



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.10.2009
C(2009)8117 final

PUBLIC VERSION

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COMMISSION DECISION
of 28.10.2009
ON THE STATE AID
No C 16/2008 (ex NN 105/2005 and NN 35/2007)
implemented by the United Kingdom of Great Britain and Northern Ireland
Subsidies to *CalMac* and *NorthLink* for maritime
transport services in Scotland

(Only the English version is authentic)

(Text with EEA relevance)

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THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provision(s) cited above¹ and having regard to their comments,

Whereas:

1. PROCEDURE

1. By letter of 19 December 2003, the United Kingdom informed the Commission of the steps that the Scottish Executive intended to take in order to bring Scottish ferry services "into line with [their] understanding of the European rules in relation to maritime State aids".
2. By letters of 19 April 2004 and 30 June 2004, the United Kingdom informed the Commission of the intention of the Scottish Executive to carry out two public tenders for contracts to provide transport services to the northern and western islands.
3. The Commission has since received several formal complaints and informal comments from interested parties regarding alleged incompatible State aid granted to the undertakings which operate those transport services².

¹ OJ C 126, 23. 5.2008, p. 16.

² Leading to the creation of two cases with references NN 105/2005 and NN 35/2007.

4. Following these complaints, the Commission sent several requests for further information to the United Kingdom pursuant to Article 5 of Council Regulation No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 (now Art.88) of the EC Treaty³ (hereafter "the Procedural Regulation") to which answers were provided.
5. On 16 April 2008 the Commission decided to initiate the formal investigation procedure regarding State aid measures related to NorthLink Ferries Limited, Cowal Ferries Limited and CalMac Ferries Limited⁴.
6. On 16 July 2008 the United Kingdom sent its observations in reply to the decision to initiate the formal investigation procedure. By letters of 22 December 2008 and 2 February 2009 the United Kingdom provided additional information.
7. The Commission received comments from several interested parties following the publication of the decision to initiate the formal investigation procedure. The United Kingdom was invited to respond to those comments.
8. On 11, 12 and 13 December 2008, the Commission met with representatives of several interested parties: NorthLink Ferries Limited, Cowal Ferries Limited, CalMac Ferries Limited, Pentland Ferries, Western Ferries (Clyde) Limited, Orkney County Council, Argyll and Bute Council, Inverclyde Council, Scottish Ministers and Scottish Executive and Peer Pressure Group.
9. On the basis of the additional information received during the formal investigation procedure, the Commission concluded that part of the scheme constituted existing aid⁵. It therefore decided to initiate, in parallel to the formal investigation procedure, the cooperation procedure foreseen under Article 17 of the Procedural Regulation.
10. On 17 March 2009 the Commission met with representatives of the United Kingdom. In this meeting, in accordance with Article 17 of the Procedural Regulation the Commission informed the Member State that it considered part of the scheme to constitute existing aid and expressed its preliminary view that some aspects of the scheme were no longer compatible with the common market. The Member State's authorities were given the opportunity to submit their comments on this preliminary view both at the meeting and later in written form.
11. On 23 March 2009, the Commission requested additional information from the United Kingdom. That information was provided on 15 May 2009 and 3 July 2009.

³ OJ L 83, 27.3.1999, p. 1.

⁴ See footnote. 1.

2. DESCRIPTION

12. The case concerns the provision of regular ferry shipping services between the Scottish mainland and the islands off the west and north coasts of Scotland. These services are currently mainly provided under public service contracts⁶ and the operators benefit from compensation for their performance.

13. Since the legal frameworks governing the public services provided in the western and northern islands are different and the beneficiaries are separate legal entities, the western islands and northern islands routes are treated separately in the remainder of the current Decision.

2.1. Western islands

2.1.1. Maritime routes

14. The existing ferry routes in the western Scottish islands are set out in Map 1.

⁶ With the exception of the Gourock-Dunoon route.

Map 1: Maritime routes in western Scotland



2.1.2. Operators

2.1.2.1. CalMac Ferries Ltd.

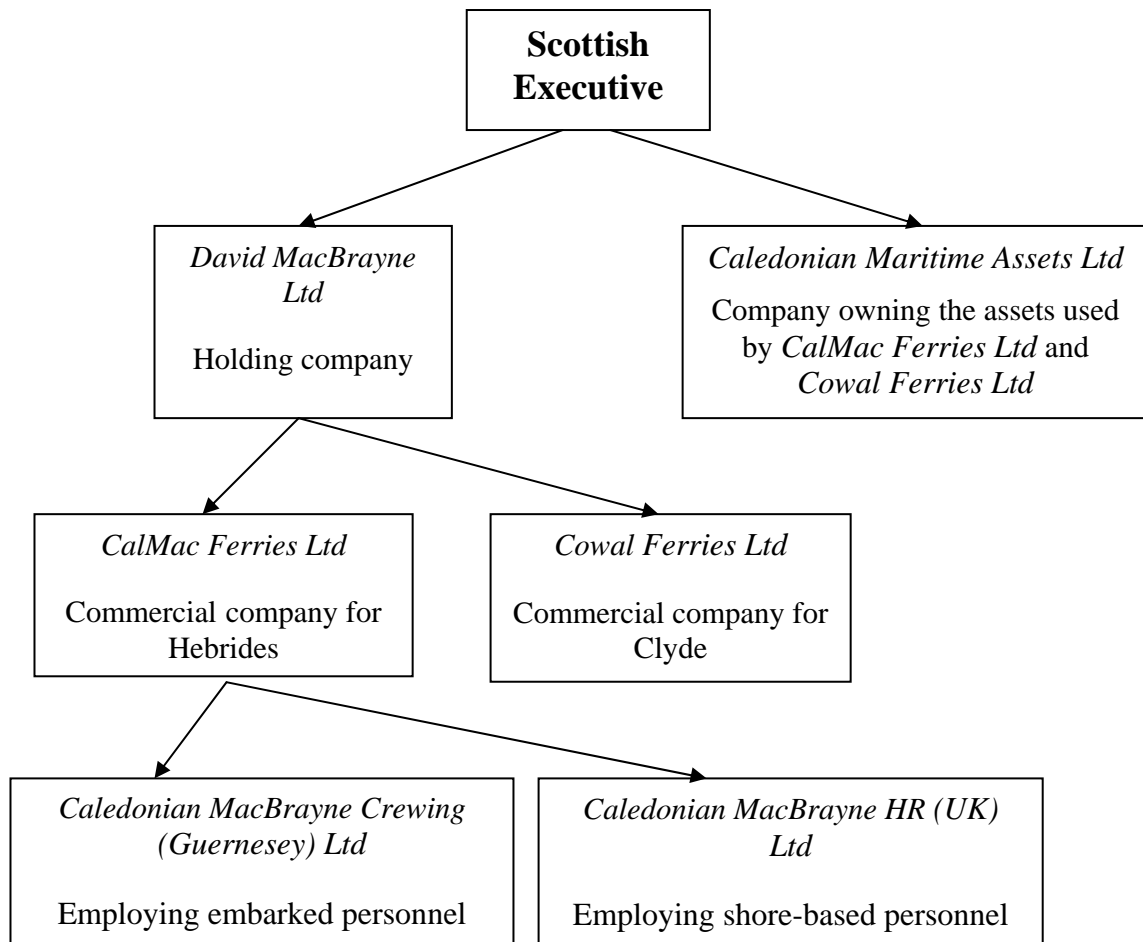
15. In the 1950s, passenger, mail and cargo coastal shipping services in the western islands⁷ were dominated by two publicly-owned companies: Caledonian Steam Packet Company Ltd. and David MacBrayne Ltd.
16. In 1973, Caledonian Steam Packet Company Ltd. was merged with part of David MacBrayne Ltd. to form Caledonian MacBrayne Ltd. The new company was made

⁷ The inner and outer Hebrides and the islands of the Firth of Clyde.

responsible for most of the regular shipping services on the Firth of Clyde and the West Highlands and Islands.

17. Before 2006 Caledonian MacBrayne Ltd. was wholly owned by the State, under the responsibility of the Secretary of State for Scotland, and, after devolution in 1999, by the Scottish Executive.
18. In October 2006 Caledonian MacBrayne Ltd. was restructured to separate the vessel and shore asset ownership role from the ferry operating role. The new structure is shown in Chart 1

Chart 1: Current ownership structure



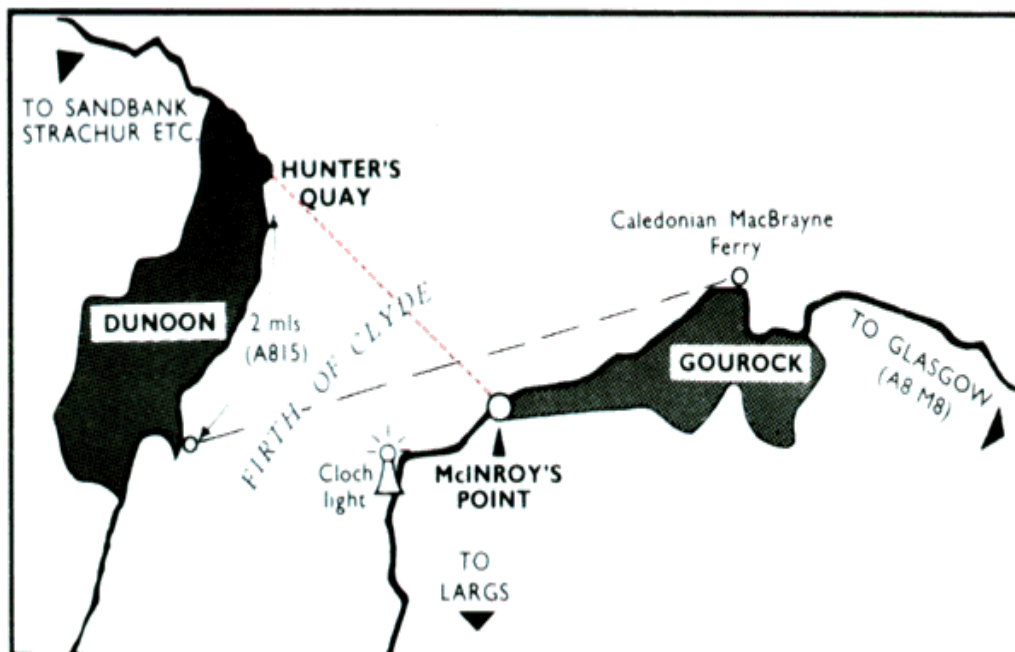
19. The ferry service operations were transferred to two new companies, CalMac Ferries Ltd and Cowal Ferries Ltd, which were created as two wholly-owned subsidiaries of David MacBrayne Ltd. The latter was previously a dormant company fully owned by the Scottish Executive.
20. CalMac Ferries Ltd. took over the services to the Hebrides, along with two wholly-owned subsidiaries, Caledonian MacBrayne Crewing (Guernsey) Ltd. and Caledonian MacBrayne HR (UK) Ltd., which employ respectively embarked and shore-based personnel.
21. Cowal Ferries Ltd. took over the services on the Clyde.

22. In parallel, Caledonian Maritime Assets Ltd. (hereafter "CMAL") retained ownership of the vessels and piers that are used for the operation of the Clyde and Hebrides ferry services.
23. Under the new arrangements, CMAL leases the vessels and piers to CalMac Ferries Ltd. and Cowal Ferries Ltd. It also owns and operates the port facilities in nearly half of the 50 destinations that CalMac Ferries Ltd. and Cowal Ferries Ltd serve. CMAL is wholly and directly owned by the Scottish Executive.
24. CalMac Ferries Ltd. at present charters a fleet of 29 vessels from CMAL to provide passenger, vehicle and shipping services to the islands off the West Coast of Scotland and in the Clyde estuary. Two other vessels are kept on separate charters.
25. Cowal Ferries Ltd also charters its three vessels from CMAL.
26. Given that the various companies referred to above belong to the same group and for simplicity, for the remainder of the current Decision the term "CalMac" will be used indistinctively to refer to the companies owned by David MacBrayne Ltd. and, in the period prior to the restructuring, to Caledonian MacBrayne Ltd., Caledonian Steam Packet Company Ltd. and David MacBrayne Ltd.
27. There are currently 26 routes within the network served by CalMac. As regards CalMac Ferries Ltd. alone, in the year ended on 31 March 2006, it transported 5.3 million passengers, 1.1 million cars, 94,000 commercial vehicles and 14,000 coaches on these routes.

2.1.2.2. Western Ferries Ltd.

28. CalMac has virtually no competition on the routes it serves. Its sole competitor, Western Ferries Ltd., operates only on the Clyde estuary between Gourock, located in the Upper Firth of Clyde, and Dunoon, located in the Cowal peninsula of Scotland as illustrated in Map 2.

Map 2: maritime routes in the Clyde estuary



29. Western Ferries started operating on the Gourock-Dunoon route in 1973. It currently has four vehicle/passenger vessels doing several daily services and

accounts for around 88% of car traffic, 86% of freight traffic and 68% of passenger traffic⁸.

2.1.3. *Public service obligations*

30. The general legal framework allowing for financial support for the performance of ferry transport services in Scotland is the Highlands and Islands Shipping Services Act of 1960⁹ as amended by Section 70 of the Transport (Scotland) Act 2001¹⁰ and by Section 45 of the Transport (Scotland) Act 2005¹¹. This legal framework was complemented by "undertakings" by the Secretary of State with the agreement of CalMac¹².
31. The legal framework is very general. It merely states that the Scottish authorities may make advances by way of grant or loan to persons for purposes relating to transport. It does not specify in detail the conditions for making such advances. The 1995 undertaking provides for grants and loans to CalMac for the performance of sea transport services to maintain or improve economic or social conditions in the Highlands and Islands. Revenue grants are intended to cover operating deficits while capital grants and loans are intended for investment purposes, such as the acquisition of vessels and works on piers and harbours.
32. All the details of the public service, such as the routes qualifying for support, regularity, frequencies, capacities, fare rates and subsidy amounts, were decided by the Scottish authorities and communicated to CalMac via annual letters.
33. In October 2006, the last 1995 undertaking lapsed with the restructuring of CalMac. No further undertaking was signed from then until September 2007, when the current 2007 public service contract entered into force.
34. Since September 2007 CalMac has been providing ferry transport services under the 2007 public service contract following its winning bid in a public tender procedure¹³ (V-Ships was the only other bidder which later withdrew from the process). The 2007 public service contract covers all routes operated until then by CalMac, with the exception of Gourock-Dunoon, and specifies in detail the public

⁸ Data provided by Western Ferries Ltd.

⁹ The text of this Act is available at the following internet address:

http://www.opsi.gov.uk/RevisedStatutes/Acts/ukpga/1960/cukpga_19600031_en_1

¹⁰ The text of this Act is available at the following internet address:

http://www.opsi.gov.uk/legislation/scotland/acts2001/asp_20010002_en_1

¹¹ The text of this Act is available at the following internet address:

<http://www.opsi.gov.uk/legislation/scotland/acts2005/20050012.htm> .

¹² These "undertakings" were commitments from the Secretary of State to finance the ferry services with the consent of the Treasury and the agreement of CalMac. Several undertakings were signed in 1961, 1973, 1975 and 1995, each reflecting earlier company structures with the responsibility for services that later formed the basis for the Clyde and Hebrides Ferry Services contract of 2007. The text of the 1995 undertaking is available at the following internet address:

<http://www.calmac.co.uk/policies/undertakingbysecretaryofstate.pdf>

¹³ The text of the invitation to tender is publicly available at the following internet address:

<http://www.scotland.gov.uk/Resource/Doc/161181/0043718.pdf> .

service obligations to be met. The services include passenger, car and freight transport. The vessels used to provide the services are leased from CMAL, the company created in October 2006 and whose only activity is the ownership and lease of the vessels.

35. In 2005-2006 a public tender for the Gourock-Dunoon route was launched, seeking operators to run an unrestricted and unsubsidised service. Three companies manifested an interest in the initial phase (Western Ferries, CalMac and V-Ships) but eventually no company submitted a bid.
36. Until the 2007 public service contract entered into force, the compensation for the operation of the Gourock-Dunoon route was not distinguished from the compensation paid for the other routes, as there was one single payment in block, with no hypothecation to individual routes. Since the entry into force of the 2007 public service contract, the subsidy for the Gourock-Dunoon route is paid separately to CalMac.
37. The public service obligations for that route and the respective compensation are intended for the transport of passengers only, commercial vehicles being excluded. However, CalMac is free to provide transport services for commercial vehicles on purely commercial terms.
38. Since the Gourock-Dunoon route was excluded from the 2007 public service contract, the legal basis for the compensation related to this route continues to be the Highlands and Islands Shipping Services Act of 1960 as amended by section 70 of the Transport (Scotland) Act 2001 and by Section 45 of the Transport (Scotland) Act 2005.
39. There has been considerable continuity over the years in the routes operated by CalMac in the western islands. Nevertheless, some changes have occurred by decision of the Scottish authorities, such as the closing of one route following the opening of a bridge, new services in existing routes and increased frequencies. Capacities have in general increased through the replacement of old vessels by new ones, generally offering larger capacity than the vessel being replaced¹⁴. In general, tariffs have increased in line with inflation¹⁵.
40. CalMac has so far received the following payments from the Scottish authorities relating to those public service obligations:

Table 1: Public money granted to CalMac since 1995 GBP million)

¹⁴ Eleven vessels have been added to the fleet since 1995.

¹⁵ Since 1995 rates have increased in the range of 2% to 5% per year.

