Report from Private Industry User group Workshop:

STATE INTERVENTION IN SCOTTISH SHIPPING MARKETS

Annex 2.3.3 to the Final Report

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Napier University
Transport Research Institute
PREFACE

This workshop report has been written as part of the SUTRANET project (Work Package 2: Motorways of the North Sea). SUTRANET (‘Sustainable Transport Research & Development Network in the North Sea Region’) is a project within the framework of the European Commission’s (EC’s) Interreg IIIB North Sea Programme.

The report describes the user group workshop with stakeholders from the Scottish shipping industry held in Edinburgh on 29 November 2006. The workshop was initiated and organised by Napier University’s Transport Research Institute (TRi).

SUTRANET, June 2007

Jorgen Kristiansen, Aalborg University, Denmark
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Summary</td>
<td>2</td>
</tr>
<tr>
<td>1 Introduction</td>
<td>4</td>
</tr>
<tr>
<td>2 Role of the state in Scottish shipping</td>
<td>5</td>
</tr>
<tr>
<td>2.1 State ownership of shipping companies in the EU</td>
<td>5</td>
</tr>
<tr>
<td>2.2 Expanding role of the state in Scottish domestic shipping</td>
<td>7</td>
</tr>
<tr>
<td>2.3 Introduction of new subsidy schemes</td>
<td>9</td>
</tr>
<tr>
<td>2.4 Failings of current policy</td>
<td>12</td>
</tr>
<tr>
<td>2.5 Perspective of private shipping operators</td>
<td>13</td>
</tr>
<tr>
<td>2.6 Port and terminal facilities used by state-owned carriers</td>
<td>15</td>
</tr>
<tr>
<td>2.7 Private shipping operators' access to ports</td>
<td>16</td>
</tr>
<tr>
<td>3 State financing of competing transport infrastructure/modes</td>
<td>17</td>
</tr>
<tr>
<td>3.1 Road transport subsidies</td>
<td>17</td>
</tr>
<tr>
<td>3.2 Railway subsidies</td>
<td>18</td>
</tr>
<tr>
<td>3.3 Air transport subsidies</td>
<td>18</td>
</tr>
<tr>
<td>3.4 Highlands &amp; Islands Air Discount Scheme</td>
<td>19</td>
</tr>
<tr>
<td>3.5 Anti-competitive policy</td>
<td>20</td>
</tr>
<tr>
<td>4 Conclusions</td>
<td>21</td>
</tr>
<tr>
<td>Annex I: Workshop Agenda and Participants</td>
<td>23</td>
</tr>
<tr>
<td>Annex II: Northlink Rate Structure History (2002-2007)</td>
<td>24</td>
</tr>
</tbody>
</table>
Executive Summary

Over the past several years the Scottish Executive (SE) has expanded the role of state-owned carriers (CalMac/Northlink) in Scottish domestic shipping. This goes against EU policy and trends, where the European Commission has sought greater liberalization of EU Member State shipping markets in an effort to bring about increased private sector investment and operation of shipping services, including subsidized services.

The SE has recently introduced new subsidy schemes, for freight, livestock, and passengers, to the direct benefit of state-owned carriers who are already in receipt of deficit funding, without appearing to consider the negative effects this has on private shipping operators, the latter generally excluded from public subsidy. The seemingly continuous introduction of new subsidy schemes over recent years results in a perpetually changing and distorted market place as far as private shipping operators are concerned. This makes planning difficult and also affects future private investment in the sector. A consequence of this is that some private sector shipping companies have ceased to operate, and this is understandably of serious concern to the remaining private operators.

The aim of subsidy should not be to replace private sector investment or indeed to remove private sector operators from the market, yet this seems to be the direct outcome of current and recent SE policy and state intervention in Scottish shipping markets.

The new Air Discount Scheme (ADS) for passengers also adversely affects the competitiveness of private ferry operators. ADS was introduced in 2006 without any tender and primarily benefits private airline operators, as witnessed by a rapid increase in air travel demand and air transport capacity. If such a system can be very rapidly introduced for the benefit of private airlines, there seems no reason why the same system should not have been extended to include private sea transport operators.

In instances where state-owned carriers experience operating cost overruns, seemingly a perennial problem particularly with Northlink, the SE has provided additional cash to cover these losses during contract periods. This means state-owned shipping companies are treated more or less like over-spending government departments. Thus, state-owned carriers would appear to receive additional public subsidy as and when required; the state being the only shareholder makes this outcome somewhat inevitable. Private sector shipping operators have no recourse to similar ‘state bankrolling’. This practice serves to further distort shipping markets.

State financing of port infrastructure and associated intermodal facilities, plus public sector blocking of reasonable harbour access to private operators, to the ultimate benefit and protection of state-owned carriers, further distorts the shipping market to the disadvantage of private operators.
The SE approach with respect to setting up the new VesCo (CMAL) and CalMac arrangement appears rather unique in the EU ferry sector, and is clearly not obligatory under EU rules. This unusual administrative ‘model’ seems more or less designed to maintain the status quo and hence continuation of extensive state-owned shipping operations in Scotland.

The inflexibility of ferry tender specifications set by the SE, with bid conditions weighing in favour of state-owned operators, including state-operator bid costs paid for by the taxpayer, has resulted in private sector withdrawals from tendering processes and a general lack of interest from most private operators. Whether by design or accident, the inevitable yet unsatisfactory outcome of this is that the only bidder left to bid in recent tenders has been a state-owned carrier.

In regard to international shipping and EU Motorways of the Sea (MoS) policy, the SE needs to consider how it can help to further improve the competitiveness of the strategically important privately-operated Superfast Ferries service. The latter is placed at an ongoing competitive disadvantage due to continued state provision of non-tolled motorway access throughout the UK for HGV’s. The state needs to consider carefully how such distortions might be overcome. The SE could consider the new EU TEN-T MoS funding programme to help Superfast reinstate a daily service frequency on the Rosyth-Zeebrugge route. A further option may be modal shift incentives similar to the Italian EcoBonus scheme for truckers.

In summary, SE policy on shipping matters seems at best confused, and at worst discriminatory. There is a strong emphasis on maintaining, protecting and expanding state-owned shipping operations, to the disadvantage of private operators. The increasing and constantly changing state subsidies applied by the SE, mostly for the direct benefit of state-owned carriers, serves to further adversely affect the competitiveness of private operators, reducing the potential for private sector investment and innovation.

