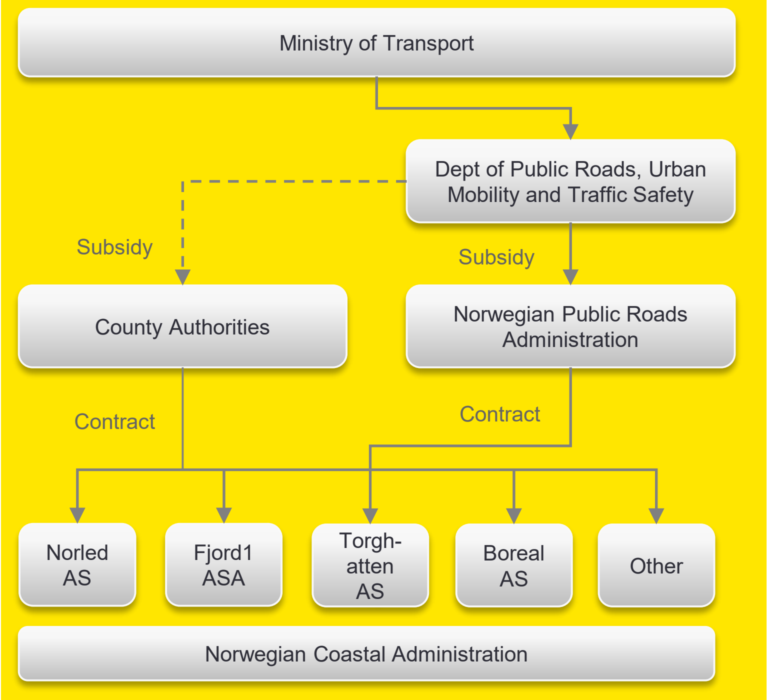
Most ferry services in Norway require government subsidy which is received on either a gross or net basis. Government subsidy accounts for [redacted] of the ferry sector's income, which with farebox revenue amounts to [redacted] per annum. Rising costs of service delivery due to ferry renewal and increased service levels have contributed to increased subsidies in recent years.

Corporate Structure

Four operators dominate the Norwegian ferries sector. These are as follows:

- Fjord1 ASA – Publicly listed company operating 29 routes. Carried 17.4m passengers in 2017.
- Norled AS – Private equity owned business operating 31 routes. Carried 9.4m passengers in 2017.
- Torghatten AS – Private equity owned business operating 41 routes. Carried 7.9m passengers in 2017.
- Boreal Norge AS – Chinese State Owned Enterprise operating 13 routes. Carried <1m passengers in 2017.

An influx of private equity interest in Norway's ferries sector has prompted the competition regulator to intervene to prevent takeovers that could lead to anti-competitive practices. However, to date, competition in the market is well preserved, with an average of 2.6 bids per tender.



Board Appointments

Fjord1, the largest and only listed business among the four main operators, is notable for the presence of maritime expertise on its board. Norled's CEO has a background in oil and gas and its Chair in the maritime industry. Torghatten's Chair has a background in logistics.

Asset Ownership and Management

Private operators are responsible for procuring and financing their own ferries. 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. Operators expect to be able to use their vessels across multiple contracts, which helps to manage the risk of assets becoming stranded if a contract is lost. Operators as well as local authorities, who manage the quay infrastructure on the county network, have received Central Government grants to install charging infrastructure and upgrade the local grid respectively.

Appendix A: International Benchmarking

Norway (cont.)

Legislative Context

The Ministry of Transport has overall responsibility for ferry services forming part of the national road system, for coastal management, the marine environment and port and sea transport policy. The National Road Administration sits within this body.

Regulatory Regime

The level of service is regulated by county councils, or for national routes the Norwegian Public Roads Administration, via the ferry services contract. The service specification typically includes capacity and departure schedule.

In 2015 the Norwegian Parliament passed legislation that requires public tenders for ferry services to include environmental requirements. This has prompted Norway's ferry operators to invest heavily in zero emission technology, including charging facilities at quayside.

Under gross contracts, prices are adjusted according to the Ferry Index, which takes into consideration inflation for costs specific to sea travel such as fuel, wages, interest and maintenance.

Source: https://www.fjord1.no/eng/About-Fjord1-ASA/Operating-segments/Ferries

Observations for Options Analysis

Ferry services are delivered under an integrated model in which contracts are managed by either the central or local roads authorities, depending on the nature of the route. Delivery is comparatively decentralised, with a majority of contracts being awarded and managed by local authorities.

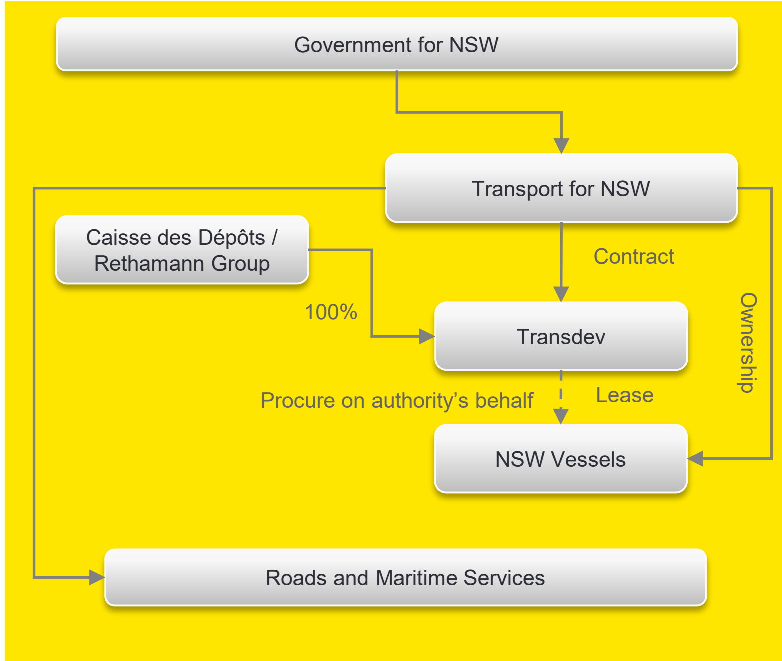
The localised nature of ferry services procurement in Norway requires the network to be tendered in small bundles. This results in a larger volume of frequently tendered contracts which helps make the market attractive to operators who are better able to manage their asset risk because vessels can more 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.