	Deficit grants	Capital grants/loans ¹⁶	TOTAL
1995/96	8.3	8.5	16.8
1996/97	11.7	2.3	14.0
1997/98	10.5	9.9	20.4
1998/99	14.4	11.9	26.4
1999/00	15.0	9.7	24.7
2000/01	19.0	6.5	25.5
2001/02	20.4	1.8	22.2
2002/03	18.9	7.7	26.6
2003/04	25.9	2.8	28.7
2004/05	25.1	8.8	33.9
2005/06	31.4	6.2	37.6
2006/07	34.2	9.9	44.1
2007/08	40.5	4.9	45.3

41. With regard to the Gourock-Dunoon route, the United Kingdom have provided financial information showing the net turnover of the public service activities (mostly passenger transport) and of the commercial activities (mostly vehicle service) carried out by CalMac since the 2002/03 financial exercise:

Table 2: Profit and loss account of public service and commercial activities of CalMac in the Gourock-Dunoon route since 2002/03 (GBP million)

	Public service activities			Commercial activities			TOTAL
	Revenues	Expenses	Profit / Loss	Revenues	Expenses	Profit / Loss	Profit / Loss
2002/03	0.7	-3.1	-2.4	1.0	-0.5	0.5	-1.9
2003/04	0.7	-3.4	-2.7	0.8	-0.5	0.3	-2.4
2004/05	0.8	-3.4	-2.7	1.0	-0.5	0.5	-2.2
2005/06	0.9	-3.8	-2.9	0.9	-0.5	0.4	-2.5
2006/07	0.9	-3.7	-2.8	1.0	-0.5	0.4	-2.4
2007/08	0.9	-3.7	-2.7	1.0	-0.5	0.5	-2.3

¹⁶ Loans are net of loan repayments. Until 2002, new vessels were funded through a combination of grants (75%) and loans (25%). Since 2002, all vessels have been funded exclusively through loans.

42. The amounts indicated in the table 2 result from an analytical accounting exercise on the basis of the statutory accounts. Commercial revenues are mostly vehicular revenues and revenues from the respective passengers¹⁷. Public service revenues are mostly from foot passengers. On the expenditure side, common costs such as personnel, vessel and terminal costs related to mixed passenger-vehicle vessels, are split according to average vessel capacity use for vehicles and for foot passengers.
43. Agreed procedures have been carried out by the Company Auditor (KPMG LLP) on the methodology, accounting detail and statement content. No significant differences were found between the amounts reported in table 2 above and the underlying books and records of CalMac.

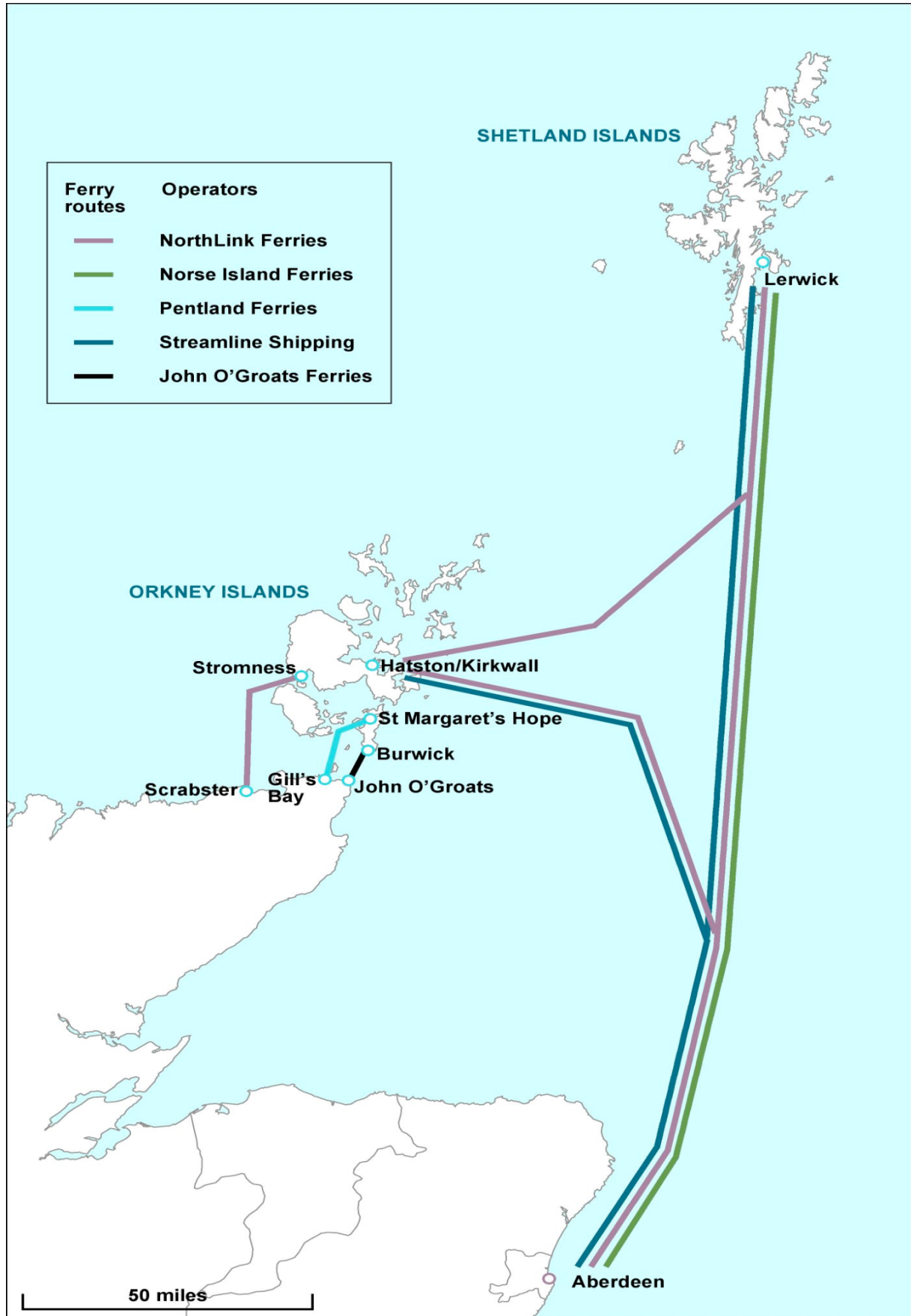
2.2. Northern islands

2.2.1. Maritime routes

44. The existing ferry routes in the northern Scottish islands (Orkney and Shetland archipelagos) are set out in Map 3.

¹⁷ It is assumed that, on average, two people travel with each car. The number of "vehicular" passengers as a proportion of total passengers is applied to the total passenger revenue in order to calculate passenger revenue for commercial activities as opposed to public service activities.

Map 3: Maritime routes in Northern Scotland



2.2.2. Operators

2.2.2.1. NorthLink

45. NorthLink Orkney and Shetland Ferries Ltd. (hereinafter "NorthLink 1") was established in 2000 as a 50%-50% joint venture between the Royal Bank of Scotland, one of the leading banks in the United Kingdom, and CalMac.
46. Between 2002 and 2006 NorthLink 1 operated two routes under a public service contract: one triangular route between Aberdeen (Scottish mainland), Kirkwall (Orkney) and Lerwick (Shetland) and one shorter route between Scrabster (Scottish mainland) and Stromness (Orkney), across the Pentland Firth.
47. The total annual maritime passenger traffic in those two routes is around 300000.
48. In 2006, a new company was established – NorthLink Ferries Ltd. (hereinafter "NorthLink 2") as a wholly-owned subsidiary of CalMac (itself fully-owned by the Scottish Government). NorthLink 2 took over the operation of the two northern islands routes and most of the assets and personnel of NorthLink 1 in 2006. It operates under a public service contract signed on 6 July 2006 and valid until 2012.
49. NorthLink 2 currently operates two combined passenger, car and freight vessels and two freight and livestock vessels.
50. NorthLink 1 still exists but it is basically a dormant company, with no regular activities and few assets.

2.2.2.2. P&O Ferries

51. Between 1997 and 2002, P&O Ferries operated the two routes later served by NorthLink 1 and 2 under a public service contract. P&O Ferries no longer operates on these routes.

2.2.2.3. Pentland Ferries

52. Since 2001, Pentland Ferries has been operating a daily service in the route between Gills Bay in the Scottish mainland and St. Margaret's Hope in Orkney. Pentland Ferries operates two passenger, vehicle and freight services and currently carries around 80% of all livestock and dangerous goods cargoes between the Scottish mainland and the Orkney islands.

2.2.2.4. Streamline Shipping

53. Since 1984 Streamline Shipping has been operating a bi-weekly container freight service between Aberdeen and Lerwick, using chartered freight lift-on lift-off vessels or its own container ship. In 1987 it also started container freight services from Aberdeen to Kirkwall in Orkney, using chartered freight load on/load off (hereafter "lo-lo") vessels.
54. In mid-2008, Streamline Shipping was awarded a freight contract for freight transport to the northern islands by the Scottish Executive.

2.2.2.5. John O'Groats Ferries

55. Since 1971 John O'Groats Ferries has been operating a tourist passenger ferry service from John O'Groats in the Scottish mainland to Burwick in Orkney. John O'Groats Ferries only operates its service from May until the end of September..

2.2.2.6. Norse Islands Ferries

56. Between September 2002 and June 2003, Norse Islands Ferries operated one and at times two freight-only vessels between the Scottish mainland and the Shetland Islands. Norse Islands Ferries no longer operates on this route.

2.2.3. *Public service obligations*

57. Two northern islands routes have been subject to public service obligations: the triangular route between Aberdeen (Scottish mainland), Kirkwall (Orkney) and Lerwick (Shetland) and the shorter route between Scrabster (Scottish mainland) and Stromness (Orkney).
58. Those routes were the subject of three public tenders leading to three public service contracts between the Scottish authorities and three operators: P&O Ferries from 1997 to 2002, NorthLink 1 from 2002 to 2006 and NorthLink 2 from 2006 to 2012. In the first two tenders, the public service obligations covered only passenger traffic (freight transport was not subsidised but was not prohibited either). However, the 2006to 2012 contract also includes a public service obligation for freight transport with a fixed limit.

2.2.3.1. The 1997 public service contract with P&O Ferries

59. The Scottish authorities launched an open tender exercise in June 1995 for the Aberdeen-Kirkwall-Lerwick and Scrabster-Stromness routes [. They decided not to allow CalMac to take part in the tender.
60. The tender led the Scottish Executive to choose P&O Ferries. Pursuant to the public service contract, P&O Ferries was to be paid an annual grant, subject to "claw back arrangements" aimed at capping possible benefits, should the company's profits exceed forecasts. P&O Ferries received GBP 55 million from the Scottish authorities over the period 1997to 2002¹⁸ for the execution of the contract.
61. Under the public service contract, the subsidy was limited to passengers, accompanied cars and associated vehicles, such as motorhomes and motorcycles.

2.2.3.2. The 2000 public service contract with NorthLink 1

62. In 1998 the Scottish Executive launched a new tendering process for a public service contract on the Aberdeen-Kirkwall-Lerwick and Scrabster-Stromness routes for the 2002-2007 period.

¹⁸ Source: Report of Audit Scotland of December 2005 on the NorthLink ferry services contract. The report is available at the following internet address: http://www.audit-scotland.gov.uk/docs/central/2005/nr_051222_northlink_ferry.pdf .

63. While the service specifications of the public tender indicated that operators would be required to provide capacity to carry freight, this element of the service was expected to be operated on a commercial basis, that is to say without subsidy. It was left for bidders to determine the precise level of freight services to be made available, although the capacity should be sufficient to carry at least the levels provided by P&O Ferries at the time, including reasonable increases for estimated growth in demand.
64. The public tender specified the route configuration and minimum number of sailings required but requested bidders to propose detailed timetables. It required the successful bidder's pricing plan to be agreed with the Scottish Executive and maximum tariffs to be published. It was expected that initial tariffs would not be set at a level significantly above prevailing rates.
65. In November 1998, thirteen shipping operators expressed an interest in the public tender. Six ferry operators were short-listed and three ultimately submitted bids in June 1999: SERCO Denholm, P&O Ferries and NorthLink 1.
66. The Scottish Executive ruled out the bid from SERCO Denholm because it was the highest bid and also because it considered unacceptable the bidder's request to be allowed to sell its vessels or transfer ongoing leases to the Scottish Executive at the end of the contract.
67. In September 2000 the Scottish Executive chose NorthLink 1 as the preferred bidder. NorthLink 1's bid for basic subsidy of GBP 45.7 million for the five-year contract was GBP 14 million cheaper than P&O's bid. NorthLink 1's estimated costs were higher than P&O Ferries' but it anticipated generating about £8 million more passenger income and GBP 13 million more from freight surpluses because its traffic growth assumptions were higher. NorthLink 1 was also prepared to accept less profit from the contract than P&O Ferries.
68. The contract between NorthLink 1 and the Scottish Executive was signed in December 2000. Following the contract award, NorthLink 1 ordered three new passenger/vehicle ferries and acquired a second-hand dedicated freight vessel.
69. It had first been anticipated that the new operator would have the time to commission and build new vessels to be ready to start operations in April 2002. However NorthLink 1 was only in a position to start operations on 1 October 2002. Because of this delay, the Scottish Executive prolonged the public service contract with P&O Ferries for six months.
70. NorthLink 1's cost and revenue projections underlying its bid proved to be too optimistic. P&O Ferries had been the only operator offering a roll on/roll off (hereafter "ro-ro") service for passengers, cars and freight between the Scottish mainland and the northern islands between 1997 and 2002. In its projections NorthLink 1 had also assumed that it would enjoy a monopoly on ro-ro traffic.
71. However, that assumption did not materialise. In the spring of 2001 a new operator, Pentland Ferries, started providing services from the Scottish mainland to Orkney and progressively took a substantial share of the Orkney passenger, car and freight market.

72. In July 2002 a consortium of three road hauliers¹⁹ announced that they would be part of a new ferry company, Norse Island Ferries, in reaction to the freight fares announced by NorthLink 1 in 2001, which they considered too high compared to the fares previously offered by P&O Ferries. In early September 2002 Norse Island Ferries started to offer a daily ro-ro freight service between Shetland and the Scottish mainland and, for the early months of its operation, appeared to be carrying a large proportion of the freight market.
73. Following the announcement in 2001 of the new freight service by Pentland Ferries, NorthLink 1 requested discussions with the Scottish Executive about the impact of this new competition on its financial position. NorthLink 1 made available to the Scottish Executive their business model to allow it to examine the impact of the competition on the company's viability. Based on this model, NorthLink 1 was initially projecting a total return over the lifetime of the contract of GBP 14.9 million. The changed circumstances turned this figure into a projected loss of GBP16.4 million. This raised serious concerns over the solvency of the contractor and its ability to execute the contract. According to the United Kingdom, the chief factor in this was the competition from Norse Island Ferries as this accounted for over £25.5 million of the £31.3 million negative turnaround in the company's books.
74. The competition on the Shetland freight market from Norse Islands Ferries came to an end in early June 2003, following the decision of the latter to cease trade. This offered the prospect of NorthLink 1 moving back on to a viable basis. The Scottish Executive thus decided to continue to fund NorthLink 1 in line with the terms of the public service contract, believing that the cessation of Norse Islands Ferries could be sufficient to allow the contract to run its full term.
75. However, in the summer of 2003, a few months after starting operations, NorthLink 1 informed the Scottish Executive that it could no longer realistically fulfil its contractual obligations over the remainder of the public service contract period, i.e. to the end of September 2007.
76. The Scottish Executive reviewed the company's financial position, with the assistance of independent accountants, and concluded that NorthLink 1 was near insolvency.
77. According to the Scottish Executive, if additional subsidies were not paid to NorthLink 1 there was a risk that, if the company had any formal insolvency proceedings filed against it (which could have been done by a number of creditors), the lifeline services would be interrupted. The longterm future of the public service obligations would depend on the willingness of the receiver appointed to manage the company. The receiver would not be bound by any contractual obligations of the company and would not, therefore, be bound to provide the subsidised service.
78. On 8 April 2004 the Scottish Executive announced, following contacts with the Commission services, its intention to re-tender the service and published a Contract Notice in the *Official Journal of the European Union* relating to this tender. In parallel to this new tender procedure, which will be described further below, the

¹⁹ These three road hauliers handled around 80% of the freight transported between the Shetland Islands and the Scottish mainland, resorting to ferry services of P&O Ferries.

Scottish Executive took a number of actions to ensure the continuity of the lifeline services in the interim.

2.2.3.3. The 2004 Minute of Amendment with NorthLink 1

79. On 29 September 2004, the Scottish Executive concluded with NorthLink 1 revised funding arrangements, through a Minute of Amendment (hereafter "MoA") to the public service contract. This MoA provided for a deficit funding system, ensuring that NorthLink 1 could continue the services until the handover of the contract and to the standard specified in its specifications. The MoA also provided that certain assets, leased or owned by NorthLink 1, could be made available on the occasion of the next public tender, on a discretionary basis and at estimated market value, to bidders who would wish to use them in delivering the services within the framework of the future contract. With a view to maintaining budgetary control over that period, the MoA involved measures controlling NorthLink 1's ability to go exceed the terms of an agreed budget without the approval of the Scottish Executive.
80. In addition, the MoA provided for limited "incentive payments" of around GBP 1.5 to GBP 2 million per year, assuming a range of demanding service performance, cost and revenue targets would be met or exceeded. A first element of the incentive payment would be paid provided a range of punctuality, reliability and other service performance targets were met in full. This element was designed to replace and enhance the system of performance penalties built into the original agreement. A second element would be paid on the delivery of cost savings/revenue gains in comparison to a benchmark budget which the Scottish Executive's independent accountants would have approved.
81. In August 2005, the Auditor General for Scotland asked Audit Scotland to examine the new public service contract awarded to NorthLink 1. Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000²⁰ to provide services to the Auditor General. Their mission is to ensure that the Scottish Executive is held to account for the proper, efficient and effective use of public funds.
82. According to the report published by Audit Scotland²¹ in December 2005, NorthLink 1 received from the Scottish Executive £71 million over the three first years of the public service contract, covering the period from October 2002 to end September 2005, to be compared with compensation provided for under the contract limited to GBP 50.3 million. The report gives the following break-down for the GBP 71 million received:
 - (a) GBP 33.6 million of basic compensation under the original contract;
 - (b) GBP 16.7 million of other payments allowed for under the terms of the original contract;

²⁰ The text of this Act is available at the following internet address: http://www.opsi.gov.uk/legislation/scotland/acts2000/asp_20000001_en_1.