Scottish Executive shipping policy seems entirely at odds with EU policy, the latter supporting continued market liberalization and a greater role for the private sector in provision and modernization of shipping services, as well as support for modal shift initiatives. The EU policy approach is based on the widely held view today, and not only in Europe, that it is neither necessary nor advisable for the state to own, operate and crew ships, just as the state is no longer required to provide vehicles and operate services in the bus, rail or air transport sectors.

The SE urgently needs to consider the process by which it might withdraw from owning and operating shipping businesses, in line with policy and best practice throughout the EU, thereby facilitating market liberalization and greater private sector investment and innovation, whilst ensuring essential services are maintained through operating concessions as necessary. Given the conclusions of this report, and the ongoing experience within other Member States, it might be anticipated that the European Commission will expect no less an outcome.
1. Introduction

SUTRANET (Sustainable Transport Research & Development Network in the North Sea Region) is a project funded under the EC Interreg IIIB North Sea Programme. The vision of SUTRANET is to improve the knowledge-base for developing efficient and sustainable transport networks in the North Sea Region.

SUTRANET’s aim is to expand the reserve of knowledge upon which transport related policy is founded. A key assumption is that decisions based on a better understanding and awareness of this field could lead to improved efficiency and sustainability in transport networks, notably within ferry services and short sea shipping. This in turn will help regional development and interactions.

SUTRANET is led by Aalborg University in Denmark and consists of ten partner organisations, including many of the major transport and logistics research institutes in Europe. The SUTRANET project consists of 4 work packages:

- North Sea Transport Research and Development Network
- Motorways of the North Sea
- Transport and Logistics Centres
- Training Programme Development

Further information concerning the SUTRANET Project can be obtained from: www.sutranet.org

One of the activities in SUTRANET involves coordination of industry User Group workshops. The aim is to explore relevant issues relating to provision of efficient and sustainable sea transport services. This particular report relates to a workshop that was organized to consider the issue of state funding of shipping services in Scotland, and in particular the impact this has on competing private sector shipping firms.

In recent years the amount of state funding provided by the Scottish Executive specifically for domestic sea transport services and across other transport modes has increased substantially. However, state funding of shipping services within Scotland is more or less entirely focused on state-owned shipping services, with private sector operators largely excluded from receiving public support.

The majority of major vessel owning/operating companies active in Scotland attended the SUTRANET workshop. The workshop covered a number of issues ranging from the operation and subsidy of state-owned shipping services, to port ownership and financing, and the introduction by the Scottish Executive of new and revised subsidy schemes. The aim was to assess the impacts of state intervention on private sector shipping operations in Scotland. The workshop agenda and list of participants is attached as Annex I.
2. Role of the state in Scottish shipping

2.1 State ownership of shipping companies in the EU

The present Scottish Executive (SE) policy reflects the fact that the state believes it must actually own outright firms that operate domestic (i.e. Scottish) ferry services, as well as the vessels employed, in order to maintain an effective service to island and other remote communities. However, the SE does not take this approach with other equally important transport modes, such as buses, trains or airlines. In this regard it is unclear why the state needs to own and operate ferries, particularly when such services often compete head-to-head with private operators.

State ownership and operation of shipping services is moreover contrary to industry trends occurring throughout the rest of the EU. Paradoxically, the privatization of state-owned domestic shipping services in the EU arguably began in the UK with the privatization of Sealink (British Rail Ferries) in the 1980s, followed by the sale of B&I (British & Irish) Line. For some reason or other this process was not extended to Scottish state-owned domestic shipping companies.

More recently, the Spanish government has sold its interest in domestic ferry company Transmediterannea to private operator Accionia, while the French government has transferred much of the ownership of SNCM to the private sector. The joint Danish and German state-owned Scandlines services have also recently been going through a privatization process and the new private owner of the company was announced in June 2007. In the latter case, both the company and its assets were sold. Also in Denmark, the government is currently considering the outright sale of state-owned Bornholmstraffiken, the ferry operator maintaining links between mainland Denmark and the island of Bornholm. In Sweden, a private operator maintains ferry services to the island of Gotland with the aid of government subsidy.

In Greece, private operators maintain all of the many island ferry services, some of which receive subsidy. Services between Malta and Gozo are likewise provided by private sector operators, as are services throughout the Canaries, and the Balearics.

A large number of ferry services throughout the EU are maintained with government subsidies through Public service Contracts (PSC’s). However, a basic principle applied in virtually all instances is that private companies, not the state, should operate ferry services.

With the exception of Scotland, the only EU country still maintaining a large state-owned ferry operator is Italy. Even there, however, state-owned operator Tirrenia has come under sustained criticism from the Italian Shipowners Association Contifarma, and from the EC. The Italian government is now under pressure to fully privatize the company. Tirrenia competes directly against Contifarma members on a number of domestic trades, including Sardinia and Sicily.
According to Contifarma, Tirrenia was supposed to be sold off long before now as part of an earlier agreement with the EC, but the Commission allowed an extension of state-ownership until 2008. Contifarma has objected to the Italian government proposal to the EC for a further four-year extension of Tirrenia subsidies until 2012. State subsidies given to Tirrenia have continued to increase in response to its rising operating cost structure and reducing market share. Such market distortions, suggest Contifarma, pose a considerable risk to its (private sector) members as well as to the freedom of the market, and the interests of users. Contifarma’s protest to the EC maintains that any extension between the state and Tirrenia is entirely the opposite of what the Commission wishes to see from member states, which is the complete withdrawal of the state from owning and operating ships.

The Italian government has since announced its intention to bring forward a privatization plan for Tirrenia by the end of 2008. The government stated that the Commission has refused to give the state company any more time. Tirrenia could be sold as an entire company, or perhaps unbundled into groups of shipping services. Various private owners and private equity funds are expected to be interested in buying the company and its assets. According to Contifarma, the sale of Tirrenia, which has become uncompetitive ward of the state and an active obstacle to private investment in the sector, is a long-overdue admission of the inevitable.

It is evident from the above that in other EU states the former publicly owned domestic ferry companies have either now been sold to the private sector or are currently going through this process. The method of sale has typically involved outright disposal of the respective companies and their assets and services. However, certain port facilities may be retained in the ownership of public port authorities/state/local authorities, allowing individual ports to cater for competition between ferry lines, offering impartiality to any and all users.

The SE has adopted an entirely different approach compared to the rest of the EU, and seems determined to retain CalMac and its sister-company Northlink in state ownership. The SE has recently established a vessel and asset owning company (VesCo – known as Caledonian Maritime Assets Ltd), whilst at the same time supporting the bid of a now ‘separate’ CalMac operating company in its effort to secure the forthcoming tender to continue to operate ferry services, with both entities (assets and operations) still owned 100% by the state.