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.

Appendix A: International Benchmarking

Sydney Ferries Network



Background

The Sydney Ferries Network carries c.15m passengers per year using a fleet of 32 vessels. These vessels serve 36 ferry stops across nine routes. The customer base is predominantly tourists and commuters.

The Sydney Ferries Network was previously operated by Sydney Ferries, a statutory authority. Following a review in 2007 that found the operation was inefficient and lacked adequate management, it was decided that the ferry service would be franchised to the private sector. The current contract holder is Transdev.

Contract Type

Ferry services are provided under the Ferry System Contract, which is managed by Transport for New South Wales (TfNSW). TfNSW also contracts with several smaller ferry operators to deliver public ferry passenger services across New South Wales (NSW). The nine routes serviced by these smaller operators often serve remote and isolated communities and account for 1m passenger journeys per year.

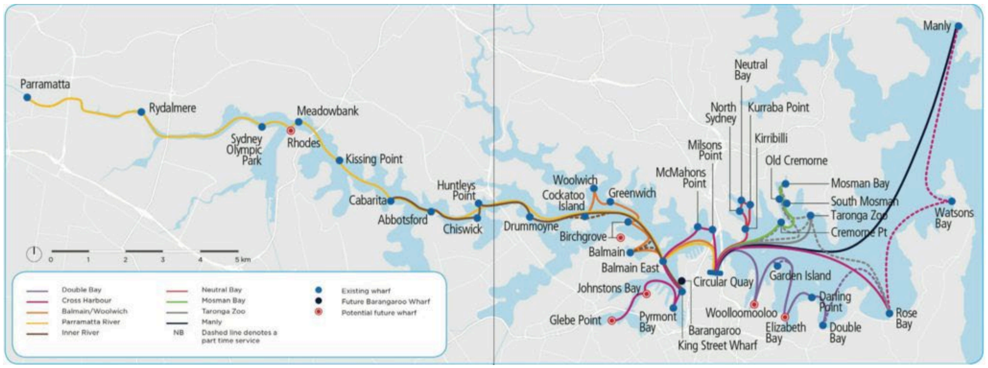
Under the franchise arrangement TfNSW retains revenue risk and control over the fare structure, routes and timetables. TfNSW also retains ownership of the fleet for the duration of the nine year contract. The operator is responsible for maintaining the vessels and leading on the procurement of new vessels. It is understood that the latter was adopted during the most recent procurement in 2019 when TfNSW invited bidders to propose the most cost efficient means for procuring new vessels.

Subsidy

The annual subsidy awarded to Transdev is in the region of £58m per annum. Transdev also retains farebox revenue of c.£21m.

Corporate Structure

Contracts are awarded by TfNSW to the operator. 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, services and logistics group. The contract is held directly with TfNSW.



Source: https://www.skyscrapercity.com/threads/sydneys-ferry-network.84840/page-26

Appendix A: International Benchmarking

Sydney Ferries Network (cont.)

Asset Ownership and Management

The Government of NSW's fleet of 32 vessels has an average age of 24 years. The vessels are largely owned outright with a small number being leased. 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 passenger ferry wharves are maintained by the Roads and Maritime Services department, which is the state boating regulator.

Regulatory Regime

The contract sets out the operator's responsibilities in terms of delivering passenger services. The operator must also comply with the Passenger Transport Act and relevant regulations and guidelines. An Independent Pricing and Regulatory Tribunal sets the maximum fares for ferry services.

Legislative Context

TfNSW is an executive agency of the Government of NSW, the administrative authority for the Australian state of NSW. TfNSW is responsible for strategy, planning, policy, regulation and funding allocation for all modes of transport in NSW. The department is administered by a Minister for Transport and Infrastructure and a Minister for Roads, Maritime and Freight.

Source: www.Transdev.com

Transport for NSW	£m	%
Direct Route Revenue	£29m	39%
Subsidy	£45m	61%
Total Revenue	**£74m**	**100%**

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 TfNSW.

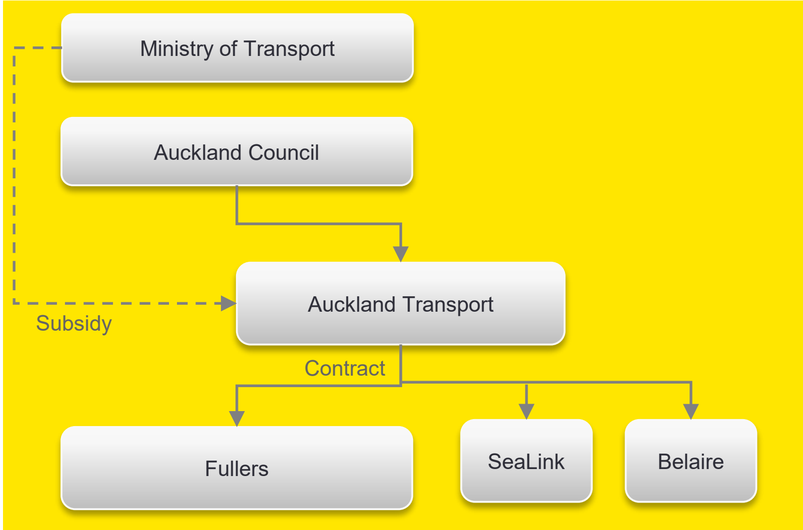
Appendix A: International Benchmarking

Auckland Ferries Network

Background

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.