²¹ See footnote. 18.

- (c) GBP 18.2 million of additional funding to maintain the delivery of services; and
- (d) GBP 2.5 million to pay off in one instalment some leases used by NorthLink 1.
83. On the basis of the information submitted by the UK authorities, the Scottish Executive made a further grant of GBP 21.6 million to NorthLink 1 between September 2005 and the handover of the contract to its successor on 6 July 2006.
84. The United Kingdom has provided financial information showing the net turnover of the public service activities (mostly passenger transport) and of the commercial activities (mostly freight transport) carried out by NorthLink 1 from the 2002/03 financial exercise to the 2005/06 financial exercise:

Table 3: Profit and loss account of public service and commercial activities of NorthLink 1 from 2002/03 to 2005/06 (GBP million)

	Public service activities			Commercial activities			TOTAL
	Revenues	Expenses	Profit / Loss	Revenues	Expenses	Profit / Loss	Profit / Loss
2002/03	26.7	-28.3	-1.7	7.7	-7.3	0.5	-1.2
2003/04	38.0	-35.5	2.5	10.5	-10.0	0.5	3.0
2004/05	33.8	-34.6	-0.8	10.3	-10.1	0.1	-0.7
2005/06²²	31.1	-30.2	0.9	7.4	-7.2	0.2	1.1

85. The amounts indicated in table 3 result from an analytical accounting exercise on the basis of the statutory accounts. Commercial revenues correspond to income from transporting freight and livestock²³. Public service revenues comprise the Government funding and revenues from the sale of tickets. On the expenditure side, common costs such as harbour dues, terminal costs and administrative expenses, are split according to the relative weight of public service and commercial activities in those costs.
86. Agreed procedures have been carried out by the Company Auditor (KPMG LLP) on the methodology, accounting detail and statement content. No significant differences were found between the amounts reported in table 3 above and the underlying books and records of NorthLink 1.

²² In the nine- month period to 6 July 2006.

²³ Livestock transport and freight transport fell outside the scope of the public service contract.

2.2.3.4. The 2006 public service contract with NorthLink 2

87. In March 2004, the United Kingdom informed the Commission about the intention of the Scottish Executive to re-tender the public service contract as quickly as possible.
88. On 8 April 2004, the Scottish Executive publicly announced its intention to re-tender the service and published a Contract Notice in the *Official Journal of the European Union* relating to the tendering of the service. On 27 May 2004, it published a draft service specification for the tender as part of a consultation exercise.
89. Unlike the 2000 tender, the new invitation to tender²⁴ introduced public service obligations on freight services. The winning bidder would have to provide a comprehensive ro-ro freight service, encompassing livestock and dangerous goods and an additional freight sailing required during the week on the Kirkwall to Aberdeen service. The 2005 tariff levels were the base for 2006, allowing for indexation using the Consumer Price Index. The tariff levels for general freight had to be reduced on the Aberdeen/Kirkwall/Lerwick routes in each direction, around 19% on the Kirkwall to Aberdeen route and 25% on the Shetland Islands route.
90. NorthLink 1 owned assets which were relevant for the operation of the contract, such as information technology hardware, vessel spare parts and equipment, port equipment, office equipment, various stocks and livestock trailers. It also had ongoing lease contracts for a freight vessel, towing vehicles and a ticketing system. These assets and contractual agreements were made available to all bidders on the basis of estimated market value.
91. On 19 July 2005, the Scottish Executive invited three short-listed companies to bid. Subsequently, two bids were submitted on 30 November 2005 and the third company withdrew from the process in October 2005. On 9 March 2006 the Scottish Executive announced the selection of the preferred bidder - CalMac.
92. A new company was established, NorthLink 2, as a wholly-owned subsidiary of CalMac (itself fully-owned by the Scottish authorities) to run the public service contract awarded to CalMac, which was signed on 6 July 2006. The public service contract covered the period from 2006 to 2012. NorthLink 2 took over the operation of the two northern islands routes and most of the assets and personnel of NorthLink 1.
93. According to the United Kingdom, all of the assets of NorthLink 1 that NorthLink 2 wished were bought by the latter at actual or estimated market prices.
94. NorthLink 2 has received the following payments from the Scottish authorities in relation to the 2006 public service contract:

Table 4: Public money granted to NorthLink 2 since 2006 (GBP million)

²⁴ A summary of the 2006 invitation to tender is available at the following address on the website of the Scottish Executive: <http://www.scotland.gov.uk/Resource/Doc/55971/0015831.pdf>.

	Deficit grants	Capital grants	TOTAL
2006/07 ²⁵	21.8	1.3	23.1
2007/08 ²⁶	28.0	2.0	30.0

95. NorthLink 2 has not carried out any activities outside the scope of the 2006 public service contract (which includes carrying of livestock and freight). Therefore, all of its activities are considered as public service obligations. The United Kingdom has provided financial information showing the net turnover of the activities carried out by NorthLink 2 since the 2006/07 contract year. For indicative purposes, they have provided a notional breakdown of these results between freight and passengers (and accompanied cars):

Table 5: Profit and loss account of public service activities of NorthLink 2 in 2006/07 and 2007/08 (£ million)²⁷

	Passengers and accompanied cars			Freight			TOTAL
	Revenues	Expenses	Profit / Loss	Revenues	Expenses	Profit / Loss	Profit / Loss
2006/07	38.3	-37.5	0.8	12.1	-11.8	0.3	1.1
2007/08	39.7	-38.6	1.0	10.9	-10.6	0.3	1.3

96. The amounts set out in table 5 result from an analytical accounting exercise on the basis of the statutory accounts.
97. Agreed procedures have been carried out by the Company Auditor (KPMG LLP) on the methodology, accounting detail and statement content. No significant differences were found between the amounts reported in table 5 above and the underlying books and records of NorthLink 2.

2.2.4. *Transport fares*

98. Table 6 shows the fares charged for freight transport since 1 January 2000 by the public service contract operator (ro-ro freight service) and by Streamline Shipping (lo-lo freight service).

Table 6: Comparison of freight fares per linear metre between public service contract operator and Streamline Shipping²⁸

²⁵ Figures relate to the period from 6 July 2006 (the date when the public service contract entered into force) to 31 March 2007.

²⁶ Figures relate to the period from 1 April 2007 to 31 March 2008.

²⁷ Figures are for Contract Years ending on 30 June. Statutory Accounting Years end on 31 March.

Year	Public service contract operator		Streamline Shipping ²⁹	
	Shetland	Orkney	Shetland	Orkney
2000 (P&O Ferries rates)	£43.70	£37.90	£37.05	£31.62
<i>2002 (indicative rates by NorthLink 1)</i>	<i>£44.00</i>	<i>£36.00</i>		
2002/2003 (NorthLink 1 rates)	£36.00	£25.50	£33.69	£29.40
2004 (NorthLink 1 rates)	£38.50	£27.50	£34.87	£28.86
2005 (NorthLink 1 rates)	£39.45	£28.20	£33.24	£30.29
2006 (NorthLink 1 rates)	£40.60	£29.00	£40.43	£32.07
July 2006 (NorthLink 2 rates)	£30.60	£23.50	£40.43	£32.07

99. Streamline Shipping contends, on the basis of the published data, that NorthLink 1 and NorthLink 2 have depressed freight prices to a level which is not sustainable for Streamline Shipping and this has been possible only because of the subsidies received by the public service operator for passenger traffic.
100. The United Kingdom points out the comparison illustrated in Table 6 is potentially misleading since Streamline Shipping does not charge per linear metre³⁰. They claim that lo-lo and ro-ro services represent different segments of the freight market to the northern islands, even though some overlaps can occur in using the two services. The lo-lo operation tends to be less time-sensitive with only two services per week and cargo is typically of lower value. Thus, the United Kingdom claims that any comparison of the two services is artificial and that it is difficult to draw conclusions from any such comparison.
101. NorthLink 1 indicated in December 2001 - prior to executing the public service contract - that it would charge £44.00 and £36.00 per linear metre for trailers to Shetland and Orkney respectively. These rates were justified by the fact that NorthLink 1 needed to charge a rate that was both commercially sustainable and acceptable to the market. It was also stated that these rates would be fixed for a period of five years. NorthLink 1 stated that it could not "sustain a situation when we [NorthLink 1] carry trailers for free or for very small amounts". At the same time, NorthLink 1 emphasised that its freight business was not subsidised.
102. According to Streamline Shipping, NorthLink 1 responded to the competition from Streamline Shipping and Norse Island Ferries by introducing in 2002, at the very beginning of its contract, significant reductions (to £36.00 and £25.50 per linear metre for trailers to Shetland and Orkney respectively) on the charges previously

²⁸ Source: Streamline Shipping.

²⁹ Since rates for lo-lo operations are not usually quoted per linear metre, Streamline Shipping has calculated its rates on a per linear metre basis in order to make the comparison.

³⁰ The lo-lo service typically involves grouping and consolidating individual loads including loose freight or pallets which are often reloaded into a container and loaded on to a cargo vessel.

indicated by NorthLink 1 as being commercially sustainable. Streamline Shipping and Norse Island Ferries suspect that NorthLink 1 was providing its freight services at below cost.

103. NorthLink 1 introduced specific reduced rates in December 2003:

- (a) A special rate for empty trailers;
- (b) A special flat rate of £200 for non time-sensitive goods travelling between Aberdeen and Kirkwall (the so-called "Sunday Special"); and
- (c) A commercial traffic rebate scheme providing for discounts of up to 10% determined according to the level of eligible lane metres shipped per month.

104. Since NorthLink 2 started in July 2006 to execute the third public service contract, the commercial pressure exerted on Streamline Shipping has allegedly increased further. According to Streamline Shipping, the then Minister for Transport, when awarding to NorthLink 2 the new public service contract, announced that freight rates from Aberdeen to Shetland would be reduced by 25% and to Orkney by 19%. This was only possible, according to Streamline Shipping, thanks to the increased annual subsidy to NorthLink 2.

105. According to Streamline Shipping, in July 2006 the standard rates charged by NorthLink 2 were £30.60 per linear metre for Shetland and £23.50 per linear metre for Orkney. These rates are to be compared with £40.43 per linear metre for Shetland and £32.07 per linear metre for Orkney charged by Streamline Shipping. In addition, the empty trailer and 'Sunday Special' concessions have allegedly remained in place, with reductions on the rates offered by NorthLink 2 of up to 73%.

106. Streamline Shipping argues that, whilst it has sought in the past to compete by reducing rates, the scale of the reductions afforded to customers by NorthLink 2 has rendered this strategy no longer possible. Streamline Shipping estimates that to cover its costs it must charge rates which are equivalent to £36.67 per linear metre. Such a rate is higher than the rates currently offered by NorthLink 2.

107. Pentland Ferries argues that NorthLink 2 has been practicing a discount scheme for Orkney residents called "friends and family" that is having a very detrimental effect on the competing service provided by Pentland Ferries, especially since the start of the operation of Pentland Ferries' new catamaran Pentalina in March 2009. Namely, it is argued that in 2008/2009 NorthLink has been extending this discount to a very large number of "friends and family", thereby effectively decreasing passenger travel prices in a generalised way and damaging the competing service offered by Pentland Ferries.

108. The discount scheme consists in islanders nominating up to 6 Family and Friends households, which live outside Orkney and Shetland, to be eligible to receive a 30% discount on their NorthLink travel³¹.

³¹ Source: NorthLink's web site (www.northlinkferries.co.uk).

109. The UK authorities explained that this discount scheme, which is available only in the Low and Mid seasons, only benefited 4,952 passengers in 2008. Since NorthLink 2 carried 295,913 passengers in 2008, the discount scheme accounts for only 1.6% of NorthLink 2's carryings. Total revenue from this scheme (for all eligible passengers and cars) in 2008 amounted to around £95,000 which compares with NorthLink 2's total fare box revenues for 2008 of around £20 million, that is to say less than 0.5% of total revenues. The UK authorities argue that such a small-scale discount scheme is unlikely to have any significant effect on the commercial interests of Pentland Ferries.
110. The published passenger tariffs of NorthLink 2 (Scrabster-Stromness) and Pentland Ferries (Gill's Bay - St. Margaret's Hope) are currently the following³²:

Table 7: Comparison of published passenger fares between public service contract operator and Pentland Ferries

	NorthLink 2			Pentland Ferries	
	Low ³³	Mid ³⁴	Peak ³⁵	To 31/03/2009	01/04/2009 – 31/10/2009
PASSENGERS					
Adult single	£13.80	£15.00	£16.10	£10.00	£13.00
Child single (5-15 yrs)	£6.90	£7.50	£8.10	£5.00	£6.00
Infant (0-4 yrs)³⁶	FREE				
VEHICLES					
Car and motorhome (< 6m)	£43.60	£44.80	£48.20	£25.00	£30.00
Motorcycle	£13.20	£15.00	£16.70	£10.00	£11.00

111. It was also argued by an interested party that NorthLink 2 is offering Bed & Breakfast accommodation in Orkney (when the ship is static overnight) as a commercial activity at rates which are below cost and that this is affecting hotel-based Bed & Breakfast providers.

³² Source: respective web sites (www.northlinkferries.co.uk and www.pentlandferries.co.uk).

³³ Low season: January, February, March, November, December (excluding 19 December – 8 January).

³⁴ Mid season: April, May, June, September, October, 19 December – 8 January.

³⁵ Peak season: July, August.

³⁶ Pentland Ferries does not charge for children up to 5 years old.

2.3. Grounds for initiating the formal investigation procedure

2.3.1. Western islands

2.3.1.1. Existence of State aid

112. With regard to the State aid payments made to CalMac until the signature of the 2007 contract, in the decision to start the formal investigation procedure, the Commission expressed doubts about whether these payments met the criteria laid down in the Altmark case³⁷ and consequently fell outside the concept of State aid in accordance with Article 87(1) of the Treaty.
113. Namely, the Commission doubted whether: the public service obligations imposed on CalMac had been clearly defined; the parameters on the basis of which the compensation had been calculated had been established before the imposition of the public service obligations in an objective and transparent manner; there had been an overcompensation of the costs borne by CalMac with the performance of the public service obligations; the level of compensation needed had been determined on the basis of an analysis of the costs which a typical and wellrun undertaking would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit.
114. The Commission came to the preliminary conclusion that the relevant payments to CalMac until the signature of the 2007 contract could involve an advantage and might thus constitute State aid within the meaning of Article 87(1) of the EC Treaty.
115. As regards the 2007 public service contract with CalMac, the Commission did not have sufficient information to draw preliminary conclusions about the existence of State aid and requested the UK authorities submit the required information.
116. The Commission noted that some interested parties were of the view that the bundling of all routes, with the exception of the route between Gourock and Dunoon, unduly and significantly restrained competition during the tender since only CalMac was allegedly able to offer a bid covering the entire bundle. Also, the Commission raised the question whether the tender condition that the successful bidder had to charter the CMAL vessels might have constituted an advantage to CalMac.
117. If that would have been the case, the Commission would consider that the contract has not been awarded through a truly open and non-discriminatory public procurement procedure. This might have led to a situation where the Scottish authorities paid a higher compensation for the relevant public service requirements that would otherwise have been the case and therefore to the existence of State aid within the meaning of Article 87(1) of the Treaty.

³⁷ Judgment of the Court of Justice of the European Communities of 24 July 2003 in case C-280/00 - Altmark Trans & Regierungspräsidium Magdeburg; [2003], OJ C 226, 20.9.2003, p. 1 ECR I-7747.

2.3.1.2. Compatibility with the common market

118. In the opening decision the Commission considered that Article 86(2) of the Treaty seemed to be the appropriate legal basis to assess the compatibility of the measure with the common market³⁸.
119. The Commission expressed doubts about the fulfilment of the conditions of its Decision on the application of Article 86(2) of the Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (hereinafter "SGEI Decision")³⁹.
120. In order to be compatible under Article 86(2) of the Treaty, the subsidised services must correspond to genuine and legitimate services of general economic interest (hereafter "SGEI"), must be adequately entrusted to the beneficiary and the compensation must not cause disproportionate effects on competition and trade.
121. In the opening decision, the Commission took the preliminary position that the services entrusted to CalMac were legitimate SGEI but, for lack of evidence, was not in a position to assess whether the act of entrustment was adequate and whether the aid granted to CalMac was proportional to its objective and therefore to assess whether the possible State aid was compatible with the common market.

2.3.2. *Northern islands*

2.3.2.1. Existence of State aid

122. The Commission took the preliminary view that the financing of NorthLink 1 under the MoA was unlikely to meet the fourth Altmark criterion, which requires that the level of compensation is determined on the basis of an analysis of the costs which a typical and wellrun undertaking would have incurred in discharging the public service obligations. Thus, the payments in question were likely to constitute State aid under Article 87(1) of the Treaty.
123. With regard to NorthLink 2, the Commission sought clarifications on the transfer of assets from NorthLink 1 and on the compliance of the 2006 contract with the four Altmark conditions. The presence of State aid was therefore not excluded.