The SE claims this approach is necessary to comply with EU rules on state aid. However, it is clear that this form of approach is in fact highly unusual and has not been adopted by any other EU member state, so it is clearly not in any way obligatory. Moreover, it represents anything but a proven model, and appears reminiscent of the discredited UK railway reform process (i.e. RosCo – ‘Rolling Stock Company’ and OpsCo – ‘Operating Company’). It seems unlikely that the European Commission would prefer the SE option of VesCo plus continuation of state-owned ferry operator CalMac (and Northlink for that

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matter), as opposed to the more typical method of privatization adopted by other member states. The Commission is clearly advocating the sale of state-owned ships and transport services to private operators with the aim of achieving service innovation, modernization, access to superior management practices, international expertise, and economies of scale, for the ultimate benefit of communities and economies served.

Evidence from throughout the EU suggests the Scottish ferry market would benefit from reform, and a shift away from an increasingly expensive state-owned monopoly provider, whilst employment would be safeguarded. However, the SE is actually now doing the exact opposite; since 2002 the SE has helped to create a further state owned shipping operator – Northlink – the latter being awarded contracts in 2001 and 2006 to operate services to the Northern Isles, squeezing out private sector bidders and investment in the process. The SE is therefore expanding the role of the state through its ownership of Northlink, in addition to state ownership of CalMac/VesCo, and this is entirely at odds with EU policy and developments elsewhere in the EU.

2.2 Expanding role of the state in Scottish domestic shipping

CalMac is today one of the last nationalized ‘industries’ in Scotland remaining in full state ownership. State ownership/operation of any commercial enterprise is usually a good reason why the private sector needs to be brought in to change things (e.g. to improve ship design and procurement, technology, operations, management, working practices etc), for the benefit of markets and hence customers. The SE seems oblivious to the advantages market liberalization would bring, and appears intent on maintaining and indeed expanding the state-owned shipping sector indefinitely, contrary to EU policy in this area.

The weakness of this strategy is most evident with the CalMac approach to ship acquisition. Private sector operators claim that larger vessels in the fleet often have far too much passenger capacity for the routes served, resulting in high manning levels and limited utilization of capacity. Moreover, there is a preference towards large traditional slow-speed designs, when on some routes more optimized ship types could offer a superior service, operationally and economically (e.g. catamarans, medium-speed and high-speed vessels).

Building inappropriate vessels (usually one at a time, unlike most private operators), and ignoring opportunities for major service enhancement is regarded as characteristic of a state-owned enterprise. Ignoring potential for more optimized ship designs results in a loss of opportunity to maximize benefits from innovation for the communities served. This is also one of the main potential weaknesses of the SE’s unique (in the ferry sector) and unproven VesCo concept. For example, VesCo is responsible for decisions on optimal ship designs for all routes. This therefore removes all decisions regarding optimal ship type from private operators assuming, that is, private operators win any of the future operating contracts. Clearly, private bidders will tend to have very different views on optimal ship design and the operation of specific routes, and the level of innovation that is possible. The VesCo
approach ignores and indeed prevents the potential for market innovation, operating on the assumption that state-owned ferry asset managers know better than commercial ferry operators, which is highly unlikely. As the current operating cost structure of the CalMac network is very largely determined by the fleet employed and its associated manning arrangements (crew costs alone accounting for over half of total operating expenditure), the VesCo arrangement means that the underlying operating cost structure will not alter and therefore the overall system will not receive any benefits from a more commercial entrepreneurial/innovative orientation.

Inadequate and inappropriate ship designs/configuration, high manning levels, and high capital costs, results in an inefficient cost structure relative to private sector operations. It also results in a poor overall level of service quality and high transport prices for the economies and communities served, despite rising subsidy levels\(^2\). Delivery of ferry services on the current ‘model’ will therefore continue to demand high and increasing levels of subsidy, whilst at the same time ignoring the benefits to be gained from innovation, to the disadvantage of the communities served.

The SE uses the term ‘lifeline’ to describe subsidized ferry services. ‘Lifeline’ suggests a degree of fragility in regard to the routes and communities served. It also instills an element of fear (especially fear of change) amongst users. Yet, in certain cases it is private operators who even today carry most of the commodities such communities depend on for their survival, such as lpg and Hazardous cargo carried on Pentland Ferries service between Gill’s Bay and St. Margaret’s Hope in Orkney, and on Streamline’s container link between Aberdeen and Orkney/Shetland. Hence the term ‘lifeline’ is often confused with public sector provision of an essential service, which is not necessarily the case; the reality, in Scotland and indeed throughout the EU, demonstrates that it is perfectly possible for the private sector to maintain essential shipping services, with or without subsidy, using privately-owned and operated ships.

The SE claims that private operators would seek to ‘cherrypick’ the good routes but ignore the poor performing routes. However, as the recent CalMac trading accounts make clear, all of the Scottish routes are loss making. In any event, private sector operators do not see ferry routes in this light. Rather, private operators see the need and opportunity for innovation, to serve routes in a different way, in some cases with different and more optimized vessels, giving scope for improved service frequencies, extended operating hours, and more flexible working practices to cater for the ever changing needs of the market, at the same time improving the underlying operating cost structure. Service innovation of this nature would be expected to drive up demand, and hence revenue, in turn reducing subsidy levels at the same time as improving service quality.

The inflexible nature of the tendering arrangements, for both the Western Isles and Northern Isles, has been a critical limiting factor in recent tender

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processes as far as private operators are concerned. As vessels and ports are a given, as are schedules, pricing, and labour, there is arguably no scope for innovation. The tender processes are predicated on the assumption that decision makers connected with state-owned ferry services (i.e. CalMac, Northlink, Scottish Executive civil servants, and politicians) know the ferry business sufficiently that they are capable of designing an optimized ferry system, inclusive of best port locations and optimal ship designs/configurations. In reality, none of these entities are likely to have the knowledge and expertise of the private sector ferry operator, and more especially international operators.

The advantages that would result from private sector ferry operation will only be achieved through market liberalization, whilst simultaneously putting in place safeguards to protect the communities concerned. At the present time the market is heavily constrained through the heavy-handed approach of the state, and the outcome is inferior service levels which adversely affects the competitiveness of the economies and communities served, and which also results in constantly rising subsidy levels. Moreover, with seemingly no limit to subsidy awarded to state-owned carriers to cover ever rising operating losses, there is arguably little incentive for innovation on their part.