Auckland Transport (AT) is responsible for managing the Ministry of Transport's investments in public Transport in Auckland. In this capacity AT is responsible for service planning, network design and operations and putting in place contracts for service delivery, including ferry services.



Contract Type

Private sector operators provide ferry services to 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.

Subsidy

AT funds 81% of its activities via grant funding from Auckland Council and the New Zealand Transport Agency. 11% of its funding is derived from public transport income, with the remainder from parking and enforcement and other revenue.

Corporate Structure

The predominant player in Auckland's ferries sector is Fullers360, owned by the Private Equity business Souter Investments. Fullers carries 5.5m passengers per annum, owns 21 vessels and provides 19 services, four of which are under contract with AT.

There are two other minor operators in the market that hold contracts with AT: SeaLink and Belaire Ferries.

Asset Ownership and Management

Operators supply their own vessels. AT manages 21 ferry facilities on behalf of Auckland Council, the infrastructure owner.

Source: www.greaterauckland.org.nz

Appendix A: International Benchmarking

Auckland Ferries Network (cont.)

Legislative context

New Zealand's public transport is provided and maintained by a number of national regional and local bodies, including AT.

The Ministry of Transport is the principal government transport policy advisor and administers transport related legislation such as the Land Transport Management Act (LTMA). It is under this legislation that AT is able to guide the ferry network by specifying ferry service policy, guidelines, standards and specifications.

Regulatory Regime

AT contracts with private operators to deliver services in line with minimum service levels. However, these contracts between AT and operator are in place only for those services that are deemed 'integral' to Auckland's Public Transport Network under the Regional Public Transport Plan (RPTP). It is understood that when the RPTP was established no ferry routes were included within its scope. Since then certain ferry routes have been incorporated; however, a number of key ferry routes continue to be deemed exempt from these regulations, and remain outside of AT's control for this reason.

Source: https://www.fullers.co.nz/

Auckland Transport	**£m**	**%**
Direct Route Revenue	Unknown	N/A
Subsidy	Unknown	N/A
Total Revenue	**Unknown**	**N/A**

Observations for Options Analysis

Auckland Transport'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 for ferry services in 2019 was reported 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 is done in NSW.

2 Domestic Benchmarking

Appendix B: Domestic Benchmarking

Infrastructure Overview

Introduction

As well as exploring international comparators, we have explored domestic sectors that share similarities with the 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 potential structural options for the future CHFS network.

Approach

For the domestic benchmarking section we have reviewed four sectors:

- Scotland's road network
- Scotland's rail network and proposed UK reforms
- Highlands and Islands Airports Limited
- Scottish Water

This exercise focused on a number of Scotland's key infrastructure sectors that provide services under contract with government as these are considered most relevant to the ferry sector. 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

Background

The roads network in Scotland is made up of six categories of roads:

- Motorways and trunk roads – Scotland's strategic road network catering for through traffic
- A roads – Major roads which deliver the basic road links to certain areas or communities
- B roads – Roads serving a local purpose and connecting to strategic routes
- C roads – Principally interconnecting roads in rural areas
- Unclassified roads – Principally local access roads
- Private roads

Responsibility for maintaining the roads is shared between TS and local authorities in Scotland.

- TS maintains the 3,500 kilometre network of motorways and trunk roads
- 32 Scottish LAs are responsible for the maintenance of 51,000 kilometres of other public roads (categories A, B, C and unclassified)

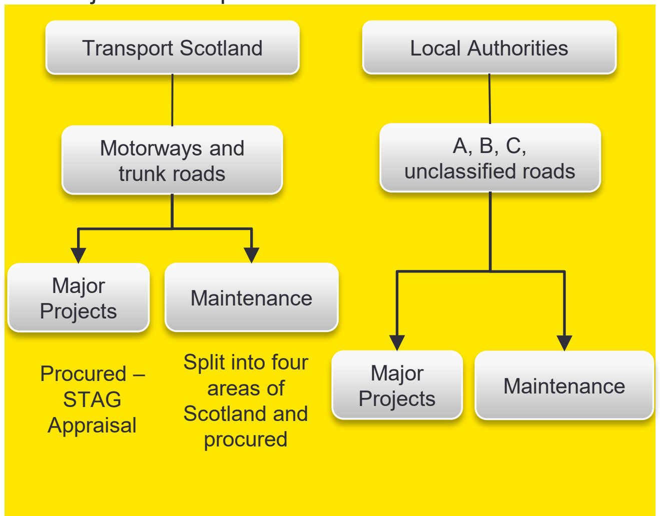
Contract

Contracts are procured for both maintenance and major projects.

Trunk road maintenance is planned by TS but the work is undertaken under contract. These contracts cover four geographical areas.

Major road enhancement projects follow the Scottish Transport Appraisal Guidance (STAG) appraisal process of TS and are the responsibility of the TS Road Directorate. Contract lengths for these services are in the region of eight years.

Local authorities use a mixture of their own trading operations and private contractors to maintain the network. Councils' roads trading operations tend to undertake routine, cyclic and winter maintenance for councils, while larger structural maintenance projects are subject to competitive tender.



Appendix B: Domestic Benchmarking

Scotland's Road Network (cont.)

Asset Ownership

TS owns / procures the trunk road network in Scotland and procure the maintenance and major project enhancements from the private sector in line with procurement regulations. Local authorities own all A, B and C roads in Scotland.