2.3.2.2. Compatibility with the common market

124. In its decision to start the formal investigation procedure the Commission could not identify a compatibility basis for the possible State aid to NorthLink 2 through a potential transfer of assets from NorthLink 1 below market price.
125. With regard to the possible State aid granted to NorthLink 1 under the 2000 contract and the MoA and to NorthLink 2 under the 2006 contract, the services delivered by these companies could be considered as legitimate SGEI and the acts of entrustment could be considered as appropriate. On the contrary, for lack of

³⁸ See footnote No 1.

³⁹ Commission Decision of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (notified under document number C(2005) 2673); OJ L 312, 29.11.2005, p. 67.

sufficient evidence it is doubtful whether the possible State aid granted to NorthLink 1 and 2 was proportional to its declared objective.

3. COMMENTS FROM INTERESTED PARTIES

126. During the time-frame provided for by Article 6(1) of the Procedural Regulation, the Commission received comments from several interested parties. In accordance with Article 6(2) of the Procedural Regulation, the UK authorities were given the opportunity to respond to the comments received from interested parties within that time-frame. The following interested parties submitted their views: the European Transport Workers' Federation, Mr James Knight of TSL contractors Limited, Western Ferries, Mr John Rose, Streamline Shipping, Professor Dr. Alfred J. Baird of Napier University, Pedersen Consulting, Mr James Knight and Mr Andy Knight (on behalf of Isle of Mull Ferry Company Limited), McGill's Bus Service Limited and two other parties which requested that their identity and the content of their submission be kept confidential.
127. *Streamline Shipping's* comments are similar to those made in its complaint of July 2004. They consider that the financial crisis of NorthLink 1 was a direct result of that undertaking's strategy to damage competition, initially from Norse Island Ferries and subsequently from Streamline Shipping, by severely reducing the freight rates to unprecedented levels. It was this strategy that led the Government to inject finance beyond what was needed for the fulfilment of the public service obligations. They quote the Auditor General's report of December 2005, which stated that "the level of freight charges and the resultant competition from Norse Island Ferries was one of the key factors which contributed to NorthLink 1's financial problems" and that "while chartering the extra (freight) vessel was intended to ensure there was adequate capacity to meet demand, it created a situation whereby freight capacity actually exceeded demand. The additional costs of running another vessel exceeded the extra income generated and added to the cash flow problems".
128. With regard to NorthLink 2, Streamline Shipping argues that its vessels are under-utilised. The announced reduction in market rates by 25% to Shetland and 19% to Orkney for NorthLink 2 when compared to the rates charged by NorthLink 1 has badly damaged Streamline Shipping, it is argued.
129. *Western Ferries* repeated its concerns about the subsidies paid to CalMac for the operation of the Gourock-Dunoon route. Western Ferries considers that this route is commercially viable, as demonstrated by its own profitable operation. It also considers that the Altmark conditions are not fulfilled since the level of the subsidy is more than that which would be needed in respect of a passenger-only service using a passenger-only vessel (estimated surplus of £1.3 million). It is also argued that the aid is being used to subsidise the vehicle service, for example by keeping vehicle transport prices unchanged in the face of higher fuel costs (CalMac increased prices in 2009 by only 3.8%, i.e. 1% below inflation). Moreover, unlike the NorthLink and CalMac networks, this route has not been tendered out and is therefore not in line with EU requirements. Furthermore, Western Ferries considers that the recent tender for CalMac's network was too prescriptive and that the bundling of all routes is unwarranted. In such conditions, only CalMac was able to bid.

130. With regard to CalMac's financial transparency, it is claimed that the reported cost of the Gourock-Dunoon route (£4.2 million in year to March 2008) underestimates the real full cost of the service because the pension liability relating to the respective crew is not reflected, there is no transparency in inter-company charges for shared head-office functions and the daily lease costs for the service vessel are significantly understated. There is no evidence that the Scottish Government has been actively monitoring possible cross-subsidisation of the vehicle business.
131. Western Ferries considers that, unlike in the situation of NorthLink, there is already sufficient market provision for passengers, cars and freight. For the future, there is no reason to subsidise vehicles due to the existing service of Western Ferries.
132. The *European Transport Workers' Federation* expressed disappointment that there is a need to review again the lifeline services provided by CalMac and NorthLink. They stress the need for a stable public service, which is legitimately defined in accordance with Council Regulation (EEC) No 3577/92 of 7 December 1992 applying the principle of freedom to provide services to maritime transport within Member States (hereinafter "Maritime Cabotage Regulation")⁴⁰.
133. *One interested party* expressed concerns about the dependency on a State provider whose monopolistic position is enforced through the channelling of State aid. This party considers that the tendering process for the routes operated by CalMac was narrowly defined and cannot be considered as an open tender. The interested party calls for unbundling of the routes subject to tender.
134. *Mr James Knight* considers that CalMac is not providing good value for money and that efficient private providers should take over the services currently provided by CalMac. He provides possible alternative plans to reduce the subsidies needed to operate the routes and to increase the incentives for innovation and cost efficiency.
135. *Another interested party* considers that the frequency restriction imposed on CalMac by the UK authorities on the Gourock-Dunoon route in fact constitutes State aid to Western Ferries, seriously distorts competition and reinforces the dominating position of Western Ferries. On the other hand, it considered that the State aid granted to CalMac is in exchange for a legitimate public service mission.
136. *Mr John Rose* considers that the tendering for the NorthLink 1 and NorthLink 2 contracts did not comply with EU rules. He also contends that the Gourock-Dunoon route cannot be considered as a lifeline service since a road alternative already exists and a private ferry company already provides a better service without subsidies.
137. *Professor Alfred Baird* submitted studies indicating that the efficiency of NorthLink's operations could be improved through improved fleet composition, that the increasing role of the State in Scottish ferry markets goes against EU policy and trends and that, in general, it is neither necessary nor desirable for the State to operate maritime transport services.

⁴⁰ OJ L 364 , 12.12.1992, p. 7.

138. *McGill's Bus Service* considers that there is no need for the subsidised foot passenger service between Gourock and Dunoon, since they are already providing the same service on a commercial basis.
139. *Pedersen Consulting* argues that the tender process for the western islands was so complex and expensive to comply with, that only CalMac was able to tackle the process. As regards the Gourock-Dunoon route, Pedersen Consulting considers that there is no sense in retaining a subsidised vehicle transport service since Western Ferries already profitably carries almost 90% of all vehicular traffic. However, a direct passenger connection with the Gourock rail head may make sense as a public transport operation. With regard to NorthLink, it is claimed that the tendering process was completely inadequate and resulted in an inefficient service, while Pentland Ferries already provides an unsubsidised and profitable service. The Stromness-Scrabster route could easily be made virtually obsolete, thereby saving taxpayers' money.

4. COMMENTS FROM THE UNITED KINGDOM ON THE OPENING DECISION AND ON THE COMMENTS FROM INTERESTED PARTIES

140. In its decision to open the formal investigation procedure the Commission expressed doubts as to whether the condition that the successful bidder in the public tender leading to the 2007 public service contract between the UK authorities and CalMac had to charter the CMAL vessels might have constituted an advantage to CalMac.
141. The UK authorities believe that there was no advantage in this provision for CalMac or CMAL. On the contrary, they consider that the ready availability of a fully compliant fleet capable of fulfilling the route requirements at commencement of the contract was an advantage to other bidders, lowered the barriers to potential bidders coming forward and created a level playing field in the tendering process.
142. The UK authorities referred to the Commission Communication on the interpretation of the Maritime Cabotage Regulation⁴¹ (section 5.3.2.1.) which states that "where Member States' authorities themselves own vessels or have them otherwise at their disposal, these may be placed at the disposal of all potential service operators under the same non-discriminatory terms". The UK authorities consider that it would be almost impossible for a single operator to have a new fleet of compliant vessels to service all the routes and maintain the links to remote island communities in time for the beginning of the contract period.
143. In the decision to open the formal investigation procedure, the Commission also questioned whether the bundling of all western islands routes in the 2006 public tender, with the exception of Gourock-Dunoon, would have unduly and significantly restrained competition during the tender as argued by some interested parties.

⁴¹ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the interpretation of Council Regulation (EEC) No 3577/92 applying the principle of freedom to provide services to maritime transport within Member States COM(2003) 595 final; not published in the Official Journal.

144. The UK authorities consider that tendering these routes as a single bundle was justified for a number of reasons: it maximised value for money for the Scottish Executive; it facilitated the provision of relief vessels in the event of a failure across the network; it avoided cherry picking of the more profitable routes; it facilitated management, enhanced fleet safety and maintenance; and avoided the additional administrative burden and cost of conducting multiple tenders.
145. According to the Commission Communication on the interpretation of the Maritime Cabotage Regulation (section 5.5.3.), "Member States often wish to group public service routes to and from different islands into a single bundle in order to generate economies of scale and attract operators. Bundles as such are not contrary to Community law provided that bundling does not lead to discrimination. The most appropriate size of bundles should be decided by taking account of the best synergy to be made in meeting essential transport needs."
146. In the decision to open the formal investigation procedure, the Commission also raised the question whether the transfer of certain assets⁴² in the amount of £1.55 million from NorthLink 1 to NorthLink 2 had been carried out below market price, thereby possibly constituting State aid to NorthLink 2.
147. The UK authorities argued that the possibility to buy assets from NorthLink 1 was already foreseen in the public tender document and that therefore all bidders had equal access to these assets on the same conditions. During the tender process information was passed on to the two selected bidders about the prices of the assets up for sale. There was no obligation to buy the assets, though, as bidders might prefer to bring in their own solutions.
148. All bidders were allowed to inspect the vessels and the equipment and other assets. The value of the more significant assets (vessel, tugmasters and NorthLink brand in the amount of £1.3 million) was established by independent valuations. The remaining assets, in the amount of £0.25 million were valued on the basis of market estimates.
149. With regard to the possible application of the SGEI Decision⁴³, the UK authorities considered that most of the routes on the Clyde and Hebrides and on the NorthLink's network appear to be covered by the SGEI Decision. Only four of the routes served by CalMac and NorthLink do not fulfil the threshold criteria and these should be assessed directly under Article 86(2) of the EC Treaty.
150. The UK authorities considered that the public service contracts with CalMac and NorthLink constitute appropriate entrustment acts, by specifying in detail the nature and duration of the public service obligations, the undertakings and the territories concerned, the nature of any exclusive or special rights assigned to the undertakings, the parameters for calculating, controlling and reviewing the compensation and the arrangements for avoiding and repaying any overcompensation.

⁴² A vessel, tugmasters, vessel engineering spares, port equipment, IT hardware, NorthLink brand, etc.

⁴³ See footnote no. 39.

151. Moreover, CalMac and NorthLink are obliged to keep separate accounts for SGEI and non-SGEI activities, only the costs related to the SGEI activities can be subject to compensation (all variable costs incurred in providing the SGEI, a proportionate contribution of fixed costs common to SGEI and non-SGEI activities and a reasonable profit) and there are appropriate reporting and monitoring procedures in place.
152. With regard to the Gourock-Dunoon route, the UK authorities recognise that it may be questionable whether the service provided by CalMac constitutes a legitimate SGEI, since a private sector operator operates on an adjacent route without subsidy. However, they consider that the Western Ferries service is seen by many local people as complementary and useful but not as an effective substitute for the town centre to town centre CalMac service.
153. The UK authorities informed the Commission that, after the unsuccessful tender procedure carried out in 2006 for the Gourock-Dunoon route, they intend to launch a new open, transparent and non-discriminatory public tender for a public service contract for this route with the following characteristics:
- a) the public service contract will cover a town centre to town centre ferry service by means of a 6-year public service contract;
 - b) the tender will allow for a subsidy to operate this route (unlike the preceding tender);
 - c) the current timetable restrictions will be removed;
 - d) the subsidy will cover only passenger traffic;
 - e) the winning bidder will be allowed to provide an unrestricted commercial vehicle transport service, subject to appropriate accountancy measures and audit monitoring to prevent cross subsidisation from the passenger service to the commercial vehicle service;
 - f) the winning bidder will be free to bring in its own vessel solutions, replacing the old vessels currently operating on the route.
154. The UK authorities intend to procure the replacement vessels through CMAL, which will then lease them to the operator awarded the public service contract. The UK authorities consider that this SGEI is justified for several reasons dealing with the frequency, convenience of service, overall journey time, integration with other means of transport and service reliability, among others.

5. ASSESSMENT OF THE MEASURE

5.1. Existence of State aid

5.1.1. Criteria under Article 87(1) of the Treaty

155. Under Article 87(1) of the Treaty “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods

shall, in so far as it affects trade between Member States, be incompatible with the common market.”

156. The criteria laid down in Article 87(1) of the Treaty are cumulative. Therefore, in order to determine whether the above-described payments to CalMac, NorthLink 1 and NorthLink 2 constitute State aid within the meaning of Article 87(1) of the Treaty, it must be established whether the financial support:
- involves a loss of State resources imputable to the State;
 - provides a selective advantage to certain undertakings or the production of certain goods;
 - distorts or threatens to distort competition; and
 - affects trade between Member States.
157. The various payments described above have been granted through State resources and are imputable to the Member State concerned. Thus, the first criterion under Article 87(1) of the Treaty is met.
158. The relevant payments, in the form of deficit grants and capital grants/loans are only made to certain specific undertakings. They are therefore selective.
159. The regular financing of CalMac and NorthLink 1 and NorthLink 2 reduces the operating costs that these undertakings would normally have to bear and provides them with an economic benefit compared to other undertakings which finance their activities based on commercial revenues only. Nevertheless, in order to establish that there is an advantage capable of constituting State aid in the sense of Article 87(1) of the Treaty, the Commission must assess whether the "Altmark conditions" are fulfilled⁴⁴.
160. The market for maritime cabotage routes has been fully liberalised since the entry into force of the Maritime Cabotage Regulation, i.e. since 1 January 1993. If an advantage had been granted to any of those undertakings taking into account the Altmark criteria, this advantage would be liable to distort competition and affect trade between Member States. As such, the third and fourth criteria of Article 87(1) of the Treaty would also be fulfilled.
161. The Commission also confirms its preliminary assessment that the payments made to CalMac and NorthLink 1 and NorthLink 2 are not consistent with the behaviour that a private investor would have under normal market conditions. Therefore, those payments cannot be considered as exempt from State aid on the basis of the market economy investor principle.
162. The sale of assets that occurred during the transition from the NorthLink 1 to the NorthLink 2 contracts did not contain State aid elements. All assets owned by NorthLink 1 which were relevant for the operation of the ferry services were made available to all bidders during the 2004-2005 public tender (See Recital 88 above. The sale, which totalled around GBP 1.5 million for all assets, was carried out on

⁴⁴ See footnote no. 37.

the basis of the actual market price or the estimated market price, depending on the assets. Since these assets were available at the same price to all bidders and since these prices corresponded to the market price of the goods, their sale did not involve the use of State resources and did not confer a selective economic advantage to any undertaking. Thus, the existence of State aid elements in the asset sale is excluded.

163. In the decision to open the formal investigation procedure, the Commission questioned whether the rates charged for certain loans advanced to CalMac were consistent with the market economy investor principle and therefore whether they contained State aid.
164. This would have been important to establish whether CalMac had been overcompensated for discharging its public service obligations, taking into account all sources of public funding. However, since in the case of CalMac the aid scheme is an existing aid and since its compatibility must only be assessed for the future (see section 5.2 below), there is no need for the Commission to further assess the State aid character of these loans as they only relate to the past.

5.1.2. *Altmark criteria*

165. As mentioned in recital 112 above, in order to establish that there is an advantage capable of constituting State aid in the sense of Article 87(1) of the Treaty, the Commission must assess whether the Altmark conditions are fulfilled.
166. According to the Altmark case-law, compensation for public service obligations or contracts does not favour the recipient(s) - and thus does not fall within the scope of the prohibition laid down in Article 87(1) of the Treaty - when the following four conditions are cumulatively met:
 - the recipient undertaking is actually required to discharge public service obligations and those obligations have been clearly defined (hereinafter "Altmark 1");
 - the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner (hereinafter "Altmark 2");
 - the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations (hereinafter "Altmark 3"); and
 - where the undertaking which is to discharge public service obligations is not chosen in a public procurement procedure, the level of compensation needed has been determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately equipped, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations (hereinafter "Altmark 4").

5.1.2.1. CalMac

167. In the case of CalMac, there are two distinct stages as indicated in the decision to open the formal investigation procedure: a first stage prior to the 2007 contract when the public service obligations were directly entrusted to CalMac without a prior public tender via "undertakings" and when all the conditions of the provision of public service were specified in annual letters sent to CalMac by the Scottish authorities; and a second stage after the 2007 contract, which was awarded following a public tender procedure specifying in detail the public service obligations. The situation of the Gourock-Dunoon route must be distinguished since this route was excluded from the 2007 contract and the conditions of the public service obligations continue to be specified in annual letters sent to CalMac by the Scottish authorities.

a. Before the 2007 contract

168. As indicated in the decision to open the formal investigation procedure, there is little doubt that before the 2007 contract the compensation for the public service obligations imposed on CalMac did not fulfil all the Altmark criteria. The public service obligations were not clearly defined in a legal Act. Moreover, the specifications of the public service obligations, such as the ports to be served, regularity, continuity and frequency were not clearly established in a formal act. The parameters for establishing the compensation were not established ex ante in a transparent manner and the level of compensation was not calculated on the basis of an analysis of the costs of a typical undertaking. The preliminary assessment of the decision to open the formal investigation procedure is therefore confirmed.