2.3 Introduction of new subsidy schemes

Over the last few years the SE has introduced several new transport subsidy schemes in a seemingly arbitrary fashion. These schemes always have the effect of benefitting state-owned carriers, but they tend to have quite the opposite effect on private shipping service providers. Recent examples include:

(a) A new freight subsidy introduced in 2006 for the benefit of state-owned Northern Isles operator Northlink Ferries, serving to further distort the market against private operators;

(b) The ‘promise’ of a container freight subsidy to help mitigate the adverse effects of additional freight subsidies for the state-owned ferry operator;

(c) The introduction during 2006 of an Air Discount Scheme (ADS) subsidy, giving island residents traveling by air a 40% discount on fares from islands and remote regions of Scotland, which has a material effect on the choice of transport mode selected.

Additional subsidy awarded to Northlink in 2006 specifically for freight carried has resulted in significant reductions in that operator’s rates, to the detriment of private sector competitors. Annex II illustrates the effect additional subsidies have had in reducing Northlink’s freight rates for different routes. Essentially, whilst such subsidies will benefit users, they also have the effect of under-cutting the freight rates of private operators and thereby distort the market.
With regard to a LoLo container shipping subsidy, the original advert for this was placed in August 2005. It stated that the Scottish Executive sought to place a contract for a subsidy with a suitably experienced and qualified organisation to operate a load-on load-off (LO-LO) freight only shipping service to the Northern Isles (Orkney Islands and Shetland Islands) and any associated activity. The support was offered as a public service contract for an operating subsidy under EU Regulation 3577/92, the same regulation governing ferry subsidies.

An unsubsidised service is currently operated by the Streamline Shipping Group, using the Daroja on the Lerwick-Kirkwall-Aberdeen route. Two companies were subsequently invited to submit tenders, Streamline and Eimskip UK Ltd, though the latter pulled out. The selected bidder was to be announced in the summer, with the new contract to start later in 2007. The new contract is for two round trips on the route each week, with subsidy to be paid on each tonne carried, up to a set limit.

As of end June 2007 no LoLo subsidy contract had been put in place. This means that Northlink has had the advantage of almost two years additional freight subsidy (over and above its ‘normal’ operating subsidy). No compensatory freight subsidy scheme has been proposed for the remaining private shipping operators serving the same markets (e.g. ferry operators).

The primary commercial beneficiary of the Air Discount Scheme (ADS) subsidy introduced by the SE in May 2006 is private airline Loganair, the latter operating a BA franchise between Scottish islands and mainland Scotland. An obvious question here is why this private transport (air) operator should receive a 40% subsidy, but not private ferry (sea) operators serving the same communities?

The new air subsidy also impacts on state-subsidised ferry operators because passengers will make a decision to travel either by air or by sea. For the state-owned subsidized shipping operators this perhaps does not matter so much as the greater the losses that they make simply means more state subsidy is paid to them, as demonstrated in the period 2002-2005. In this respect state-owned ferry operators are treated by the SE in much the same way as an over-spending government department.

Within a few months of the ADS subsidy being introduced, Loganair announced a need to increase aircraft capacity by 50% or more on some services to take account of the rise in demand. This extra traffic is undoubtedly due to increased demand from island residents who used to travel by ferry but who now instead travel by air because of the 40% state subsidy on airfares. The SE has clearly not thought through the implications of the Air Discount Scheme, and in particular the impact this has on competing transport services, particularly non-subsidised private ferry operators.

In March 2007, it was announced that February’s passenger traffic at Kirkwall Airport in Orkney had grown by a “massive” 26.6% compared to the same
month in 2006\(^3\). Highlands & Islands Airports (HIAL) put down the rapid rise in volumes to the Air Discount Scheme. HIAL further stated that an additional 71,000 passengers used its 10 airports since April 2006 compared to the same period in 2006/06.

Also during March 2007, the former First Minister Jack McConnell announced that there would be a similar 40% discount applied on lifeline ferries for island residents from 2008, expected to cost the Executive a further £5 million\(^4\). However it is uncertain if this further additional subsidy would apply to private operators. If it is not, as seems to be implied, this would lead to further state-sponsored discrimination against private ferry operators. Moreover, while this new proposal and the ADS 40% subsidy reduces transport costs for island residents, it does not apply to other travelers such as tourists, which also seems discriminatory.

It is of serious concern to private shipping operators that government is making rate changes after contracts are signed between the SE and its state-owned operators covering new concession arrangements. This has happened on freight/livestock carried by Northlink Ferries, to the disadvantage of private operators who compete for the same traffic. In addition, there is significant inconsistency on tariffs, with an entirely different approach in respect to freight for the Western Isles compared to the Northern Isles, and with recent disclosures of further ‘hidden’ subsidies for state-owned CalMac adding to the concerns. According to Western Ferries, the Scottish Executive has confirmed in correspondence that over a period of several years hauliers have been receiving discounts of over 70% from CalMac, at taxpayers’ expense\(^5\). The episode has resulted in a formal complaint from Western Ferries to Audit Scotland.

Over recent years subsidy levels have been increased to state-owned carriers well above that stipulated in contractual agreements. Northlink’s annual subsidy increased threefold from £11 million/year to over £31 million/year during the 2002-2005 period, remaining at the higher level ever since. The SE has given various explanations for this, including higher fuel costs, higher labour costs, and, perhaps most bizarre of all, to cover the ‘effects of competition’. With respect to cost overruns, state-owned carriers more or less have to explain to the SE why their costs have increased, and this then results in additional subsidy payments forthcoming from the shareholder (i.e. the state). In the real world, private sector carriers have to either absorb such additional costs or pass them on to the customer through increased charges; private sector operators do not have the luxury of a ‘state bank’ that they can go to when they need more money.

Former UK Transport Secretary Douglas Alexander MP recently decided that the government should not use taxpayers’ money to bail out private train

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\(^3\) Anon (2007) High increase in air passenger numbers, The Orcadian, 22\(^{nd}\) March, p. 13.
\(^5\) Western Ferries News Release, 22\(^{nd}\) December 2006 (Richard Meade, Fleishman Hillard, Edinburgh)
operators such as GNER when such companies fall into financial difficulty. GNER operates, under contract to the government, the UK's east coast mainline rail franchise. Conversely, the Scottish Executive has no option but to bail out its own loss-making state-owned ferry companies. The solution to this has to be for government to remove itself from the ferry business altogether, as is the case with all other modes of transport and transport services, in line with developments in the ferry sector throughout the EU.