Regulatory Regime

The Scottish Road Works Commissioner (SRWC) is an independent public official whose role was established under section 16 of the Transport (Scotland) Act 2005. They are accountable to Scottish Ministers. The SRWC's purpose is to improve the planning, coordination and quality of road works throughout Scotland.

As Keeper of the Scottish Road Works Register (SRWR), the Commissioner monitors performance, promotes and encourages good practice across utility companies and roads authorities. The monitoring is at a strategic level and is related to how well the works are being planned and coordinated.

Coordination and planning of road works in Scotland is undertaken by local authorities and utility companies by entering details of their planned works on the SRWR. The Commissioner has powers to impose financial penalties on LAs and utility companies who systematically fail in their duty to co-ordinate when undertaking road works.

The Commissioner's role in roads is around monitoring the performance of road maintenance and improving the quality of Scotland's roads network. They do not therefore have a role in setting the minimum level of spend or monitoring of capital spend.

Observations for Options Analysis

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.

Devolving responsibility for roads maintenance has resulted in variable service quality: an Audit Scotland report on roads maintenance found that 87% of those surveyed felt trunk roads were in an acceptable condition, compared to 67% for council roads. This may reflect the pressures that are often placed on local authority budgets. It also found that there is significant variation in the condition of roads between different local authorities.

The above illustrates that moving to a decentralised model can lead to a lack of consistency in the level of service. Variable levels of spend between local authorities has also been noted. A similar trend was noted 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 (SRWC) has been put in place with an aim to improve the quality of Scotland's roads, however, in spite of this, road maintenance performance has continued to decrease, as has operational spend.

Appendix B: Domestic Benchmarking

Scotland's Rail Network

Background

TS is responsible for managing the ScotRail contract and developing the long-term priorities for Scotland's railways. The Department for Transport (DfT) is responsible for transport in England.

Contract Type

The current franchise contract is in place with Abellio ScotRail, the contract commenced in April 2015 for a period of 7 years. The contract had an option to extend to 10 years; however, in 2021 TS announced that it would not extend the existing contract and would instead operate the railways from March 2022 using an Operator of Last Resort, i.e. the service would be run by a company wholly owned by the SG.

Subsidy

The subsidy is called the Franchise Payment and is defined within the Franchise Agreement. Revenue demand risk sits with the operator; however, from year five of the contract revenue risk has to a degree been shared as the revenue support provisions under the franchise agreement were activated by actual revenue being below the pre-determined threshold relative to the bid of Abellio.

Asset Ownership

Network Rail owns most of the UK's rail infrastructure (tracks, signals, bridges, tunnels and stations), and receives funding from the SG to maintain and improve Scotland's rail infrastructure.

Abellio ScotRail leases the stations it manages from Network Rail and its trains from rolling stock companies (ROSCOs). It secures the use of tracks through a track access agreement with Network Rail.

Corporate Structure

TS, on behalf of Scottish Ministers, is responsible for managing the operating contract for Scotland's railways. Abellio ScotRail is a private sector operator, wholly owned by the Dutch Government. Network Rail is the owner of the infrastructure.

Legislative Context

The Railways Act 2005 established the current regulatory structure for rail in Britain, devolving most of the funding, strategic planning and management of Scotland's rail industry to the Scottish Executive in April 2005.

Regulatory Regime

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, deciding funding for these bodies based on a regulatory assessment of how much their outputs should cost if efficiently delivered. The ORR is responsible for setting and monitoring targets for Network Rail, including setting station access charges and track access agreements.

ORR regulates access to the network for train operators and is also the competition and consumer authority responsible for protecting customers' interests and ensuring fair treatment. As the regulator of Network Rail the ORR is responsible for monitoring how Network Rail manages its delivery of improvement schemes and the upkeep of its assets.

In 2014, the Office for National Statistics reclassified Network Rail as a public body. This meant that it became subject to a fixed borrowing limit.

Observations for Options Analysis

Asset ownership in the rail industry is divided among several parties, with Network Rail owning the core rail infrastructure and leasing railway stations to the Train Operating Companies (TOCs). The TOCs lease their rolling stock from rolling stock companies (ROSCOs).

Separating ownership of rolling stock from the operator reduces the latter's asset risk, which is intended 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 Williams-Shapps Plan (see next slide) has sought to address via greater integration.

The ORR is the economic regulator for the sector and independently sets delivery targets for Network Rail as well as determining the sector's funding requirements. This provides an independent perspective on the sector's needs.

Appendix B: Domestic Benchmarking

Great British Railways

Background

The DfT is responsible for managing the rail network in England and Wales. The rail network was privatised in 1990, which split the state monopoly into private entities for infrastructure (including stations and rail track ownership, renewal and maintenance) and franchising was introduced for operating trains. In 2001, the infrastructure, maintenance and renewals were taken over by Network Rail, a UK public sector body.

Under the franchise structure it was widely reported that the operating model had become complicated and fragmented. In 2019 Keith Williams undertook a review of the UK rail industry and made a series of recommendations for reform. In May 2021, the Secretary of State for Transport announced a number of reforms to the UK rail industry which will be introduced from 2023. As per the new plan, a new public body, Great British Railways (GBR), will be set up by 2023. The features of GBR are described below.

Contract Type

GBR will contract with private companies to operate the trains under the new Passenger Service Contract (a management service contract). Fare revenue will go to GBR, with operators delivering to the specification and managing their costs in doing so. The length of contracts will vary. On some parts of the network, longer contracts than those used under franchising (typically eight years) may be adopted to support major investment programmes, or the delivery of significant changes for passengers more effectively.

- Existing contracts will be honoured and will transfer from the DfT to GBR
- GBR will specify timetables, branding, service levels and set fares.

Subsidy

Subsidy will be based on operating costs plus a margin of profit as per the operator’s tender. Operators will take cost risk and balance this with service quality in order to be efficient while also meeting the needs of passengers.