169. Since the compensation for the operation of the Gourock-Dunoon route is still done on that basis, the assessment above also applies to this route.

b. After the 2007 contract

Altmark 1 – clearly defined public service obligations

170. In this particular sector there is a Regulation specifying what elements should be part of an adequate definition of public service obligations. The fulfilment of the Altmark 1 criterion should therefore be assessed with regard to Article 4 of the Maritime Cabotage Regulation, which sets out the specifications that should be part of the definition of the public service obligations, namely: ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels.

171. The 2007 contract clearly meets this condition by defining in detail all these parameters. Precise figures for manning of the vessels are not included in the tender document, but the requirements, for example, in terms of quality of service and protection of employment regulations leave little margin for significant discrepancies in the manning of the vessels.

172. The public service contract also has a reasonable duration - six years – in compliance with the Community guidelines on State aid to maritime transport (hereinafter "Maritime Guidelines")⁴⁵.

Altmark 2 – ex ante, objective and transparent establishment of parameters for compensation

173. In the context of the Altmark assessment, the second condition requires that the parameters for the compensation are clearly established in advance in an objective manner, taking into account all the variables (e.g. fuel costs, investments in new vessels, etc.).
174. On the one hand, before the public service obligations started being discharged, the parameters for compensation were rather clear. They were equal to the costs foreseen by the bidders, which had to be estimated in detail, plus an agreed level of profit margin minus the expected revenue from the operation of the ferry service. There is a clawback clause stating that if the agreed profit margin is exceeded, the subsidy is reduced accordingly. This calculation is made for each of the six years of the contract before the beginning of the contract (hereinafter "the Base Case scenario"). The public service contract foresees a series of exceptional events that may trigger a revision of the compensation amount (e.g. unforeseen harbour works, new vessel, wage increases, etc.).
175. On the other hand, at the end of each year of contract, the Base Case scenario will be reviewed to reflect the actual experience of the previous year. The Base Case scenario may also be revised during a given year in exceptional circumstances. The compensation may be increased or decreased several times during the contract period. The revision of the Base Case scenario is proposed by the operator (CalMac) and must be agreed by the Scottish Executive. There is also the possibility to refer the matter to an expert in case of disagreement. Although the public service contract contains some indications on how the compensation will be adjusted in the case of certain unforeseen circumstances, the exact parameters of these adjustments are not known in advance. The amount of compensation will rather be adjusted via a bilateral arbitration procedure between the Scottish authorities and CalMac, possibly involving the intervention of an expert. The criteria used in this arbitration procedure are not set out in advance in an objective manner for all possible events. This arbitration procedure gives rise to a lack of transparency in the determination of the parameters for compensation. It also introduces a risk of variation in the compensation granted each year that is not dependent on transparent, predetermined and objective criteria.
176. Therefore, the Commission cannot establish, beyond reasonable doubt, that the Altmark 2 condition is fulfilled.

Altmark 3 – no overcompensation (including reasonable profit)

177. As indicated in the preceding section, the parameters for the compensation are in general clearly established, with the exception of the criteria used in the arbitration procedure foreseen under certain circumstances. Even though some parameters of the compensation are not precisely defined in advance, the Commission considers

⁴⁵ OJ C 13, 17.01.2004, p. 3.

that the procedure in place to review the compensation amount in such circumstances is appropriate to ensure that there will be no overcompensation. This is because the possible additional compensation will be based on actual costs incurred. Thus, the Altmark 3 condition is fulfilled (see also section 5.3.3.3 below).

Altmark 4 – tender procedure - in case of no tender, costs calculated by reference to typical undertaking

178. In the present case the public service obligations were attributed following a public tender procedure.
179. It must first be assessed whether the tender was well-designed, fair, open and transparent. Otherwise, the cost to the State could be higher than the minimum necessary for discharging the public service obligations.
180. The main issues raised by interested parties in this context were the bundling of all routes in the tender, with the exception of Gourock-Dunnon, and the requirement for the winning bidder to use CMAL's vessels.
181. As regards the bundling of routes, it was argued that this effectively excluded opponents since CalMac, which was already providing all the services, was the only bidder capable of making an offer for the entire bundle of routes.
182. However there was a second bidder (V-Ships) which made a bid for the whole bundle. V-Ships eventually withdrew from the process arguing that the condition that CMAL's vessels must be used prevented innovation and flexibility on the services to be provided.
183. The geographical area covered by the 26 routes is quite homogeneous: all routes are relatively short (maximum of around 100 kilometres) and the ports used are relatively concentrated (in a range of around 250 kilometres in the mainland).
184. The UK authorities provided credible arguments justifying the bundling of the 26 routes.
185. They argued that bundling ensures maximum flexibility of the fleet to best serve the network. For example in case of break-down of a vessel, the immediate provision of a relief vessel is critical to ensure the reliability of the lifeline services. Relief vessels are also needed in case of poor weather conditions, when vessels have to undertake maintenance works and when there is an unexpected need for increased capacity. At present, CalMac can organise a relief vessel often by managing a series of sequential movements of vessels between routes. It would be more difficult to ensure continuity of services and capacity optimisation if there were a range of operators serving the network.
186. Moreover, the bundling of all routes enhances integration of the network by making it easier combine safety, quality and environmental aspects of vessel and port operations and to ensure that standards are applied evenly across the network. The United Kingdom's Maritime & Coastguard Agency Regional Office for Scotland and Ireland has made it clear that the fragmentation of the network may not be the most efficient way to ensure the continuation of safe and reliable services.

187. Furthermore, bundling leads to economies of scale particularly in ticketing and marketing and supports integrated transport by allowing customers access to bookings on a series of routes in a single transaction. This also applies to tourism promotion.
188. It may be argued that in order to minimise costs, each route should be tendered out separately. However, the Commission acknowledges that the administrative costs and burden of such individual tendering (26 individual tenders) could be too high.
189. A mid-way solution, bundling only some routes might also be considered, but it would be speculative to predict whether the outcome of such tendering in terms of overall cost to the public budget would be higher or lower than the actual cost resulting from the bundled tender.
190. The Commission Communication on the interpretation of the Maritime Cabotage Regulation (section 5.5.3) states that "Member States often wish to group public service routes to and from different islands into a single bundle in order to generate economies of scale and attract operators. Bundles as such are not contrary to Community law provided that bundling does not lead to discrimination. The most appropriate size of bundles should be decided by taking account of the best synergy to be made in meeting essential transport needs".
191. Given the legal framework which explicitly allows for the bundling of routes and the reasonable arguments presented by the UK authorities, it cannot be concluded that the bundling of routes is an unnecessarily unfair condition of the public tender and inevitably increases the cost to the State for discharging the public service obligations.
192. The requirement for the winning bidder to use CMAL's assets is a reasonable condition of the tender, taking into account that the Scottish authorities had a clear interest in using already available vessels rather than having to keep them unused or otherwise to dispose of these assets. The Commission Communication on the interpretation of the Maritime Cabotage Regulation (section 5.3.2.1.)⁴⁶ foresees that "where Member States' authorities themselves own vessels or have them otherwise at their disposal, these may be placed at the disposal of all potential service operators under the same non-discriminatory terms". Moreover, it is a neutral condition for bidders, given that any bidder would pay the same price for the use of the same vessels. Even though this requirement is legitimate, it may lead to an increased cost in the service. Indeed, it cannot be excluded that if bidders were free to present alternative vessel solutions, this might lead to lower overall net costs of the public service obligations.
193. Furthermore, given the specificities of the vessels needed to operate the Scottish western islands routes, it could be difficult for a single operator to have a new fleet of compliant vessels capable of serving all the routes and maintaining the links to remote island communities in time for the beginning of the contract period.

⁴⁶ COM(2003) 595 final - Not published in the Official Journal.

194. CalMac had a competitive advantage in the tender since it already served the routes, but it would be erroneous to conclude that because of this advantage the tender was unduly tailor-made and effectively excluded other bidders⁴⁷.
195. Therefore, it is concluded that the tender procedure was conducted in an adequate manner and that it was open, non-discriminatory and transparent.
196. As mentioned above, the parameters for calculating the compensation are to be reviewed every year at least. This revision is in some cases the result of an arbitration process between the operator and the Scottish authorities. Consequently, there is a risk that the State will have to provide more (or less) funds to the operator than the compensation foreseen in its bid.
197. If the invitation to tender had required the bidders to commit to a given fixed compensation for the six years of the contract, with all risks being assumed by them, the State would incur no risk and would theoretically minimise costs. However, it cannot be excluded that, if the bidders had to take on all the risks of the operation, there would be no undertakings willing to bid or that the bidders would bid much higher to price in the added risk.
198. It cannot be concluded, beyond reasonable doubt, that the Altmark 4 condition is met.

Conclusion

199. , Given that it cannot be concluded beyond reasonable doubt that the Altmark 2 and 4 criteria are met the public service contract with CalMac is deemed to contain State aid elements.

5.1.2.2. NorthLink

a. NorthLink 1 (2002-2006)

Altmark 1 – clearly defined public service obligations

200. As mentioned in recital 170 above, in this particular sector there is a Regulation specifying which elements should be part of an adequate definition of public service obligations. The fulfilment of the Altmark 1 criterion should therefore be assessed with regard to Article 4 of the Maritime Cabotage Regulation.
201. It is clear that the invitation to tender met this criterion by defining in detail all parameters referred to in the Maritime Cabotage Regulation, i.e. ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels. This is confirmed by the Report of Audit Scotland of December 2005.
202. The public service contract also had a duration below the six years recommended by the Maritime Guidelines.

⁴⁷ There was in fact another bidder in the process.

Altmark 2 – ex ante, objective and transparent establishment of parameters for compensation

203. On the one hand, before the public service obligations started being discharged, the parameters for compensation were rather clear. They were equal to the costs foreseen by the bidders, which had to be estimated in detail, plus an agreed level of profit margin minus the expected revenue from the operation of the ferry service. There was a clawback clause stating that if the agreed profit margin was exceeded, the extra profits would be shared with the Scottish Executive. Most of the economic/financial risks were to be borne by the winning bidder (risk of costs exceeding estimates, risk of falling demand, inflation risk, etc.).
204. On the other hand, some risks remained with the Scottish Executive or were shared between the parties, notably the risk of policy changes (EU or national) and legislative risks (changes in corporate tax law, for example). The contract also required the Scottish Executive to pay additional grants to NorthLink 1 in case its return on capital was less than a certain rate or if other factors outside its control affected its revenue (e.g. increase in fuel prices by more than 10%). Following the financial difficulties of NorthLink 1 in 2003 extra payments were made and in 2004 the MoA was signed, envisaging monthly payments to NorthLink 1 and the possibility for additional payments depending on NorthLink 1's financial performance.
205. The possibilities for extra funding going beyond the level of compensation foreseen in the original contract were not established on the basis of ex ante, objective and transparent parameters, as shown by the subsequent need to provide additional funds outside the scope of the public service contract. In any case, the additional funding possibilities under the MoA and the additional payments made to NorthLink 1 following its financial difficulties were not based on objective and transparent parameters.
206. Therefore, it cannot be established beyond reasonable doubt, that the Altmark 2 condition is fulfilled.

Altmark 3 – no overcompensation (including reasonable profit)

207. As indicated in the preceding section, the parameters for the compensation were in general clearly established, with the exception of the criteria used in the arbitration procedure foreseen under certain circumstances. Even though some parameters of the compensation were not precisely defined in advance, the procedure in place to review the compensation amount in such circumstances was appropriate to ensure that there would be no overcompensation. Thus, the public service contract of NorthLink 1 respected the Altmark 3 condition.

Altmark 4 – public tender - in case of no tender, costs calculated by reference to typical undertaking

208. As in the case of CalMac analysed above (recital 178 above), NorthLink 1's public service obligations were entrusted following a public tender procedure.
209. It must therefore be assessed whether the tender was well-designed, fair, open and transparent. Otherwise, the cost to the State could be higher than the minimum necessary for discharging the public service obligations.

210. The tender procedure covered two routes (26 routes in the case of CalMac analysed above – see recitals 183-191 above). The bundling issue is therefore less relevant in the case of NorthLink 1 and NorthLink 2 than in the case of CalMac. For the same reasons invoked above with regard to CalMac, the Commission does not consider that the bundling of the two routes calls into question the open, non-discriminatory and transparent character of the tender.
211. However, the subsidies granted to NorthLink 1 under the MoA, which went beyond the level of compensation foreseen in the original contract, were not the result of a public tender and were not determined on the basis of an analysis of the costs of a typical undertaking. In fact, by introducing a new deficit funding system during the implementation of the contract, the MoA in fact altered the nature and extent of the initial tender, thereby affecting its transparency in relation to the way it had been presented to potential bidders.
212. Accordingly, it cannot be concluded beyond reasonable doubt that the Altmark 4 criterion is met.

Conclusion

213. Given that it cannot be concluded beyond reasonable doubt that the Altmark 2 and 4 criteria are met, the public service contract with NorthLink 1 is deemed to contain State aid elements.

b. NorthLink 2 (2006-2012)

Altmark 1 – clearly defined public service obligations

214. As mentioned above, in this particular sector there is a Regulation specifying what elements should be part of an adequate definition of public service obligations. The fulfilment of the Altmark 1 criterion should therefore be assessed with regard to Article 4 of the Maritime Cabotage Regulation.
215. It is clear that the invitation to tender met this criterion by defining in detail all parameters referred to in the Maritime Cabotage Regulation, i.e. ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels.
216. The public service contract also has a reasonable duration - six years – in compliance with the Maritime Guidelines.

Altmark 2 – ex ante, objective and transparent establishment of parameters for compensation

217. On the one hand, before the public service obligations started being discharged, the parameters for compensation were rather clear. They were equal to the costs foreseen by the bidders, which had to be estimated in detail, plus an agreed level of profit margin minus the expected revenue from the operation of the ferry service. There is a claw back clause stating that if the agreed profit margin is exceeded, the extra profits would be shared with the Scottish Executive. In this second contract with NorthLink 2, more risks are borne by the Scottish Executive or shared between the parties (weather risk, inflation risk, risk of falling demand, change in transport policy, etc.).

218. On the other hand, similar to the 2007 public service contract with CalMac, subsidy amounts are to be reviewed annually on the basis of the actual performance in the previous year. The operator will submit a provisional draft revised Base Case scenario which then has to be agreed by the Scottish authorities. In case of conflict an expert is called upon to arbitrate. Although the public service contract contains some indications as to how the compensation will be adjusted in the case of certain unforeseen circumstances, the exact parameters of these adjustments are not known in advance. The amount of compensation will rather be adjusted via a bilateral arbitration procedure between the Scottish authorities and NorthLink 2, possibly involving the intervention of an expert. The Commission notes that the criteria used in this arbitration procedure are not set out in advance in an objective manner for all possible events. This arbitration procedure gives rise to a lack of transparency in the determination of the parameters for compensation. It also introduces a risk of variation in the compensation granted each year that is not dependent on transparent, predetermined and objective criteria. Therefore, it cannot be established beyond reasonable doubt that the Altmark 2 condition is fulfilled.

Altmark 3 – no overcompensation (including reasonable profit)

219. As indicated in the preceding section, the parameters for the compensation are in general clearly established, with the exception of the criteria used in the arbitration procedure foreseen under certain circumstances. Even though some parameters of the compensation are not precisely defined in advance, the procedure in place to review the compensation amount in such circumstances is appropriate to ensure that there will be no over-compensation. This is because the possible additional compensation will be based on actual costs incurred. Thus, the Altmark 3 condition is fulfilled (see also section 5.3.4.3 below).

Altmark 4 – public tender - in case of no tender, costs calculated by reference to typical undertaking

220. In the present case the public service obligations were attributed following a public tender procedure.

221. It must first be assessed whether the tender was well-designed, fair, open and transparent. Otherwise, the cost to the State could be higher than the minimum necessary for discharging the public service obligations.

222. As with NorthLink 1, the Commission does not consider that the bundling of the two routes calls into question the open, non-discriminatory and transparent character of the tender.

223. As in the case of CalMac, the requirement for the winning bidder to use the vessels of NorthLink 1 is a reasonable condition of the tender, taking into account that the Scottish Executive had a clear interest in using already available vessels rather than having to keep them unused or otherwise to dispose of these assets. Moreover, it is a neutral condition for bidders, given that any bidder would pay the same price for the use of the same vessels. Even though this requirement is legitimate, it may lead to a higher cost of the service. Indeed, it cannot be excluded that if bidders were free to present alternative vessel solutions, this might lead to lower overall net costs of the public service obligations.

224. For these reasons and in line with the assessment above regarding CalMac⁴⁸, the Commission cannot conclude, beyond reasonable doubt, that the Altmark 4 criterion is met.

Conclusion

225. Given that it cannot be concluded beyond reasonable doubt that the Altmark 2 and 4 criteria are met, the public service contract with NorthLink 2 is deemed to contain State aid elements.