2.4 Failings of current policy

A consequence of the SE’s shipping policy is that subsidy paid to state-owned operators has been constantly increasing and now appears to be out of control. The introduction of new subsidy schemes has exacerbated the position as far as non-subsidised private shipping operators are concerned. This means that market distortions are worsening all the time, placing added pressure on non-subsidised carriers. It also means there is less chance of private operators entering the market, and indeed there is the very real prospect of existing private operators leaving the market.

In fact, there has been a number of private sector shipping ‘casualties’ over recent years, including Orcargo (Orkney), Norse Island Ferries (Shetland), and Taygran Shipping (Western Isles), all of which have left the market as a result of increased subsidy payments being made by the SE to competing state-funded operators. The issue here is that rising subsidy levels applying to state-owned operators (and also now applying to private airlines) can effectively remove competing non-subsidised private operators from the market. It needs to be recognized that this is entirely likely to be the continued outcome from such a policy, a policy that if anything is moving even further in favour of state-owned carriers.

If subsidy is necessary and is intended to lower transport costs for island economies and communities, which should be its primary purpose, then subsidy should be made available fairly to all service providers based on actual demand, as with the recently introduced Air Discount Scheme. If this method of subsidy (i.e. ADS) is possible for air transport operators, and introduced without the need for any tender procedure, it should also be equally applicable to sea transport operators.

Basically any commercial airline serving the islands can benefit from the ADS subsidy. Similarly, a comparable Sea Discount Scheme (SDS) could very easily be implemented, and applicable to any commercial shipping operator on specified routes. This would also have the important effect of rewarding successful operators; that is, those operators carrying the most traffic, whereas the current method of subsidization is used to cover the higher operating costs of state-owned shipping services.

Private shipping operators in Scotland can appreciate the rationale in making transport costs cheaper for users, whether for passengers or freight. What cannot be accepted, however, are the distorting effects such subsidy schemes have on private, non-subsidised shipping operations serving the same
markets and communities. UK competition/regulatory bodies have been less than interested to intervene in what is seen as a state aid matter. Similarly, the Auditor General in his investigation into the enormous extra subsidy payments made to Northlink Ferries during the period 2002-2005 has been reluctant to criticize the SE on the apparent basis that state-owned subsidised ferry services have a specific legal and governmental status. In other words, it would appear that the SE believes it can simply provide more subsidies ad nauseam for state-owned operators (and now also for private airlines) without consideration of the impacts this has on competing non-subsidised shipping operators.

Based on recent experience elsewhere and reflecting EU policy, it is likely that the European Commission will take a rather different view of this situation.

2.5 Perspective of private shipping operators

Subsidy is generally regarded by private enterprise as a ‘bad thing’, although where there is a demonstrable social requirement to maintain an essential transport service this is considered acceptable. However, when subsidy ‘gets out of control’, with levels fluctuating widely and suddenly, and with subsidy aimed almost exclusively at state-owned operators, this is unacceptable. Subsidy for Northlink Ferries was initially supposed to be around £11 million per annum, and this has now risen to £31 million per annum in less than 4 years. The SE argue this is because Northlink is the ‘lifeline’ carrier, yet in a number of cases private operators are also carrying much of the hazardous goods (LPG, animal feeds etc.), as well as general freight, livestock and passengers.

The present ‘subsidy system’ has a long and chequered history. In the view of private operators, state-owned shipping operators are treated not like commercial entities but more like ‘government departments’. The state appears entirely consistent in applying a ‘blank cheque’ approach to state-owned carriers, covering any and all cost overruns for whatever reason. In tender processes, it is evident that the SE favours state-owned carriers and more or less expects its wholly owned carriers to win the tenders. This has resulted in private sector operators withdrawing entirely from the tender process. In regard to its withdrawal from the Clyde and Hebrides ferry tender, ship management firm V.Ships stated that:

“…..the various constraints within the tender do not allow the company to maximize its services to the communities directly involved and there would be little opportunity to add value via creative management and innovation.”

(The Scotsman, 30th January 2007)

Similarly, in withdrawing from the Gourock-Dunoon tender, Western Ferries noted that:

“Information issued by the Executive was inconsistent, subject to alteration and delay. The critical carrying and financial information was
available to CalMac from the start of the tender process, but it took Western Ferries 11 weeks to receive it.”
(The Herald, 14th November 2006)

CalMac’s recent bid documentation submitted to the SE to again operate its services amounted to more than 100,000 pages, in a process reported to cost the company (i.e. the taxpayer) in excess of £17 million, and taking 6 years to complete. The relevance of such an extensive level of bureaucracy and complexity in the bidding process, in addition to the very high cost associated with putting a bid together, is questioned by private operators, and given as some of the reasons for the lack of private sector interest shown.

Ultimately, because they own shipping firms, Ministers have little alternative but to allow state-owned ferry lines to operate on a virtual blank cheque basis, which is an unacceptable practice as far as private shipping operators are concerned and should not be allowed to continue. This practice needs to be made illegal, if it is not already in fact illegal under EU rules on state aid for maritime transport. The only outcome of such a discriminatory policy in the long run is the commercial failure of private operators coupled with an avoidance of private enterprise and innovation that would be expected to generate benefits for remote communities/economies served; this should be neither the aim nor the outcome of any subsidy regime.

Tendering the CalMac route network as a ‘single bundle’, as intended, will prevent market entry and favours the state-owned company. Private operators consider it imperative to split the routes for tender. The main reason for this is that while some routes do need subsidy, others do not, in the opinion of private sector operators, notwithstanding that CalMac declares all its routes to be loss-making. The current delivery model involves huge losses, for both state-owned carriers CalMac and Northlink, and high prices, and this also highlights the fact that a single bundle is not an optimal solution. There is now an increasingly urgent need to allow private operators the freedom to deliver better quality and more efficient service on specific routes.

With respect to the 2002 Northern Isles tender, private sector operators highlight the fact that the lowest bid from P&O was not accepted, the SE instead selecting a higher-cost state-owned bid from Northlink (then part state-owned, now fully state-owned). The winning bidder subsequently went well over budget, requiring large amounts of additional subsidy (in excess of £31 million/year). An important point here is that it is questionable that a privately owned operator would have been bailed out to anywhere near the same extent as a state-owned carrier. Moreover, despite its massive commercial failure over the 2002-2005 period, Northlink was subsequently selected once more as the ‘new’ operator in a further tender exercise during 2006, in preference to private sector bidder V.Ships.

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With regard to a level playing field, it is evident that private shipping operators in Scotland have yet to find a field on which they can play. Impediments to free and fair competition are reflected in the quite extraordinary levels of subsidy now being awarded by the SE to its protected state-owned shipping companies, supplemented by frequent introduction of additional subsidy schemes and payments directed primarily at state-owned carriers.