Asset Ownership

Network Rail will merge with GBR. GBR will take ownership of the railway’s infrastructure from Network Rail, which it is intended will support more integrated management of the UK rail sector.

Corporate Structure

GBR will bring together the whole system and perform a role similar to that which Transport for London does in London. GBR will own the railways across the UK and run them as an integrated system.

Legislative Context

The role of the ORR will change to help improve accountability, transparency and efficiency across the network. Legislation will be passed to revise its role to focus on monitoring, reporting and improvement across the sector, making it a core part of the system that will hold GBR to account.

The ORR will also act as an appeals body for operators, including open access and freight, and suppliers to ensure GBR applies its policies fairly, including on track access and charging. The ORR will be able to direct GBR to change decisions that are not in line with policy or the rules-based access system underpinned by legislation.

Observations for Options Analysis

Franchises previously awarded by DfT to TOCs placed revenue risk with the operator; however, without the ability to set fares, the operators were restricted in how they could influence demand and this model has ultimately proved unsustainable, with several high profile franchise failures.

This, in addition to delays in large scale infrastructure projects, prompted a review of how best to structure the rail industry to ensure risk sits with the party best able to manage it. The outcome of which is an integrated model in which GBR will own all infrastructure assets and be responsible for contracting for the operation of services.

Appendix B: Domestic Benchmarking

Highlands and Islands Airports Limited

Background

Highlands and Islands Airports Limited (HIAL) is a private limited company owned by Scottish Ministers. It was established in 1986 by the Civil Aviation Authority (CAA). HIAL's vision and goals are aligned with the SG's strategic priorities for a wealthier and fairer, healthier, safer and stronger, smarter and greener Scotland. HIAL supports some of Scotland's most remote communities, most of which are heavily reliant on air travel as a means of transporting goods and services. As such, HIAL is vital to the social and economic welfare of the areas it serves.

Contract Type

A framework document between HIAL and the SG sets out the broad context within which HIAL will operate and defines key roles and responsibilities which underpin the relationship between HIAL and TS. The document states that effective strategic engagement between TS and HIAL is necessary for the delivery and improvement of public services. Elsewhere the document considers principles for budget management and income generation. Relevant parts of the Scottish Public Finance Manual including best value, procurement and project management are also referenced.

Subsidy

HIAL receives an operating subsidy, which is receivable 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; £12m was received in 2019/20 per its annual accounts.

Asset Ownership

HIAL owns and operates 10 airports across the Highlands and Islands and one further airport at Dundee. It handles over 1.7 million passengers per year. Loganair is the principal airline operating from HIAL's airports, although a small number of other commercial operators also fly to HIAL's airports.

Corporate Structure

The Board determines the business strategy of HIAL in conjunction with the executive team, taking into account the Scottish Ministers' expressed policy to encourage economic and social development in the areas served by HIAL.

The Board has collective responsibility for maintaining a sound system of corporate governance and internal control that supports the achievement of HIAL's policies, aims and objectives whilst safeguarding public funds and assets. The role of the Board is set out in the Framework Document between the SG and HIAL.

The HIAL Board is responsible for providing leadership, direction, support and guidance, and in ensuring that HIAL delivers its functions effectively and efficiently and in accordance with the aims, policies and priorities of the Scottish Ministers.

Members of the HIAL Board are appointed by Scottish Ministers. The Board is currently composed of eight members.

Regulation

Airport operations across the group are regulated by the CAA. Security standards are set by the DfT and inspected by the CAA.

Observations for Options Analysis

As HIAL is wholly owned by Scottish Ministers its vision and goals can more readily be aligned with those of Scottish Ministers. This helps Scottish Ministers to direct HIAL in its delivery of lifeline services. As has been noted in 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. It would not be desirable to retain these risks without also retaining capacity to manage them.

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.

Appendix B: Domestic Benchmarking

Scottish Water

Background

- 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 value for money and harmonise charges across Scotland.

Contract Type

- 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 Scottish Ministers. This includes the principle that services should be provided at the "lowest overall reasonable cost". Since the introduction of competition into the water retail market in 2005, Scottish Water Business Stream has provided services to retail customers under contract.

Funding

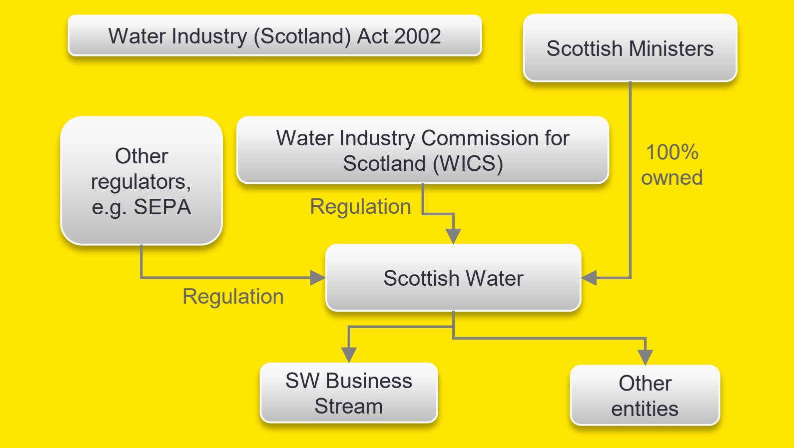
- Scottish Water is funded through revenue raised from customer charges and borrowing from the SG via the Scottish Consolidated Fund. There is evidence to suggest that the lower cost of government borrowing versus private markets has generated savings for the consumer. SG lending is provided in line with advice received from the economic regulator, the Water Industry Commission for Scotland (WICS). Together these sources of funding finance Scottish Water's investment programme, operating costs, Private Finance Initiative service fees and interest charges on loans. Surpluses realised by Scottish Water are reinvested in the provision of services for customers.