5.2. Nature of the aid

5.2.1. General considerations

226. Having established that the payments granted to CalMac, NorthLink 1 and NorthLink 2 constitute State aid within the meaning of Article 87(1) of the Treaty, the Commission must assess whether this State aid is existing or whether it constitutes new aid. In this respect, it should be noted that when initiating the formal investigation procedure the Commission did not address the question whether the aid should be considered as new or existing aid.
227. As mentioned previously⁴⁹, during the course of the formal investigation procedure, it became apparent, however, that part of the aid might be considered as existing aid in view of the date of entry into force of the legal provisions providing for the aid. Therefore, the Commission decided to initiate, in parallel to the formal investigation procedure, the cooperation procedure foreseen under Article 17 of the Procedural Regulation.
228. In the case of existing State aid, the Commission is only required to check its compatibility at present and recommend possible changes for the future. Inversely, in the case of new aid, the Commission is required to check its compatibility with the common market also in the past.
229. Under Article 1(b)(i) of the Procedural Regulation as amended, existing aid is "without prejudice to Articles 144 and 172 of the Act of Accession of Austria, Finland and Sweden, to Annex IV, point 3 and the Appendix to said Annex of the Act of Accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia, and to Annex V, point 2 and 3(b) and the Appendix to said Annex of the Act of Accession of Bulgaria and Romania, all aid which existed prior to the entry into force of the Treaty in the respective Member States, that is to say, aid schemes and individual aid which were put into effect before, and are still applicable after, the entry into force of the Treaty".
230. According to Article 4(1) of Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty⁵⁰ (hereinafter "the Implementing Regulation), "an alteration to existing aid shall mean any change,

⁴⁸ See recitals 178-198 above.

⁴⁹ See par. 9 above.

⁵⁰ OJ L 140, 30. 4.2004, p. 1.

other than modifications of a purely formal or administrative nature which cannot affect the evaluation of the compatibility of the aid measure with the common market".

231. According to the established case-law⁵¹, not every alteration to existing aid should be regarded as changing the existing aid into new aid. In that case, the Court of First Instance held "it is only where the alteration affects the actual substance of the original scheme that the latter is transformed into a new aid scheme. There can be no question of such a substantive alteration where the new element is clearly severable from the initial scheme."
232. The Court Justice has also clarified that "(...) whether aid may be classified as new aid or as alteration of existing aid must be determined by reference to the provisions providing for it"⁵². When the relevant legal provisions have not been changed as regards the nature of the advantage or the activities of the beneficiaries, there is no new aid.
233. Therefore, it should be assessed, by reference to the legal framework and to the evolution of the scheme, whether there have been substantial changes since the United Kingdom's accession to the EU in 1973 that would involve new aid. The caselaw refers to changes in the nature of the advantage, the objective pursued, the beneficiary or the source of financing.
234. It should also be assessed whether subsequent modifications are severable from the original measure or whether the non-severable changes affect the actual substance of the original legal framework, i.e. the nature of the advantage or the source of financing, the purpose or legal basis of the aid, the beneficiaries or the scope of activities of the beneficiaries so that the latter as a whole is transformed into a new aid.

5.2.2. *CalMac*

235. CalMac has been providing ferry shipping services in the western Scottish islands long before the UK accession to the European Community in 1973.
236. The initial legal basis for the subsidies was section 2(1) of the Highlands and Islands Shipping Services Act of 1960 which allowed the Scottish Ministers⁵³ to provide grants/loans to persons providing public sea transport services. Sections 2(3) and 2(4) of the Act provided that an "Undertaking" (which took the form of subordinate legislation in practice) had to be used when such a grant/loan exceeded £10,000 and that any such Undertaking had to be approved by the Scottish Parliament⁵⁴.

⁵¹ Judgment of the Court of First Instance of 30 April 2002 in joined cases T-195/01 and T-207/01 - *Gibraltar v. Commission*; [2002] ECR II-2309.

⁵² Judgment of the Court of Justice of 9 August 1994 in case C-44/93 - *Namur-Les Assurances du Crédit SA*; [1994] ECR I-03829.

⁵³ Before devolution in 1999 the Scottish Office, a Department of the UK Government.

⁵⁴ Before devolution the UK Parliament.

237. Section 45(1) of the Transport (Scotland) Act of 2005, which came into force on 10 October 2005 repealed those provisions of the 1960 Act but section 45(2) provided that any Undertaking which had been entered into before 10 October 2005 would continue to have effect. This meant that the Undertaking dated 7 April 1995 entrusting the public service obligations to CalMac continued to have effect after the entry into force of the 2005 Act.
238. Since 1 October 2006, when the restructuring of the CalMac group took place and a new legal entity was created to operate the Gourock-Dunoon route, compensation for the public service obligations in this route is based on Section 70(1) of the Transport (Scotland) Act of 2001 as amended by the Transport Scotland Act of 2005.
239. Until 1 October 1997, when the Clyde and Hebrides ferry services contract entered into force, the public service obligations were specified in annual letters from the Scottish Ministers to CalMac (regularity, frequencies, capacities, fare rates and subsidy amount).
240. Since 1 October 2007, the specifications of the public service obligations are part of the public service contract which followed a public tender procedure, except for the Gourock-Dunoon route.
241. As regards the Gourock-Dunoon route, since 1 October 2007 the subsidy requirements have been determined administratively on the basis of the Scottish Ministers' approvals of the company's annual financial plans and the in-year monitoring by the Scottish Government of actual deficit requirements.
242. In light of the above, the Commission is of the opinion that the purpose of the aid scheme has clearly remained constant since the inception of the scheme. It is to provide ferry transport services between the Scottish islands.
243. The evolution of the legal basis of the scheme did not materially change the nature of the advantage given to CalMac since 1973. CalMac has continuously been receiving deficit grants, capital grants and loans (for piers and harbours infrastructure and for vessels). The source of this financing has also not changed as all funds continue to come from the national budget.
244. There have been regular increases in the amount of annual compensation. These increases should not, however, be regarded as new aid. As the Court of Justice has stated⁵⁵ "(...) the emergence of new aid or the alteration of existing aid cannot be assessed according to the scale of the aid or, in particular, its amount in financial terms at any moment in the life of the undertaking if the aid is provided under earlier statutory provisions which remain unaltered."
245. The Commission is of the view that the increasing aid amounts are the consequence of increased financial needs of the public service provider in fulfilling its public service mission, while the public service obligations, the funding arrangements and the amendments to the statutory provisions for the compensation have not suffered material changes.

⁵⁵ See footnote. 52.

246. The beneficiary of the measure has been the same since the beginning of the scheme. Although CalMac underwent a restructuring process in 2006, it has always been the sole beneficiary of the aid and has always been a fully-owned public company. In 2006 its vessel and shore assets were separated from its ferry operating role. This change cannot be seen as altering the beneficiaries of the scheme as the two separate legal entities continue to be the only interveners in the compensation scheme. This legal separation is a change of technical nature that does not lead to a material change of beneficiary of the aid.
247. Likewise, the attribution of the operations on the Hebrides and Clyde to two separate legal entities (CalMac Ferries Ltd and Cowal Ferries Ltd, two wholly-owned subsidiaries of David MacBrayne Ltd) must be seen as a change of technical nature that does not lead to a material change of beneficiary of the aid.
248. There have been some adaptations to the overall service and routes served by CalMac. A few new services were added while a few others were discontinued. One of these adaptations, for example, resulted from the opening of a new bridge which rendered the existing service superfluous. The Commission considers that these are technical changes intended to adapt the public service offer to the needs of the population. These adaptations did not change the overall purpose of the scheme. The public service obligations are defined as a whole and limited technical adjustments to the routes served do not materially change the essence of the scheme.
249. For the reasons set out above, the Commission has concluded in the course of its investigation that the aid scheme concerning CalMac constitutes an existing aid⁵⁶ and initiated the co-operation procedure provided for under Article 17 of the Procedural Regulation in parallel to the formal investigation procedure. It informed the Member State about this conclusion and expressed its preliminary view that some aspects of the scheme were no longer compatible with the common market. The Member State's authorities were given the opportunity to submit their comments on this preliminary view.
250. Since the State aid scheme in favour of CalMac is an existing aid, its compatibility must accordingly be assessed exclusively by reference to the present situation⁵⁷ and the Commission is not required to assess the compatibility of the aid granted to CalMac in the past.

5.2.3. *NorthLink*

251. It is clear that the payments made to NorthLink 1 under the public service contract for the operation of the Northern islands routes in the period 2002-2006 and under the MoA constitute new aid since NorthLink 1 was not developing any public service activities in these routes before 2002.

⁵⁶ For a similar reasoning, see Commission decision of 28 January 2009 in case E 4/2007 - France - Différenciation des "redevances par passager" sur certains aéroports français, especially section 4 thereof.

⁵⁷ Meaning the situation from the date of entry into force of the 2007 public service contract with CalMac, except in the case of the Gourock-Dunoon route, for which the relevant situation dates back to the inception of the service.

252. Similarly, the payments made to NorthLink 2 constitute new aid, independently from the question whether NorthLink 1 and NorthLink 2 should be seen as separate beneficiaries or whether NorthLink 2 should be considered as a mere continuation of NorthLink 1.

253. Therefore, all aid paid from 2002 to NorthLink 1 and NorthLink 2 must be considered as new aid.

254. The compatibility of the scheme with the common market must therefore be assessed for the period since 2002.

5.3. Compatibility

5.3.1. Applicability of Article 86(2) of the Treaty

255. Article 86(2) of the Treaty is the legal basis to assess the aid granted to CalMac, NorthLink 1 and NorthLink 2.

256. Under Article 86(2) of the Treaty, it must be assessed whether:

- The ferry services in Scotland constitute SGEI and are clearly defined as such by the UK authorities (definition)⁵⁸;
- CalMac, NorthLink 1 and NorthLink 2 are explicitly entrusted by the Member State with the provision of that service and are subject to supervision as to the fulfilment of their tasks (entrustment and supervision);
- The funding is proportionate to the net cost of providing the public service, taking also into account other direct or indirect revenues derived from the public service, and does not lead to unnecessary distortions of competition or effects on trade (proportionality).

5.3.2. Applicability of SGEI Framework⁵⁹ / SGEI Decision⁶⁰

257. As from its entry into force, the SGEI Decision exempts from the notification requirement public compensation for the performance of SGEI under certain conditions. The SGEI Framework lays down the conditions for compatibility of measures subject to the notification requirement as from its entry into force.

258. The SGEI Framework explicitly excludes the transport sector in its point 3 and is therefore not applicable in the present case. Nevertheless, the principles of interpretation formulated therein can be useful in assessing the compatibility of the measures under analysis, given the general context of application of Article 86(2) of the Treaty⁶¹.

⁵⁸ In addition, the public service contract must be concluded on a non-discriminatory basis according to the Maritime Cabotage Regulation.

⁵⁹ Community framework for State aid in the form of public service compensation; OJ C 297, 29.11.2005, p. 4.

⁶⁰ See paragraph no. 119.

⁶¹ In this context, State aid rules in the air transport sector already refer specifically to the principles of the SGEI Framework (see paragraph 67 and footnote 2 of the Commission Communication of 9

259. The SGEI Decision does not exclude maritime and air transport. In the decision to open the formal investigation procedure, the possible application of the SGEI Decision was raised and the Commission expressed the preliminary position that it did not appear to be applicable in the present case.
260. There are two exceptions from the notification requirement in Article 2 of the SGEI Decision which might be relevant in the present case:
- "(a) public service compensation granted to undertakings with an average annual turnover before tax, all activities included, of less than EUR 100 million during the two financial years preceding that in which the service of general economic interest was assigned, which receive annual compensation for the service in question of less than EUR 30 million";*
- "(c) public service compensation for air or maritime links to islands on which average annual traffic during the two financial years preceding that in which the service of general economic interest was assigned does not exceed 300,000 passengers".*
261. The question of which entity should be considered for the application of condition (a) above (CalMac, NorthLink 1 and NorthLink 2 separately or together) was raised in the decision to open the formal investigation procedure.
262. The Commission notes that both CalMac and NorthLink 2 are currently receiving more than EUR 30 million each per year in compensation for the operation of the respective maritime routes⁶². Therefore, condition (a) is not met.
263. As regards NorthLink 2, the latest data available shows traffic of 301,000 in 2004/2005 for the two routes served. For CalMac, the figures are much higher. Therefore, condition (c) is not met either.
264. In conclusion, the Commission confirms its preliminary assessment that the SGEI Decision is not applicable in the present case.

5.3.3. Existing aid granted to CalMac

5.3.3.1. Definition

a. Hebrides and Clyde (excluding Gourock-Dunoon)

265. As mentioned previously (see section 5.2 above), only the current situation is relevant for the compatibility assessment of the aid granted to CalMac, since it is an existing aid. Thus, only the provisions of the 2007 public service contract have to be assessed for all routes, except for Gourock-Dunoon, which is excluded from this contract. In accordance with the co-operation procedure provided for under Article 88(1) of the Treaty the Commission has obtained from the United Kingdom all necessary information for the review of the existing aid scheme.

December 2005 "Community guidelines on financing of airports and start-up aid to airlines departing from regional airports"; OJ C 312, 09.12.2005, p. 1).

⁶² The compensation paid to CalMac and NorthLink 2 for the 2007/08 financial exercise was £45.3 and £30.0 million, respectively (see tables 1 and 4 above).

266. The assessment made above with regard to the fulfilment of the Altmark 1 criterion applies here as well. The 2007 public service contract, which followed an open and transparent public tender procedure, is in accordance with Article 4 of the Maritime Cabotage Regulation, which sets out the specifications that should be part of the definition, namely: ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels.
267. The public service contract sets out that the obligations imposed upon the Operator shall not preclude it from using the vessels for any other purposes provided that the obligation to provide the SGEI has been and continues to be satisfied. In practice, this allows the Operator, for example, to carry commercial vehicles, which is an activity outside the scope of its public service tasks. This condition in no way constitutes a manifest error in the definition of the SGEI attributed to CalMac, since it refers to activities outside the scope of the definition of the SGEI that may be carried out by CalMac on commercial terms (without State subsidisation).

b. Gourock-Dunoon

268. Since the Gourock-Dunoon route was excluded from the 2007 public service contract, the legal basis for the compensation related to this route continues to be the Highlands and Islands Shipping Services Act of 1960 as amended by section 70 of the Transport (Scotland) Act 2001 and by Section 45 of the Transport (Scotland) Act 2005.
269. The public service obligations for this route and the respective compensation are intended for the transport of passengers only, commercial vehicles being excluded. However, CalMac is free to provide transport services for commercial vehicles on purely commercial terms.
270. The definition of the public service obligations is not in line with Article 4 of the Maritime Cabotage Regulation. Indeed, the basic characteristics of the public service such as the ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels, are not formally defined in a legal Act.
271. It has been argued by interested parties that the definition of the public service obligations in the Gourock-Dunoon route constitutes a manifest error by reference to a competing service. Indeed, there is another company - Western Ferries - providing transport services (passenger, vehicle and freight) in a similar route serving broadly the same locations, although starting and ending on different points. McGill's Buses (a local bus operator) has introduced a connecting bus service from Dunoon town centre that takes foot passengers directly onto Western Ferries' service and then drops passengers off in Glasgow city centre via Gourock.
272. The United Kingdom has provided credible information on the adequacy of a SGEI for passenger transport on this route. While they recognise that McGill's buses and Western Ferries do provide a "through" service for foot passengers on a very limited number of sailings, their characteristics in terms of frequency, convenience, travel time, transport integration, reliability and access for passengers mean that they are not substitutable to the service provided by CalMac. Thus, there is a sound economic and social justification for public support for a town centre to town centre passenger service.

273. The CalMac service offers higher frequencies - 18 return trips on weekdays compared to 8 return trips (mostly at peak times) offered by McGill's buses and the latter does not offer a Sunday service. The overall journey time is lower for the CalMac service especially at off-peak times (sometimes up to 50% higher journey times for the McGill's service). The CalMac service is also closely integrated with the rail connection to Glasgow unlike the Western Ferries timetable. The CalMac service is also less prone to delays and disruption than the bus-ferry-bus competing service (e.g. mechanical breakdowns of buses or delays caused by traffic congestion or road works can affect the reliability and travel time of the competing service).
274. Western Ferries itself recognises that "the future for any subsidised service to Dunoon can only be the continuation of the passenger-only public service obligations, provided by passenger-only vessel/vessels". Western Ferries currently accounts for 68% of passenger carryings while it accounts for 86-88% of commercial and car traffic. This shows that CalMac is playing a significant role in passenger traffic, while less so in commercial and car traffic.
275. The role of the Commission under Article 86(2) of the EC Treaty must be limited to checking for manifest errors in the definition of SGEI. Although there is another competing service for passenger traffic in the same route, this other service is not substitutable to CalMac's service and the distinctive features of the latter do not warrant the conclusion that there has been a manifest error in the definition of the public service obligations.
276. One related issue raised by Western Ferries is that CalMac is allowed to operate combined vehicle and passenger vessels on this route, while the public service obligations cover only passenger traffic. Western Ferries claims that this gives rise to cross-subsidisation and unfair competition and that therefore the public service obligations should be discharged on the basis of a passenger-only vessel.
277. Under Article 86(2) of the EC Treaty this cannot be considered as a manifest error in the definition of the SGEI. Operators entrusted with public service obligations can also develop unsubsidised commercial activities. Where they do carry out commercial activities, they must meet certain requirements, such as separation of accounts, an adequate allocation of common costs and the absence of cross-subsidisation between the two types of activities.
278. Provided that these requirements are met in the present case, the Commission cannot impose that the SGEI be provided via a passenger-only vessel. It cannot be denied that in the present case the commercial and public service activities are very closely linked - the same vessels provide public service and commercial services simultaneously - and share most of the costs. This indicates the need for special vigilance with regard to the separation of accounts and the cost allocation mechanism⁶³. However, it does not amount to a manifest error in the definition of the public service.
279. In conclusion, the definition of the public service obligations is not in line with Article 4 of the Maritime Cabotage Regulation. Indeed, the basic characteristics of the public service such as the ports to be served, regularity, continuity, frequency,

⁶³ See also in this context paragraphs 295 to 298 of this decision.

capacity to provide the service, rates to be charged and manning of the vessels, are not formally defined in a legal Act. Therefore, the current definition of the SGEI for the operation of the Gourock-Dunoon route constitutes a manifest error..