2.6 Port and terminal facilities used by state-owned carriers

It seems to be accepted by the SE that the state should finance port infrastructure used by state-owned ferry operators’ ships. However, the state does not finance port infrastructure used by competing privately operated shipping services, the latter must be financed and paid for by the private sector. In the view of private operators this represents a further and substantial market distortion. Not only do state-owned carriers receive subsidy for ships and ship operations, they also have the benefit of terminals that are built and paid for at taxpayer expense.

For example, in enabling Northlink Ferries to commence Northern Isles operations during late 2002, the SE invested in excess of £60 million in new port and terminal infrastructure at several ports, including Aberdeen, Scrabster, Kirkwall, Stromness and Lerwick. Yet the SE has made no public finance available to competing private shipping operators to assist with the cost of their port infrastructure/facilities.

This is an ongoing process. Proposed alterations costing in excess of £1.0 million to the passenger facility and in respect of a new livestock lairage at the state-owned ferry operators Kirkwall terminal, are to be financed by the state (national and local government). This is despite the fact that private operator Pentland Ferries is now carrying most of the sheep out of Orkney to mainland Scotland, using its own privately financed terminals elsewhere. Clearly, private operators stand to be disadvantaged because of ongoing public subsidies that are used to improve state-owned competitors’ port/terminal facilities.

Also of concern is SE and local authority investment in new specialized livestock containers for the Northern Isles. These containers will only be available for use at the state-owned operator’s state-funded on-terminal lairage facilities, and therefore will only be carried on the state-owned carrier’s vessels. The containers will not be permitted to be used on competing private operators’ vessels using other ports. The purchase of these containers by the state and their selective use only by state-owned carriers, serves to direct traffic to specific terminals, and represents a further distortion to competition.

This implies that not only is the state financing shipping operations of state-owned carriers, in different ways, it is further distorting the market through port infrastructure subsidies, and also with respect to subsidies for provision of specialised intermodal freight units and associated on-terminal logistics facilities.
2.7 Private shipping operators’ access to ports

Private sector operators can have difficulty gaining access to state-funded port facilities. This barrier to entry is expected to continue with establishment of the state-owned VesCo (Caledonian Maritime Assets Ltd), which will have control over terminal assets, the latter expected to serve primarily CalMac ferry services. In general, shipping operators expect ports to be open to all reasonable users, as in other EU countries.

Private operators also encounter difficulties where local authorities own harbour facilities and when such entities seek to prevent use of these facilities by private operators in an effort to protect the market share of state-owned ferry services. For example, Pentland Ferries has been refused access to Burwick Harbour in Orkney by the port owner, Orkney Islands Council, in an alleged effort by the Council (and the state) to protect competing state-owned operator Northlink Ferries operation across the Pentland Firth.

The blocking of publicly-owned ports to private operators and the ongoing funding by state entities with respect to port infrastructure, port facilities, and intermodal equipment to the benefit of state-owned carriers, has a significant influence in artificially strengthening the competitiveness of state-owned ferry operators. These issues need to be addressed to ensure a level playing field exists, to bring about innovation and modernisation, to overcome barriers to entry, and to ensure service improvements for remote communities. The actions of the state in this respect only serve to worsen market distortions and inefficiencies, leading to rising subsidy levels, while simultaneously depriving local communities of improved services through innovation.
3. State financing of competing transport infrastructure/modes

3.1 Road transport subsidies

For access to international markets, road transport infrastructure from the Channel ports through England to/from Scotland is free at the point of use (i.e. there are no road tolls imposed on users). Government provides this road infrastructure, which is paid for by the UK taxpayer. Moreover, the real cost of road transport is much more than simply the cost of providing and maintaining road infrastructure; the DfT’s own figures suggest that every road mile of freight costs an additional £0.51 to the public purse, taking into account congestion, pollution and accidents, resulting in an invisible subsidy of £7 billion for the UK as a whole.

Whereas road infrastructure is provided free by the state, private ferry operators such as Superfast Ferries are expected to provide the North Sea ‘Motorway of the Sea’ (MoS) platform between Rosyth-Zeebrugge (400 miles). MoS are what the EC’s van Miert High Level TEN-T Group referred to as ‘floating infrastructure’. Within SUTRANET, MoS is defined as comprising both the deck of a ship plus port infrastructure.

Taking advantage of the free road infrastructure, international road traffic between Scotland and continental markets is nowadays increasingly carried by low-cost East European truck drivers, with reducing volumes carried by UK-based drivers. These vehicles also have the advantage of being able to load up with cheaper fuel on the continent, sufficient for a roundtrip in the UK. The Road Haulage Association claims that such vehicles are inadequately regulated, resulting in poor quality/maintained vehicles, and overloaded trailers etc.

Superfast Ferries main competitor in the freight market is therefore the 500 miles of free motorways between central Scotland and the Channel ports, and the 250 miles of free motorway to Humber ports. Superfast Ferries must fully charge for the provision of its privately maintained seaway (i.e. ships’ deck, as floating infrastructure) for the entire route, whereas alternative road infrastructure is provided free by the state for much of the same route over land. This results in a distorted transport market.

As these distortions exist today, then it stands to reason that if government wants to see more freight move by ‘Motorways of the Sea’ it will have to compensate long-distance ferry operators/users with some form of tariff rebate scheme. This form of support has the benefit of potentially rapid introduction, thereby helping to secure the position of the privately financed

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MoS service, whereas road charging in the UK is believed to be several years away. Another possibility would be some form of ‘EcoBonus’, as introduced by the Italian government, giving a direct incentive to truckers to shift from road to sea. The EcoBonus scheme will pay for between 20-30% of the sea-freight rate charged by the shipping operator providing the MoS platform.

In general, aside from domestic island trades, the UK/Scottish governments do not provide subsidies for sea transport. In this respect sea transport infrastructure means both the seaway itself (i.e. the deck of a ship) as well as the ports (i.e. the nodes). This re-definition of seaway ‘infrastructure’ is an important conclusion developed from the ‘Motorway of the Sea’ (MoS) research work undertaken during the SUTRANET project.

In effect, government expects the market to provide port infrastructure and associated shipping services to compete against state-funded and free at the point of use motorways. State funding of motorway road infrastructure, and free access to the latter obviously serves to distort the transport market, making life very difficult for private ferry operators who must provide and finance the alternative ‘Motorway of the Sea’ infrastructure themselves. While other EU member states now understand this, the UK government and the SE have yet to recognize such distortions exist, and likewise the need for appropriate policy mechanisms to assist MoS service developments.