Asset Ownership

- Following its establishment in 2002, the assets of its three predecessors were transferred to Scottish Water. In 2019/20 Scottish Water was responsible for maintaining over 1,800 waste water treatment works and invested £277m in its waste water assets. The price caps set by WICS are calculated to support investment in maintaining and renewing these assets.

Corporate Structure

- Scottish Water is a public sector body classified as a public corporation of a trading nature. It is answerable to the Scottish Parliament through Scottish Ministers. Scottish Water does not have shareholders.



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.

Appendix B: Domestic Benchmarking

Scottish Water (cont.)

Legislative Context

- The Water Industry (Scotland) Act 2002 established Scottish Water. Further legislation has since been introduced to strengthen the economic regulation of the sector by establishing the WICS and introducing retail competition for non-domestic customers.

Regulatory Regime

- 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 Scottish Ministers for a period of four years.
- 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.
- Price caps for each regulatory period are informed by a Strategic Review of Charges undertaken by WICS. The process for setting price caps is as follows:
  1. Scottish Ministers set the objectives that Scottish Water should achieve during the regulatory period and determine a set of principles that should underpin the way customers are charged. Ministers consult on these objectives.
  2. Scottish Water presents business plans setting out how much funding it would require to achieve these objectives.
  3. The WICS issues a draft determination of charges that sets charge limits sufficient to deliver Ministerial objectives at the lowest reasonable cost.
  4. Before issuing the final determination Ministers can review their objectives in light of the price impact for consumers.
  5. The final determination must be accepted by Scottish Water as it is a binding contract. Scottish Water has the option to appeal the determination via the Competition and Markets Authority.

- Other bodies that are concerned with regulating or providing an independent perspective on Scottish Water's activities include: the Drinking Water Quality Regulator and the Scottish Environment Protection Agency, as well as the Scottish Public Services Ombudsman and Citizens Advice Bureau.

Source: https://www.scottishwater.co.uk/about-us/what-we-do/the-water-industry-in-scotland

3 Tax, Pensions and Accounting

Appendix C – Tax, Pensions and Accounting

Appendix C includes commentary received from EY specialists in relation to taxation, pensions and accounting matters relevant to each option. Extracts are included as part of the evaluation in the main body of the report; however for a complete understanding it is recommended that Appendix C is read in detail.