280. However, in principle it is possible in the future to legitimately define a SGEI for passenger transport on this route, including the possibility for the provider to carry out commercial activities on the basis of a combined passenger/vehicle vessel. This would not *as such* constitute a manifest error, provided that its characteristics are precisely defined in a legal Act.
281. As mentioned above, the United Kingdom informed the Commission that they would launch a new open, transparent and non-discriminatory public tender for a passenger-only public service contract for this route, as the implementation of an appropriate measure.
282. Therefore, it is up to the United Kingdom to ensure that this public tender will contain an appropriate definition of the public service obligations that is compatible with Article 86(2) of the Treaty. The Commission will monitor whether the appropriate measure as accepted by the United Kingdom is correctly implemented.

5.3.3.2. Entrustment

a. Hebrides and Clyde (excluding Gourock-Dunoon)

283. It seems evident that CalMac has been explicitly entrusted with the provision of the public service in question. The 2007 public service contract contains precise indications about the services that CalMac has to provide and on how the scope of the public service remit may be changed.
284. The public service contract also contains clear provisions on the control of the execution of the public service by imposing regular detailed information from CalMac to the Executive about the operation of the routes. There are performance indicators which are regularly assessed, for example. If the performance standards are not met, then the grant may be reduced accordingly.

b. Gourock-Dunoon

285. In the case of the Gourock-Dunoon route, the Commission considers that CalMac has not been adequately entrusted with the operation of this route. Indeed, apart from the fact that the SGEI is currently not well defined, there are no clear legal provisions laying down the conditions under which CalMac must provide this SGEI. There are also no clear provisions for the calculation of the compensation or performance indicators that would affect the annual grant, for example. Therefore, the entrustment of this route to CalMac is currently not sufficiently clear and comprehensive.
286. It is up to the UK authorities to ensure that, in the context of the new public tender for a passenger-only public service contract for this route, the public service obligations will be clearly entrusted to the winning bidder.

5.3.3.3. Proportionality

a. Hebrides and Clyde (excluding Gourock-Dunoon)

287. Since the State aid granted to CalMac until now is considered to be an existing aid, the Commission does not need to assess whether there has been any overcompensation of CalMac's public service obligations in the past. Therefore, the assessment must be forward-looking. It must exclusively be assessed whether the provisions of the 2007 public service contract provide sufficient guarantees to avoid over compensation and possible anti-competitive behaviour by CalMac.
288. As mentioned above⁶⁴, the public tender was carried out in an open and transparent way.
289. The provisions of the public service contract are appropriate to prevent over compensation for the performance of the public service obligations. Compensation is limited to operating costs minus operating revenues (including reasonable profit). The costs which are eligible for compensation are also clearly defined in the public service contract.
290. There is a clawback mechanism that will return the major part of any potential excess compensation to the Scottish authorities. Only a small amount is not returned. For example, if over compensation is £1 million, only £275,000 will be kept by CalMac. In case over compensation is £10 million, only £725,000 will be kept by CalMac. This system is intended to create an incentive for CalMac to reduce costs and be more efficient. These amounts are very limited and in accordance with the definition of "reasonable profit" laid down in the SGEI Framework (point 18 thereof)⁶⁵. Although the SGEI Framework does not apply in the present case, the Commission considers that the potential excess compensation amounts that may be retained by CalMac are very limited and proportional with regard to the compensation amounts.
291. Furthermore, the profit margin foreseen in the public service contract results from a competitive bidding procedure and so it is ensured that this margin is set at a reasonable level.
292. There is also a clause in the public service contract which ensures that, in case the public service provider receives further public support from other sources, the grant under the terms of the contract will be reduced accordingly.
293. In conclusion, the public service contract contains sufficient safeguards against over compensation for the performance of the public service obligations.
294. Besides the issue of over compensation, the Commission has also assessed, in the light of the complaints received on this aspect, whether the public service contract

⁶⁴ See recitals 178-198 where compliance with Altmark criterion 4 is assessed.. Although that condition is not met, the tender is considered as sufficiently open and transparent, according to the criteria laid down in the Maritime Cabotage Regulation.

⁶⁵ By way of comparison, where over compensation amounts to GBP10 million (a very unlikely and unprecedented scenario), the GBP725,000 CalMac would retain would represent only around 1.7% of the annual compensation paid to CalMac in 2007/2008 and a much lower proportion of total revenues.

contains sufficient safeguards to avoid anti-competitive behaviour by CalMac that might cause undue distortions of competition. This would be the case, for example if CalMac were in a position to consistently undercut competitors' prices, thereby driving them away from the market.

295. In this context, it must be underlined that there is currently no competition at all on these routes. Also, the public service contract sets strict conditions on the pricing of the tickets. It includes the schedule of the prices for 2007/2008 and imposes consultation of the Scottish authorities in case prices are reviewed. In particular, CalMac would infringe the provisions of the public service contract if it were to unilaterally and unjustifiably reduce prices to drive existing competitors out of the market or to foreclose the entry of potential competitors. Moreover, no additional compensation can be claimed by CalMac for any reduction in revenue arising from discounts or reductions in the prices established in the published tariff schedule. This also prevents possible anti-competitive price behaviour.
296. Another possible distortion of the market would occur if the public service provider could, acting alone significantly modify or increase its public service offer, for example by adding new routes or significantly increasing frequencies. If CalMac would automatically be eligible for further compensation for these added services, this might cause an unwarranted distortion of competition beyond what can reasonably be accepted as counterpart for the fulfilment of the public service obligations.
297. The public service contract explicitly provides for prior consultation and approval by the Scottish Ministers before any major adjustments are made to the published timetables and frequencies or to the agreed services.
298. There are also specific provisions in the public service contract which prohibit the public service provider from cross-subsidising between its public service and non-public service activities and requiring all transactions between CalMac and its subsidiaries to be carried out on an arms length basis.
299. Almost all of CalMac's activities fall under the scope of the public service contract. Nevertheless, in order to ensure transparency, there must be separation of accounts between its public service activities and its non-public service or commercial activities in compliance with the provisions of the Transparency Directive⁶⁶.
300. Under the terms of the public service contract, CalMac must report, on a yearly basis, on the actual costs incurred with the provision of the public service tasks. This "Actual Outcome Statement" isolates the public service costs from the rest of CalMac's activities. Therefore, it is ensured that the amount of public funds allocated to CalMac and the use of those funds are clearly distinguished from the remainder of CalMac's activities. The public service contract provides explicitly for the need to keep clear, separate and transparent accounting systems for the financing and operating of the public service activities.

⁶⁶ Commission Directive 2006/111/EC of 16 November 2006 on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings (Codified version), OJ L 318, 17.11.2006, p. 17.

301. In order to ensure that the costs incurred with the public service activities are clearly distinguished from the costs incurred with other activities, it is also necessary to put in place an appropriate system for allocating costs which are common to both types of activities.
302. The public service contract contains in detail all the costs that are admissible for compensation. Besides the deficit grant, which is intended to cover all the operating costs associated with the operation of the public service (e.g. CMAL vessel lease costs, seagoing personnel costs, fuel, terminal traffic dues, ticketing, insurance, etc.), supplements are foreseen for unexpected fuel cost rises and for capital expenditures (e.g. acquisition of assets for the provision of the public service activities, harbour works for the same purpose, etc.). All the costs covered by the deficit grant are precisely quantified in the Base Case scenario and the conditions for applying and for determining the potential fuel supplements and capital supplements are precisely defined in the public service contract.
303. Therefore, that the public service contract is sufficiently clear as regards the allocation of costs between public service and non-public service activities.
304. In accordance with its normal practice regarding existing aid schemes, the Commission will continue to monitor CalMac's activities and, in particular, the proper allocation of costs, the avoidance of cross-subsidisation and the full transparency with regard to the separation of accounts.
305. The Commission positively notes in this context that the UK authorities intend to publicly consult interested parties whenever substantial changes are introduced in the public service obligations of CalMac for the Hebrides and Clyde routes. They will also require CalMac to produce separate audited profit and loss accounts for public service activities and for commercial activities starting in the 2009-2010 financial year and intend to include such requirements in all future public service contracts for ferry services in the Hebrides and Clyde.

b. Gourock-Dunoon

306. Western Ferries claimed that a passenger-only service based on a passenger-only vessel would save taxpayers' money by reducing the amount of the annual subsidy to CalMac. However, Article 86(2) of the Treaty does not require the Member State to choose the most cost efficient way of delivering the public service.
307. In the case of the Gourock-Dunoon route, there are no clear provisions for avoiding over compensation, no explicit safeguards against anti-competitive behaviour or cross-subsidisation and no formal requirement for the separation of accounts or provisions for cost allocation.
308. Therefore, as regards the Gourock-Dunoon route, there are not sufficient guarantees that the aid is proportional to the public service obligations of CalMac and that therefore appropriate measures are necessary to render the aid compatible for the future.
309. The UK authorities accepted, as an appropriate measure, to organise a public tender procedure. In the context of the existing aid scheme for this route, the Commission

finds that when implementing the public tender procedure the UK authorities have to ensure that this tender for a passenger-only public service contract for the Gourock-Dunoon route includes clear provisions for avoiding over compensation and explicit safeguards against anti-competitive behaviour and cross-subsidisation, including the obligation to consult publicly interested parties on major changes to the public service remit. A formal requirement for the separation of accounts and appropriate provisions for cost allocation are also required.

310. The Commission also notes positively in this context that the UK authorities intend to publicly consult interested parties whenever substantial changes are introduced in the public service obligations of CalMac for the Gourock-Dunoon route. They will also require CalMac to produce separate audited profit and loss accounts for public service activities and for commercial activities starting in the 2009-2010 financial year and intend to include such requirements in all future public service contracts for ferry services in the Gourock-Dunoon route.

5.3.3.4. Conclusion on the existing aid part

a. Hebrides and Clyde (excluding Gourock-Dunoon)

311. The SGEI for the operation of the Clyde and Hebrides routes, with the exception of Gourock-Dunoon, is well defined and has been duly entrusted to CalMac. There are sufficient safeguards to ensure that the compensation granted to CalMac is proportional to its public service obligations. Thus, the State aid granted to CalMac for the operation of these routes is compatible with Article 86(2) of the EC Treaty.

b. Gourock-Dunoon

312. The public service for the operation of the Gourock-Dunoon route is not sufficiently well defined and has not been entrusted in a sufficiently precise and transparent way. There are insufficient safeguards to ensure that the compensation granted to CalMac is proportional to its public service obligations. Thus, the State aid granted to CalMac for the operation of the Gourock-Dunoon route is incompatible with Article 86(2) of the Treaty.
313. The Commission notes that the UK authorities, under the co-operation procedure foreseen for existing aid schemes, have accepted as an appropriate measure to launch a new open, transparent and non-discriminatory public tender for a passenger-only public service contract for this route along the lines described above. According to Article 19 of the Procedural Regulation, the Member State shall be bound by its acceptance to implement the appropriate measure.
314. In order to ensure compatibility of the public service for this route with Article 86(2) of the EC Treaty, the implementation needs to take place according to the following requirements: the tender and the subsequent public service contract must be launched within a reasonable time period; must contain a clear and precise definition of the public service obligations; must provide for a full and detailed entrustment of the public service provider; must contain appropriate safeguards for preventing over-compensation, cross-subsidisation and anti-competitive behaviour (including the obligation to consult publicly interested parties on major changes to the public service remit) and contain clear provisions on cost allocation and separation of accounts.

315. For the reasons mentioned above, it must be concluded, in accordance with Article 18 of the Procedural Regulation, that the existing aid for this route is no longer compatible with the common market. Under Article 18 of the Procedural Regulation, the appropriate measures mentioned above and their correct implementation should ensure future compatibility of the aid with Community law.
316. By letter of 15 May 2009, the UK authorities have committed to initiate the procedures required for launching a public tender for this route before the end of 2009, thereby accepting the appropriate measures proposed. The subsequent public service contract should start before end June 2011.
317. The Commission notes in this context that the UK authorities intend to publicly consult interested parties whenever substantial changes are introduced in the public service obligations of CalMac for the Gourock-Dunoon route. They will also require CalMac to produce separate audited profit and loss accounts for public service activities and for commercial activities starting in the 2009-2010 financial year and intend to include such requirements in all future public service contracts for ferry services in the Gourock-Dunoon route.
318. In view of the above and in accordance with Article 19 of the Procedural Regulation, the Commission records the acceptance of the appropriate measures by the UK authorities and considers that, subject to the correct implementation of the appropriate measures as described above, the scheme will be in compliance with Article 86(2) of the Treaty. Thus, the compatibility of the scheme with the EC Treaty is subject to the verification by the Commission that the appropriate measures as accepted by the UK authorities have been accurately and duly put into effect by the Member State.
319. The Commission will closely monitor the implementation of the appropriate measures described above and requests the UK authorities to regularly inform it of all steps taken in the implementation process.
320. The Commission retains the right to continuously assess the existing aid scheme under Article 88(1) of the EC Treaty and to propose further appropriate measures required by the progressive development or the functioning of the common market.

5.3.4. *NorthLink*

5.3.4.1. Definition

a. NorthLink 1 (2002-2006)

321. As mentioned previously (see section 5.2.3 above), the aid granted to NorthLink 1 and NorthLink 2 constitutes new aid. Therefore, besides from assessing the current situation, the Commission is also required to assess the compatibility of the measure since the first public service contract was signed with NorthLink 1.
322. The relevant provisions for assessing whether the public service tasks of NorthLink 1 were adequately defined are contained in Article 4 of the Maritime Cabotage Regulation, which sets out the specifications that should be part of the definition, namely: ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessels.

323. It is fairly clear that the public service contract covering the period 2002-2006 meets this criterion by defining in detail all these parameters. The invitation to tender specified, in particular: the route configuration and minimum number of sailings, the requirement for capacity to carry freight (although not subject to subsidy) and livestock, the minimum capacity requirements (at least equal to those already offered by P&O Ferries) and the initial tariffs, which could not significantly exceed those charged by P&O Ferries.
324. This public service contract also had a reasonable duration – less than six years – in compliance with the Commission's interpretation of the Maritime Cabotage Regulation.
325. The MoA, which was signed in 2004 following financial difficulties of NorthLink 1 in 2003, basically provided for additional deficit funding and did not significantly change the definition of the public service obligations already in place.

b. NorthLink 2 (2006-2012)

326. As indicated already in the decision to open the formal investigation procedure, the Commission considers that the public service tasks entrusted on Northlink 2 correspond to a legitimate SGEI.
327. Like the previous public service contract with NorthLink 1, it is clear that the second public service contract with NorthLink 2 also clearly defines all the parameters for the public service obligations in accordance with Article 4 of the Maritime Cabotage Regulation. The invitation to tender specified, in particular: the route configuration and minimum number of sailings, the requirement for ro-ro capacity to carry freight (this time also eligible for subsidy) and livestock, the minimum capacity requirements (at least equal to those already offered by NorthLink 1) and the initial tariffs, which could not significantly exceed those charged by NorthLink 1.
328. Like the previous contract with NorthLink 1, this public service contract also has a reasonable duration -six years – in compliance with the Commission's interpretation of the Maritime Cabotage Regulation.

5.3.4.2. Entrustment

a. NorthLink 1 (2002-2006)

329. It seems clear that NorthLink 1 was explicitly entrusted with the provision of the public service in question in the period 2002-2006. The public service contract contained precise indications about the services that NorthLink 1 had to provide and on how the scope of the public service remit might be changed.
330. The Scottish Executive Transport Group monitored NorthLink 1's performance against the terms of both the original and the revised contracts. NorthLink 1 issued regular performance reports to this body.

b. NorthLink 2 (2006-2012)

331. As is the case with NorthLink 1, it is clear that NorthLink 2 was explicitly entrusted with the provision of the public service in question in the period 2006-2012. The

public service contract contains precise indications about the services that NorthLink II has to provide and on how the scope of the public service remit may be changed.

332. The public service contract contains clear provisions on the control of the execution of the public service by imposing regular detailed information from NorthLink 2 to the Scottish authorities about the operation. There are performance indicators which are regularly assessed, for example. If the performance standards are not met, then the grant may be reduced accordingly.

5.3.4.3. Proportionality

a. NorthLink 1 (2002-2006)

333. Unlike the subsidies granted to CalMac, which constitute existing aid (see section 5.2.2 above), the aid granted to NorthLink 1 and NorthLink 2 constitutes new aid. Therefore, it is not sufficient for the Commission to assess whether the provisions of the current public service contract (covering the period 2006-2012) provide sufficient guarantees to avoid over compensation and possible anti-competitive behaviour by the public service provider. It is also necessary to assess whether there has been any over compensation of NorthLink's public service obligations from 2002 onwards and whether the public service provider has engaged in any type of anti-competitive behaviour that would have raised the cost of fulfilling its public service obligations to an extent that would not be proportional to the aim pursued by the public service contracts.
334. It must however be stressed that the compatibility assessment is limited to checking for over compensation and possible anti-competitive behaviour and does not deal with the question of cost efficient or cost minimisation, unlike the assessment of the existence of State aid under the Altmark 4 condition. In assessing compatibility with Article 86(2) of the Treaty, it is not the Commission's task to check whether the public service could have been delivered more efficiently.
335. As shown in table 3 above, the net results from the public service activities of NorthLink 1 were positive in some years (2003/04 and 2005/06) and negative in other years (2002/03 and 2004/05). The overall result from the public service activities of NorthLink 1 during the period in which it operated in the northern islands routes (2002-2006) was positive in the amount of £0.9 million. This amount corresponds to an annual average excess public funding of £0.2 million.
336. It must first be noted that the data provided by the UK authorities result from an analytical accounting exercise on the basis of the statutory accounts. These results have been validated by an independent external auditor with regard to the methodology used, the accounting details and the statement content. No significant differences were found between the amounts reported and the underlying books and records of NorthLink 1. This data has been adequately established and is credible⁶⁷.