3.2 Railway subsidies

The state continues to own, operate and finance railway infrastructure in the UK. In addition, the UK government subsidises intermodal railway company Freightliner through operating support. Subsidy is also given to the Channel Tunnel.

In Scotland, state support for railways has risen to over £600 million a year. Much of this is for passenger services, albeit with considerable operating costs related to the provision and maintenance of railway infrastructure. The substantial subsidies applying to railway infrastructure throughout the UK serves to distort the market against seaway alternatives and is broadly similar to the position with state funding of motorway infrastructure.

3.3 Air transport subsidies

In 2002 the SE introduced an International Air Route Development Fund, administered by Scottish Enterprise, the economic development agency. ARDF offers financial support to new international passenger airline services serving Scotland. However, there is no comparable fund for transport companies seeking to establish international ferry services to Scotland. This raises the question why there should be start-up aid for air but not for sea services.

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Thus, whereas an airline setting up a passenger service from/to Scotland receives financial support, the same support does not exist for an international ferry operator serving the same markets. (e.g. Superfast’s Rosyth-Zeebrugge service, or the proposed Rosyth-mid Norway ferry service). This again represents something of a distortion to competition and bias against sea transport, with government policy in support of air transport but not sea transport.

3.4 Highlands & Islands Air Discount Scheme

The domestic Air Discount Scheme (ADS) as noted in section 2.3 gives residents a 40% reduction on air passenger fares to/from remote communities within Scotland. It applies to any airline operator (air services are all privately owned) serving specified remote areas in Scotland, including all of the islands. The airline gives the traveller the 40% discount at the time of ticket purchase, and the airline then reclaims this amount from the SE.

Whilst the private shipping sector in Scotland does not object to the principle of reducing transport costs for users, the anti-competitive nature of this particular subsidy relates to the fact that it only applies to one transport mode — air. In this respect ADS clearly acts against the commercial interests of private ferry operators given that passengers make the choice of which transport mode to use, and price is a key factor in the decision-making process. A subsidy applying only to air transport means that the cost of air travel is reduced, and this puts the private ferry operator at a competitive disadvantage to private airlines.

ADS is unlike subsidy presently applying to state-owned ferry companies. The latter receive a block subsidy amount from the state, from which operating losses are covered for specified contracted services that are ‘open to tender’. However, there has been no tender process undertaken by the state for airline services to receive ADS, which tends to raise questions as to its legality. Put another way, if such a subsidy scheme can be introduced without tender for the benefit of private airlines, then why can’t the same form of subsidy apply to private ferry operators?

Included within the separate existing ferry subsidy awarded to state-owned ferry operators is provision for island residents to obtain an ‘islander discount’ on published fare levels. What this implies of course is that private ferry operators must survive within a ‘competitive’ environment in which both competing public ferry companies and competing private airlines receive subsidy, but private ferry operators do not.

Introduced in May 2006, the ADS scheme was initially approved for 2 years with a maximum budget of £11.2 million in each year. SE officials are to advise Ministers before the end of 2007 on the future of ADS including whether or not it should continue. As air passenger demand increases, subsidy payments will also rise until the maximum subsidy limit is reached.
Curiously, the demand-led nature of such subsidy schemes was the reason given for withdrawal of TRS (Tariff Rebate Subsidy) in 1996, and the complete removal of subsidy for freight, coinciding with introduction of a new annual fixed grant amount for the ‘lifeline’ ferry operator to cover the cost of providing a passenger ferry service.

ADS will of course to some extent also adversely affect demand for state-owned subsidized ferry services. As some passengers opt to choose air transport instead of the ferry, decisions influenced by the 40% ADS subsidy, state-owned ferry operating revenues will be expected to reduce. This implies that state-owned ferry lines will therefore seek (and be given) even greater subsidies than at present, by way of compensation for any traffic lost.

3.5 Anti-competitive policy

Private sector shipping organizations in Scotland understandably question the fairness and indeed the legality of current subsidy schemes, and the constant changes implemented by the SE, particularly over the last 6 years. Private operators question what the SE and the current and previous Transport Ministers’ are trying to achieve here. Is the intention to put private shipping operators out of business, as has occurred in the relatively recent past? And is this not the inevitable outcome of continued protection of state-owned carriers, in addition to the introduction of subsidies for competing modes such as air services?

Questions also arise as to the SE’s own STAG (Scottish Transport Appraisal Guidance) requirements for public sector transport investment projects. STAG is supposed to be carried out for all public sector transport investment projects, yet this does not appear to be the case with the increasingly frequent introduction of new subsidy schemes, or indeed with the seemingly arbitrary raising of subsidy levels awarded to state-owned ferry organizations, including midway through contract periods. Any comprehensive STAG appraisal would very quickly signal weaknesses and distortions resulting from current SE policy towards shipping, as highlighted during the SUTRANET workshop and in this report.

Private shipping organizations are conscious of the SE’s desire to concession ferry routes albeit with a publicly acknowledged preference for state-owned operators to win tenders. However, it is notable that the ADS scheme applies to all private airlines serving designated areas yet this scheme was not subject to any tender. If ADS applies to all airlines serving remote communities, and is not subject to open tender, then it must surely be possible to introduce a similar scheme for private shipping operators serving the very same communities by sea. This would go some way to alleviate current market distortions, notwithstanding that more fundamental change in relation to overall subsidy management as well as state-ownership of shipping organizations will be needed to ensure a level playing field as well as compliance with EU policy.
4. Conclusions

Private sector shipping organisations in Scotland are clearly disillusioned, as well as being adversely affected in a commercial sense, by the ongoing expansion of state intervention in domestic shipping markets and resulting distortions to competition. The expansion of state involvement in the provision of ferry services in Scotland goes entirely against EU policy and trends throughout the EU, where the private sector is now dominant and the state has virtually withdrawn from owning/operating ferry services. It is not at all clear why the Scottish Executive (SE) should proceed in entirely the opposite direction.

The SE’s VesCo and ‘new’ CalMac model represent a quite unique approach in Europe for any government to employ in an effort to maintain state ownership and operation of domestic ferry services. This is by no means an obligatory administrative model as far as EU rules are concerned, as appears to have been suggested by the SE. The SE has ignored the rather more straightforward and universal mechanism used to bring about market liberalisation and modernisation elsewhere; that is, through the sale of state-owned shipping operators and their assets and allowing the private sector to provide transport services, with or without subsidy.