Option	VAT	Corporation Tax	Pensions	Accounting
Commissioner or Regulator	N/A	N/A	No material impact	N/A
Regulatory Asset Base Model	N/A	N/A	No material impact	Since there is no change in the underlying structure and funds flow between SG and entities, any impacts will arise only from changes in financial performance. If the RAB regime reduces the income to CMAL significantly, it might no longer be a public corporation. This change would cause all of its revenues and spending to affect SG R-DEL.
TS and CMAL Assimilation	Transfer of business from CMAL to TS may meet the VAT transfer of a business as going concern (TOGC) requirements allowing CMAL to transfer its business and assets without need to charge VAT, subject to further detailed consideration. If TOGC conditions are not met, VAT would be due on sales price. Capital Goods Scheme (CGS) implications also need to be considered for changes in use of asset over relevant adjustment period (5yrs for ships, 10yrs for land & buildings). CGS applies to land, buildings and civil engineering work of £250,000 or more, or aircraft, ships, boats and other vessels of £50,000 or more. CMAL VAT registration could be de-registered.	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 such as the risk of balancing charges on capital allowances. 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 therefore it has a legal responsibility to financially support the pension fund. We expect the transfer of business and assets from CMAL to TS will require a new principal employer for the CalMac Pension Fund.	Assimilation would move CMAL's activities from a Public Corporation to within General Government. The result would be to move all of CMAL's income and revenue spending to SG R-DEL, in addition to its current C-DEL impact which is less likely to change.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
CMAL and DML Integration	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. CGS implications would also need to be considered. VAT compliance burden is simplified and reduced with only one VAT registration required and transactions between the two entities being removed.	Tax consequences will depend on how integration is achieved, however, where relevant conditions for a transfer of trade without a change in ownership are satisfied, transfers of trade and assets from CMAL and CFL can be effected at tax written down value with existing trading losses being transferred to the new company. Chargeable gains may arise on transfers of chargeable assets as transfers will be deemed to take place at market value. Consideration should be given to the potential benefit of a tonnage tax regime election for “Scottish Ferries Co” regarding the CFL element of trade. Public bodies relief from LBTT may be available on the reorganisation of CMAL subject to satisfying necessary conditions. We have assumed DML will not change under this option.	No material impact	Merging a Public Corporation (CMAL) with a General Government entity (DML) results in a new entity that Government controls, but its new classification will depend on whether the new body’s commercial revenues exceed 50% of its operating and financing costs (‘Market Test’). If the new body does not meet the Market Test, the net effect would be to move all of CMAL’s income and revenue spending to SG R-DEL, in addition to its current C-DEL impact which is less likely to change. If the new body does meet the Market Test, DML’s income and revenue spending would fall out of the SG R-DEL in addition to its current C-DEL impact which is less likely to change.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
CMAL and CFL Integration	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. CGS implications would also need to be considered. VAT compliance burden is simplified and reduced with only one VAT registration required and transactions between the two entities being removed.	Tax consequences will depend on how integration is achieved, however, where relevant conditions for a transfer of trade without a change in ownership are satisfied, transfers of trade and assets from CMAL and CFL can be effected at tax written down value with existing trading losses being transferred to the new company. Chargeable gains may arise on transfers of chargeable assets as transfers 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.	No material impact	Merging two Public Corporations (CMAL and CFL) results in a new entity that Government controls, but whose new classification depends on whether the new body meets the Market Test. Given that both bodies currently meet the Market Test, since they are both Public Corporations, the net budgetary impact is unlikely to change significantly beyond financial performance effects.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
CMAL assets are privatised	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.	Tax consequences will depend on how any sale is effected i.e. whether by a sale of trade and assets or by way of a sale of shares. A sale of trade and assets would give rise to chargeable gains/cessation of trade implications for CMAL that would require further analysis.	CMAL is the principal employer for the CalMac Pension Fund, and therefore it has a legal responsibility to financially support the fund. When CMAL's assets are sold to the private sector, a new principal employer would need to take its place (e.g., DML) to enable continued accrual of pension benefits for remaining employees. 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. A private sector buyer is likely to take a conservative view of any underfunding of transferring pension obligations (i.e., place a higher value on any funding deficit than CMAL does) and factor this into their purchase price. The assets and liabilities related to CMAL's inactive members (deferred / pensioner members) could also be transferred to a buyer – however, we expect buyers to have a strong preference not to take these on. A lump sum "exit" contribution to the CalMac Pension Fund or "top-up" contribution to facilitate the transfer of any assets and liabilities to the buyer's pension scheme may also be required.	This assessment assumes that CMAL receives the sale proceeds and then remits these to SG. The requirement for CFL to lease from the private sector vessel owner rather than CMAL means that C-DEL impacts from the leases will occur, because: ► The current CFL – CMAL lease is within Government and so eliminates while the new lease is with the private sector; and ► From 1 April 2021, accounting standard IFRS 16 applies to leases, and HM Treasury has directed that budgeting for leases will follow their accounting impact under IFRS 16). The net effects will therefore comprise an initial C-DEL reduction from the disposal, followed by subsequent C-DEL impacts from the leases. The lease impacts will depend on the lease liability measurement which initially will match the lease asset fair value.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
CFL does not bid on the next CHFS Contract	Provided the business of CFL was continued by the private operator, the transfer of CFL's business may meet TOGC conditions. Any CGS assets may need adjusted. CFL could be de-registered.	The sale of shares in CFL by DML may give rise to a gain in DML dependent on sales price and base cost of shares. Substantial shareholding relief may be available to exempt any gain arising where relevant conditions met. Options regarding Caledonian MacBrayne Crewing (Guernsey) (CMCG) would require further consideration.	CFL is a participating employer for the CalMac Pension Fund. When CFL is sold, it will cease to be a participating employer in the pension fund. The terms of the pension contributions to the private sector will be set out in the CHFS3 Contract. Employees will TUPE to the successful organisation.	Any sale of CFL assets to the private sector will reduce C-DEL in the year of that sale, assuming SG receives the sale proceeds. CMAL retains ownership of vessels and leases them to the private operators. However, since the lease rentals remain within a Public Corporation (and the private sector revenues will increase the chance that CMAL continues to meet the Market Test), the net budgetary impact on SG is unlikely to change.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
Cessation of non-core commercial operations	TOGC conditions may be met. Consideration to be given to any CGS assets.	Tax implications of divestment followed by a sale to a third party would require further analysis, including impact on any existing tax attributes. Pre-sale tax restructuring may be achievable on a tax neutral basis with tax reliefs available to shelter gains on disposal of shares where relevant conditions are met.	CFL, CMCG 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.	Since DML is a General Government entity, all of its income, spending and borrowing scores against R-DEL and C-DEL as relevant. This means that 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.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
Local authorities procure and manage ferry services	Reduced VAT compliance. Local authorities are subject to a different VAT regime, VAT treatment and recovery may differ.	Limited tax implications under this option with retention of CMAL and CFL in their current form, although how devolvement of activity is achieved may require further consideration. Restructuring of CMCG likely to be required under this option.	No material impact on the CalMac Pension Fund is expected on the assumption that no CFL employees transfer to LAs.	This change replaces some or all of CFL's current activities with corresponding activities from local authorities. It also means that CMAL and DML retain ownership of their assets and their activities do not change. Hence, the only SG budgetary impacts beyond changes in financial performance for CMAL and DML 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 local authority activities do not affect 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.

Appendix C – Tax, Pensions and Accounting

Option	VAT	Corporation Tax	Pensions	Accounting
Local authorities procure and manage ferry services and assets	Reduced VAT compliance and registrations. Local authorities 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.	Limited tax implications for CFL which is retained in its current form, although how activity is devolved may require further consideration. 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.	As the local authorities will procure and manage ferry services in place of TS, then the employer will transfer members from the CalMac Pension Fund to the local authorities' 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 local authorities' pension scheme. The assets and liabilities of the deferred and pensioner members of the CalMac Pension Fund could also be transferred – however, the local authority may not wish to take on inactive member liabilities. If they do not wish to take on inactive member liabilities, some 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.	This change results in CMAL's dissolution and replacement of some or all of CFL's current activities with corresponding activities from local authorities. Hence, the main SG budgetary impacts arise from any proceeds from the sale of CMAL's assets including the vessels, along with reductions in CFL's activities to the extent that those activities affect SG budgets given CFL's Public Corporation status. There will be no SG budgetary impact from the local authority leases from the private sector; however any CFL lease for a route it successfully bids for will affect SG C-DEL. This is because local authority activities do not affect any SG budgets. Further changes will occur if as a result of these changes, CFL no longer meets the Market Test and so becomes a General Government entity.

Appendix C – Tax, Pensions and Accounting

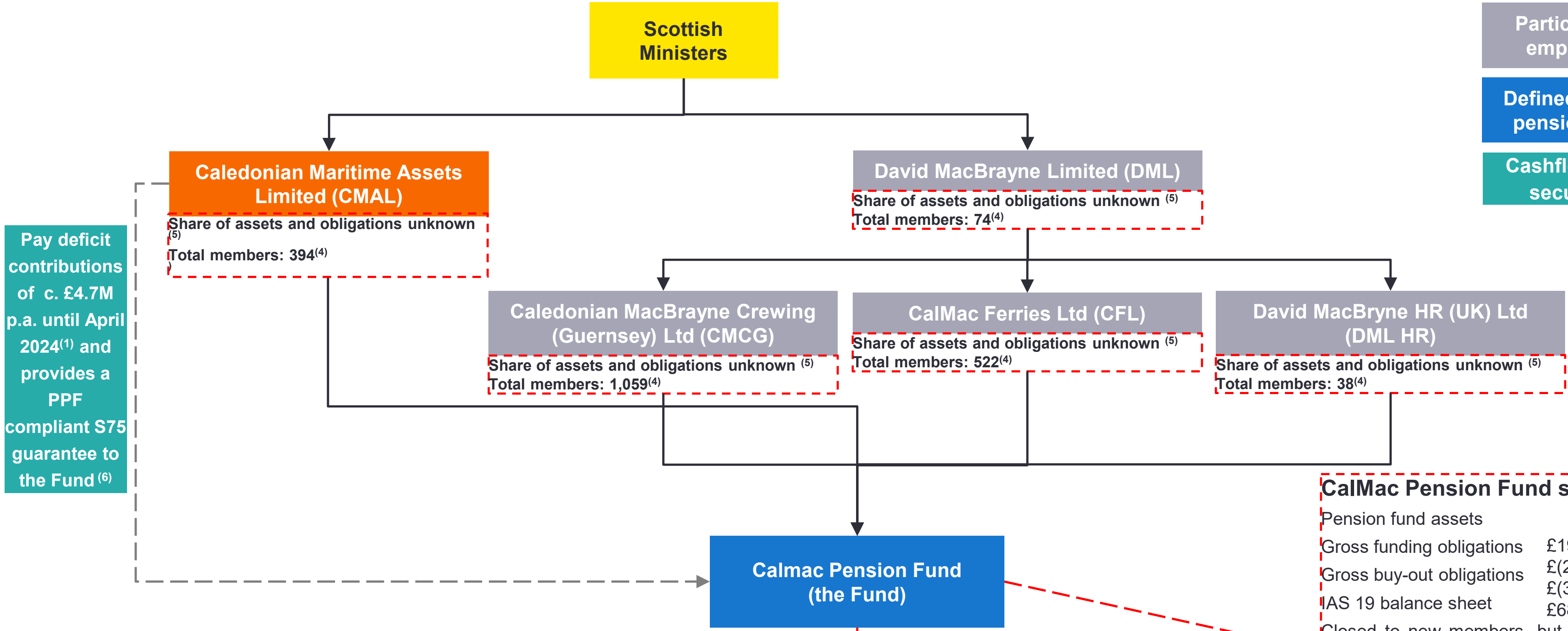
Option	VAT	Corporation Tax	Pensions	Accounting
TS manage major routes and smaller routes unbundled to local authorities	Local authorities are subject to a different VAT regime, VAT treatment and recovery may differ. There will be an increase in VAT compliance with additional parties being added to the structure. TOGC conditions and CGS implications to be considered – specific fact pattern for each contract will be determinative.	Limited tax implications under hybrid model with retention of CMAL and CFL in their current form, 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.	This change results in CMAL's retention and replacement of some of CFL's current activities with corresponding activities from local authorities. Hence, the main 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. There will be no SG budgetary impact from the local authority leases from CMAL, because these leases are between public bodies. Further changes will occur if as a result of these changes, CFL no longer meets the Market Test and so becomes a General Government entity.

Appendix C - Pensions

Pensions scope of work: Our review considers the potential pension implications that may arise in the CalMac Pension Fund under the 11 options. We note that CMAL / CFL also participate in industry-wide defined pension arrangements (MNOPF and MNRPF) as well as defined contribution pension arrangements – on grounds of materiality, we have not considered the potential implications for these pension arrangements. We recommend that an independent legal review is undertaken of the governing documentation in the CalMac Pension Fund to assess whether there are any legal risks that may arise under any of the 11 options.

Key:

- Principal employer
- Participating employers
- Defined benefit pension fund
- Cashflows and securities



Options 7 - 9 all involve either the principal employer (CMAL) or a participating employer (DML or CFL) transferring to the private sector. Pension legislation requires another employer to step in as principal employer, and the liabilities for the leaving employer must be taken on by another participating employer or otherwise funded by lump sum payment.

CalMac Pension Fund snapshot:

Pension fund assets £196.6m [2]
Gross funding obligations £(224.7m) [2]
Gross buy-out obligations £(394.5m) [2]
IAS 19 balance sheet £68m deficit [3]

Closed to new members, but open to future DB accrual. Employers pay ongoing contributions of 30.8% of employees' pensionable salaries which totaled c. £50m p.a. at 6 April 2018 (employees contribute 6% of pensionable salaries).

Total number of members as at 6 April 2018: 2,131.

Valuation at 6 April 2021 is currently underway (statutory deadline for completion is 6 July 2022)

Note 1: Based on the Schedule of Contributions agreed at the 6 April 2018 actuarial valuation for funding purposes
Note 2: Based on the actuarial basis determined by the trustees (i.e. Technical provisions) for the latest actuarial valuation as at 6 April 2018
Note 3: Based on the latest IAS19 pension accounting disclosures as at 31 March 2021
Note 4: Information provided by Aon who confirmed that the total membership numbers for each employer participating in the scheme are based on the latest scheme return
Note 5: We do not know the liability or asset obligation for each of the separate employers. We only know the total liability for the scheme as a whole.
Note 6: Information provided by Aon who confirmed that CMAL provide a Protection Pension Fund (PPF) compliant Section 75 (S75) guarantee to the Fund