Tendering the entire CalMac network as one ‘bundle’, with the CalMac fleet virtually unchanged, also ignores the fundamental objective and rationale for seeking competitive bids in the first place. Many individual routes could be operated profitably by the private sector, even on a stand-alone basis, and with sufficient cover built in to take account of vessel maintenance/refits. For innovation to flourish there needs to be a far greater degree of flexibility in service specifications, such as allowing operators the opportunity to introduce new ships. The present tendering arrangements have proven to be highly ineffective from a private shipping operator perspective, and seem more to do with maintaining the status quo (i.e. pacifying labour unions and maintaining state ownership of shipping operations) rather than providing superior quality transport services for the benefit of remote communities.

The constant introduction of new state subsidies, plus changes to subsidy amounts paid out by the SE to state-owned carriers, always and without exception with the aim of strengthening the hand of state-owned shipping operators, is unacceptable to private shipping operators. If such practices are not illegal, they should be made so. The effect of such practices on private shipping operators can be, and indeed have been, catastrophic.

Notwithstanding the adverse competitive impacts of the Air Discount Scheme (ADS) on private shipping operators, the introduction of ADS in 2006 to the benefit of private airlines illustrates the ease with which a simple demand-led subsidy scheme may be implemented, and moreover without any tender process involved. In order to help partially level the present playing field, such a subsidy scheme, assuming it does indeed comply with EU rules, should be extended to include private shipping operators (i.e. a Sea Discount Scheme), for freight as well as passengers. If subsidy is to be awarded in this way, it
should be available to all transport operators and related to actual traffic volumes carried, which is the case with ADS. Ultimately, if such a subsidy scheme is allowable in the aviation sector, it must surely also be allowable in the shipping sector, as competition exists between these modes.

The SUTRANET workshop outcomes and findings presented in this report will not please any analyst of efficient markets. Yet in the UK the OFT, and in Scotland the Auditor General, both appear unable or unwilling to do much if anything about the present worsening situation.

It therefore follows that probably the only course of action Scottish private shipping operators can take is to ensure that the European Commission is made fully aware of this matter. The Commission has in the recent past been rather used to this type of case, investigating similar situations in Spain, France and Italy, with these and all other EU states having now moved forward towards far greater liberalisation, privatisation and hence modernisation of their shipping markets, to the benefit of the economies and communities served. Scotland needs to follow suit, and remove the state from the shipping business. On the evidence presented here, it nevertheless seems probable that Scotland will be the last place in the EU to adequately reform its domestic shipping sector.
ANNEX I

**Workshop Agenda and Participants**

THE ROLE OF THE SCOTTISH EXECUTIVE IN FUNDING SCOTTISH SHIPPING SERVICES AND ASSOCIATED PORT FACILITIES AND IMPACTS ON PRIVATE SECTOR SHIPPING SERVICES

Venue: Napier University TRi, Edinburgh
       Wednesday 29th November, 2006
       0945 – 1230

0945      Arrivals and coffee
1000      Welcome and introductions

Discussion:

- Operation of state-owned shipping services
- Scottish Executive introduction of new subsidy schemes
- Port ownership and financing, port pricing and access to terminals
- Scottish executive financing of competing transport infrastructure/services
- Scottish Executive support for state-owned entities
- Other aspects of shipping services (e.g. tender process etc)

1230      End of meeting / buffet lunch

**Participants**

Terry Cairns, P&O Ferries
Andrew Banks, Pentland Ferries
Yannis Criticos, Superfast Ferries (apologies)
Gordon Ross, Western Ferries
Allan Thomson, V Ships (apologies)
Alistair Macleod, Clydefast
Tom Docherty, Red Funnel Ferries (apologies)
Hamish Ross, Isle of Man Steam Packet Company (apologies)
Stewart Roberts, Streamline Shipping Group
Roy Pedersen, Pedersen Consulting
Alf Baird, Napier University
## ANNEX II
Northlink Rate Structure History (2002-2007)

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<tr>
<td><strong>A. Aberdeen/Lerwick</strong></td>
<td>£44.00</td>
<td>£36.00</td>
<td>£38.50</td>
<td>£39.45</td>
<td>£40.60</td>
<td>£30.60</td>
<td>*  £31.27</td>
<td>£49.95</td>
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<tr>
<td><strong>B. Aberdeen/Kirkwall</strong></td>
<td>£36.00</td>
<td>£25.50</td>
<td>£27.50</td>
<td>£28.20</td>
<td>£29.00</td>
<td>£23.50</td>
<td>** £24.02</td>
<td>£40.87</td>
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<tr>
<td><strong>C. Scrabster/Stromness</strong></td>
<td>£26.00</td>
<td>£17.00</td>
<td>£17.70</td>
<td>£18.15</td>
<td>£18.70</td>
<td>£18.70</td>
<td>£19.11</td>
<td>£29.52</td>
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**Concessionary impact:**

**Volume discount**
- A. **n.a.** | £34.65 | £35.50 | £36.55 | n.a. | n.a.
- B. **n.a.** | £24.75 | £25.38 | £26.10 | n.a. | n.a.
- C. **n.a.** | £15.93 | £16.33 | £16.83 | n.a. | n.a.

**Empty trailer rate**
- A. **n.a.** | £100.00/£7.35 | £102.5/£7.54 | £105.5/£7.90 | £12.20 | £12.47*(60% reduction)
- B. **n.a.** | £75.00/£5.51 | £76.90/£5.65 | £79.10/£5.82 | £9.40 | £6.59*(73% reduction)
- C. **n.a.** | **n.a.** | **n.a.** | **n.a.** | **n.a.** | **n.a.**
Livestock pen concession

A. 1 x 6 metre cassette payload of 1.2 metre pen length = min £36.72 equates to £6.12
1 x 6 metre cassette payload of 2.4 metre pen length x £31.27 = £75.05 " £12.51
1 x 6 metre cassette payload of 3.6 metre pen length x £31.27 = £112.57 " £18.76
1 x 6 metre cassette payload of 4.8 metre pen length x £31.27 = £150.10 " £25.02

B. 1 x 6 metre cassette payload of 1.2 metre pen length = min £28.20 equates to £4.70
1 x 6 metre cassette payload of 2.4 metre pen length x £24.02 = £57.65 " £9.61
1 x 6 metre cassette payload of 3.6 metre pen length x £24.02 = £86.47 " £14.41
1 x 6 metre cassette payload of 4.8 metre pen length x £24.02 = £115.30 " £19.21

All the concessions were introduced after the demise of Norse Isle Ferries Ltd., effective 01.01.2004

All figures are based on Northlink's linear meterage tariff.