⁶⁷ With regard to the admissibility of a 'backward projection' method, see judgement of the Court of First Instance of 7 June 2006 in case T-613/97 – *UFEX and Others v Commission* (especially points 128-147).

337. The annual average excess public funding of £0.2 million is very limited when compared with the average annual public compensation granted to NorthLink 1 – approximately £23.2 million⁶⁸, representing only around 0.9% of this amount.
338. The Commission accepts the principle that the compensation paid to undertakings entrusted with a SGEI "may not exceed what is necessary to cover the costs incurred in discharging the public service obligations, taking into account the relevant receipts and reasonable profit for discharging those obligations"⁶⁹. Reasonable profit is defined as "a rate of return on own capital that takes account of the risk, or absence of risk, incurred by the undertaking by virtue of the intervention by the Member State (...)". In the present case, the average annual profit margin of around 0.6% of public service revenues⁷⁰ is very limited and can be accepted as reasonable in view of the risks incurred by NorthLink 1 in discharging its public service obligations. It must in particular be noted that these very limited profits of NorthLink 1 followed a competitive bidding procedure for the public service contract and thus had to be kept to the minimum according to market conditions.
339. Therefore, NorthLink 1 has not been unduly over-compensated for the performance of its public service tasks during the period in which it operated the northern islands routes.
340. In Streamline Shipping's original complaint of July 2004, it was alleged that at least £2 million was paid to NorthLink 1 outside the scope of the reimbursable expenses regarding its public service obligations directly for chartering a freight vessel. However, as shown above this did not lead to an overcompensation of NorthLink 1's public service obligations.
341. As regards possible anti-competitive behaviour, the price data submitted by Streamline Shipping⁷¹ does not indicate significant price differences for freight transport between NorthLink 1 and Streamline Shipping. In the Shetland route NorthLink 1's prices are higher than Streamline Shipping's prices in all years. In the Orkney route NorthLink 1's prices are lower than Streamline Shipping's prices in all years (between 5% and 13%), but this fact alone does not prove an anti-competitive behaviour. Moreover, the comparison is possibly misled since ro-ro and lo-lo freight rates are not directly comparable as mentioned by the UK authorities.
342. Moreover, the Commission notes that the commercial activities carried out by NorthLink 1 were profitable on a stand-alone basis in every year of NorthLink 1's operation. This means that the prices charged by NorthLink 1 on its commercial activities were market driven and compatible with the profit-maximising behaviour of a market investor.
343. Furthermore, in its report of December 2005, which analyses the performance of NorthLink 1, Audit Scotland does not mention any possible anti-competitive

⁶⁸ A total of GBP 92.6 million was granted to NorthLink 1 during the approximately four years of operation.

⁶⁹ See par. 14 of the SGEI Framework.

⁷⁰ The average annual revenues from the public service activities of NorthLink 1 amounted to GBP 32.4 million (see table 3 above).

⁷¹ See table 6.

behaviour (e.g. price undercutting) as a reason for NorthLink 1's financial difficulties. Rather, these difficulties are attributed essentially to increased and unexpected competition from other undertakings.

344. In conclusion, NorthLink 1 was not unduly over-compensated for the performance of its public service obligations and there is no evidence that it engaged in any form of anti-competitive behaviour during the period in which it operated in the northern islands routes. It is concluded that the State aid granted to NorthLink 1 was proportional in view of its public service obligations.

b. NorthLink 2 (2006-2012)

345. As regards the NorthLink 2 public service contract, the Commission is required to check, on the one hand, whether there has been any overcompensation of the public service obligations so far. It will also check if there has been any possible anti-competitive behaviour that would have raised the cost of fulfilling the public service obligations to an extent that would not be proportional to the aim pursued by the public service contract. On the other hand, the Commission must check whether the current provisions of the public service contract with NorthLink 2 contain sufficient safeguards to ensure the proportionality of the aid.
346. As shown in table 5, the net results from the public service activities of NorthLink 2 were positive in the two first years of operation (2006/07 and 2007/08). The overall net result of the operations of NorthLink 2 so far is positive in the amount of £2.4 million. This amount corresponds to an annual average excess public funding of £1.2 million.
347. As mentioned above in the case of NorthLink 1, it must first be noted that the data provided by the UK authorities result from an analytical accounting exercise on the basis of the statutory accounts. These results have been validated by an independent external auditor with regard to the methodology used, the accounting details and the statement content. No significant differences were found between the amounts reported and the underlying books and records of NorthLink 2. The Commission considers that this data has been adequately established and is credible⁷².
348. The annual average excess public funding of £1.2 million is limited when compared with the average annual public compensation granted to NorthLink 2 - £26.6 million⁷³, representing only around 4.5% of this amount.
349. As mentioned above, the Commission has accepted the principle of a reasonable profit for discharging public service obligations. In the present case, the average annual profit margin of around 2.4% of public service revenues⁷⁴ is limited and can be accepted as reasonable in view of the risks incurred by NorthLink 2 in discharging its public service obligations. It must in particular be noted that these limited profits of NorthLink 2 followed a competitive bidding procedure for the

⁷² See footnote 67

⁷³ See table 4

⁷⁴ The average annual revenues from the public service activities of NorthLink 2 amounted to £50.5 million (see table 5 above).

public service contract and thus had to be kept to the minimum according to market conditions.

350. Therefore, the Commission considers that NorthLink 2 has not been unduly over-compensated for the performance of its public service tasks during the period in which it has been operating the northern islands routes so far.
351. As regards possible anti-competitive behaviour by NorthLink 2, Streamline Shipping argued that the freight rate cuts of 25% to Shetland and 19% to Orkney announced at the beginning of the third public service contract in July 2006 were unduly penalising Streamline Shipping and were only possible thanks to the increased subsidy for NorthLink 2 when compared to NorthLink 1.
352. As mentioned above, NorthLink 2 does not carry out activities outside the scope of the public service contract. In particular, unlike the public service contract with NorthLink 1, the contract between the Scottish authorities and NorthLink 2 covered freight transport as a public service activity. This reduction in the freight rates was imposed by the Scottish authorities as part of the terms of the tender. Thus, this information was public and bidders had to take it into account when formulating their bids.
353. NorthLink 2 has so far not been over-compensated for its public service obligations. Moreover, as shown in table 5 above, freight transport has been profitable on a stand-alone basis in the two years of NorthLink 2's operation.
354. Additionally, the Commission recognises that ro-ro and lo-lo freight rates may not be directly comparable for the reasons set out in recital 100 above.
355. Moreover, unlike NorthLink 2, Pentland Ferries does not publish its freight tariffs and rather invites potential customers to contact its booking offices to obtain a quote and make a booking. Therefore, it would be difficult for NorthLink 2 to deliberately and consistently undercut Pentland Ferries' tariffs.
356. Also related to possible anti-competitive behaviour by NorthLink 2, Pentland Ferries argued that NorthLink 2 has been practicing a discount scheme for Orkney residents called "friends and family" that is having a detrimental effect on the competing service provided by Pentland Ferries⁷⁵.
357. As shown above in table 7, all the basic tariffs charged by NorthLink 2 for passengers and vehicles are higher than those charged by Pentland Ferries. There is no public evidence on possible discounts practiced by Pentland Ferries, but even assuming that it does not offer any discounts, the tariffs charged by NorthLink 2 including the "friends and family" discount scheme are not significantly or consistently lower than the tariffs charged by Pentland Ferries. Moreover, the discounts are not available during the busy peak season (July and August). Furthermore, as indicated by the UK authorities, the discount scheme accounts for a very small proportion of NorthLink 2's carryings (1.6%) and to an even smaller proportion of NorthLink 2's revenues (0.5%). The foregone revenue to NorthLink 2 on ticket sales as a consequence of the discounts (ignoring the possible additional

⁷⁵ See par. 107 to -109.

demand generated by the discounts) is very limited⁷⁶. Finally, Pentland Ferries was unable to prove with concrete figures that it has been financially hit by this discount scheme. Consequently, the Commission considers that there are no solid grounds for alleging anti-competitive behaviour by NorthLink 2 or any serious affectation of competition on account of this discount scheme.

358. Moreover, it was argued by an interested party that NorthLink 2 is offering Bed & Breakfast accommodation in Orkney (when the ship is static overnight) as a commercial activity at rates which are below cost and that this is affecting hotel-based Bed & Breakfast providers⁷⁷. Although this issue was not raised in the decision to open the formal investigation procedure, no concrete evidence was provided showing that the prices charged by NorthLink 2 for this service are below cost or that this service is negatively affecting revenues of competing hotel-based Bed & Breakfast operators. In addition, boat accommodation prices and the costs of providing such accommodation cannot be directly compared with hotel-based accommodation prices and the respective costs. Consequently, the Commission considers that there are no solid grounds for alleging anti-competitive behaviour by NorthLink 2 or any serious distortion of competition on account of this service. In any case, any possible distortion of competition would not affect trade between Member States given that it entirely takes place within Orkney.
359. Besides from assessing the proportionality of the aid in the past, the Commission must also check whether the provisions of the public service contract offer sufficient guarantees that there will be no overcompensation or anti-competitive behaviour in the future.
360. As mentioned above⁷⁸, the public tender was carried out in an open and transparent way.
361. In the Commission's view, the provisions of the public service contract are appropriate to prevent overcompensation for the performance of the public service obligations. Compensation is limited to operating costs (including reasonable profit) minus operating revenues. The costs which are eligible for compensation are also clearly defined in the public service contract.
362. There is a clawback mechanism that will return the major part of any potential excess compensation to the Scottish authorities. Only a small amount is not returned. For example, if overcompensation is £1 million, only £275,000 will be kept by NorthLink 2. In case over compensation is £10 million, only £725,000 will be kept by NorthLink 2. This system is intended to create an incentive for NorthLink 2 to reduce costs and be more efficient. These amounts are very limited and in accordance with the definition of "reasonable profit" laid down in the SGEI Framework (point 18 thereof)⁷⁹. Although the SGEI Framework does not apply in

⁷⁶ Based on the UK authorities estimation of the total revenue from this scheme (for all eligible passengers and cars) in 2008 - around £95,000 – the discount of 30% would represent around £40,700.

⁷⁷ See par. 111 above.

⁷⁸ See section assessing compliance with Altmark condition 4 (recitals 220-224).

⁷⁹ For comparison, if overcompensation were to total £10 million (a very unlikely and unprecedented scenario), the £725,000 that NorthLink 2 would retain represents only around 2.5% of the annual compensation paid to NorthLink 2 in 2007/2008 and a much lower proportion of total revenues.

the present case, the Commission considers that the potential excess compensation amounts that may be retained by NorthLink 2 are very limited and proportional with regard to the compensation amounts.

363. Furthermore, the profit margin foreseen in the public service contract results from a competitive bidding procedure and so it is ensured that this margin is set at a reasonable level.
364. There is also a clause in the public service contract which ensures that, in case the public service provider receives further public support from other sources, the grant will be reduced accordingly.
365. In conclusion, the public service contract contains sufficient safeguards against overcompensation for the performance of the public service obligations.
366. Besides the issue of overcompensation, it must also be assessed whether the public service contract contains sufficient safeguards to avoid anti-competitive behaviour by NorthLink 2 that might cause undue distortions of competition. This would be the case, for example, if NorthLink 2 were in a position to consistently undercut competitors' prices, thereby driving them away from the market.
367. The public service contract sets strict conditions on the pricing of the tickets. It imposes consultation of the Scottish authorities where prices are reviewed. In particular, NorthLink 2 would infringe the provisions of the public service contract if it were to unilaterally and unjustifiably reduce prices to drive existing competitors out of the market or to foreclose the entry of potential competitors. Moreover, no additional compensation can be claimed by NorthLink 2 for any reduction in revenue arising from discounts or reductions in the prices established in the published tariff schedule. This also prevents possible anti-competitive price behaviour.
368. Another possibility of distorting the market would be if the public service provider could, on its own will, significantly modify or increase its public service offer, for example by adding new routes or significantly increasing frequencies. If NorthLink 2 would automatically be eligible for further compensation for these added services, this might cause an unwarranted distortion of competition beyond what can reasonably be accepted as counterpart for the fulfilment of the public service obligations.
369. The public service contract explicitly provides for prior consultation and approval by the Scottish Ministers before any major adjustments are made to the published timetables and frequencies or to the agreed services.
370. There are also specific provisions in the public service contract which prohibit the Operator from cross-subsidising between its public service and non-public service activities and requiring all transactions between NorthLink 2 and its subsidiaries to be carried out on an arms length basis.
371. Almost all of NorthLink 2's activities fall under the scope of the public service contract. Nevertheless, in order to ensure transparency, there must be separation of accounts between its public service activities and its potential non-public service or commercial activities in compliance with the provisions of the Transparency Directive.

372. Under the terms of the public service contract, NorthLink 2 must report, on a yearly basis, on the actual costs incurred with the provision of the public service tasks. This "Actual Outcome Statement" isolates the public service costs from the rest of NorthLink 2's activities. Therefore, it is ensured that the amount of public funds allocated to NorthLink 2 and the use of those funds are clearly distinguished from the remainder of NorthLink 2's activities. The public service contract provides explicitly for the need to keep clear, separate and transparent accounting systems for the financing and operating of the public service activities.
373. In order to ensure that the costs incurred with the public service activities are clearly distinguished from the costs incurred with other activities, it is also necessary to put in place an appropriate system for allocating costs which are common to both types of activities.
374. The public service contract contains in detail all the costs that are admissible for compensation. Besides from the deficit grant, which is intended to cover all the operating costs associated with the operation of the public service (e.g. seagoing personnel costs, fuel, terminal traffic dues, ticketing, insurance, etc.), supplements are foreseen for unexpected fuel cost rises and for capital expenditures linked to the acquisition of assets for the provision of the agreed services. All the costs covered by the deficit grant are precisely quantified in the Base Case scenario and the conditions for applying and for determining the potential fuel supplements and capital supplements are precisely defined in the public service contract.
375. Therefore, the public service contract is sufficiently clear as regards the allocation of costs between public service and non- public service activities.
376. The Commission positively notes in this context that the UK authorities intend to publicly consult interested parties whenever substantial changes are introduced in the public service obligations of NorthLink 2 for the northern islands routes. They will also require NorthLink 2 to produce separate audited profit and loss accounts for public service activities and for commercial activities starting in the 2009-2010 financial year and intend to include such requirements in all future public service contracts for ferry services in the northern islands.

5.3.4.4. Conclusion

a. NorthLink 1 (2002-2006)

377. The public service obligations imposed on NorthLink 1 have been correctly defined and adequately entrusted. The State aid granted to NorthLink 1 during the period 2002-2006 has not overcompensated the company for the provision of the public service tasks it was entrusted with. There is also no sufficient evidence of anti-competitive behaviour that would have artificially raised the public service costs, thereby causing an undue distortion of competition.
378. Therefore, the State aid granted to NorthLink 1 during the period 2002-2006 is compatible with Article 86(2) of the Treaty.

b. NorthLink 2 (2006-2012)

379. The State aid granted to NorthLink 2 so far has not overcompensated the company for the provision of the public service tasks it was entrusted with. There is also no

sufficient evidence of anti-competitive behaviour that would have artificially raised the public service costs, thereby causing an undue distortion of competition.

380. The SGEI for the operation of the northern islands routes is well defined and has been duly entrusted to NorthLink 2. There are sufficient safeguards to ensure that the compensation granted to NorthLink 2 is proportional to its public service obligations. Thus, the State aid granted to NorthLink 2 for the operation of those routes is compatible with Article 86(2) of the EC Treaty.

6. CONCLUSION

381. On the basis of the foregoing it is concluded that the State aid provided to CalMac for the operation of all western islands routes, with the exception of Gourock-Dunoon, is an existing aid which is compatible with Article 86(2) of the Treaty.

382. As regards the Gourock-Dunoon route, in accordance with Article 19 of the Procedural Regulation, the Commission records the acceptance, by the UK authorities, of the appropriate measures proposed by it in accordance with Article 18 of the Procedural Regulation and considers that, subject to the correct implementation of the appropriate measures described above, the existing aid measure will also be compatible with Article 86(2) of the Treaty. The United Kingdom is required to initiate the procedures required for launching a public tender for this route before the end of 2009. The subsequent public service contract should start before end June 2011. The implementation of the appropriate measures described above will be closely monitored by the Commission and the United Kingdom is requested to regularly inform it of all steps taken in the implementation process.

383. The Commission considers that the State aid granted to NorthLink 1 and NorthLink 2 for the operation of the northern islands routes in 2002-2006 and 2007-2009 respectively is compatible with Article 86(2) of the Treaty.

HAS ADOPTED THIS DECISION:

Article 1

The existing State aid granted to CalMac Ferries Ltd. under the public service contract for the provision of ferry services in the Scottish western islands (excluding the Gourock-Dunoon route) is compatible with Article 86(2) of the Treaty.

Article 2

The existing State aid granted to Cowal Ferries Ltd. with regard to the operation of the Gourock-Dunoon route is compatible with Article 86(2) of the Treaty, subject to the acceptance, by the United Kingdom, to implement the appropriate measures in accordance with Article 19 of Regulation (EC) No 659/1999.

In particular, the United Kingdom shall initiate the procedures required for launching a public tender for the Gourock-Dunoon route before 31 December 2009. The subsequent public service contract must commence before 30 June 2011.

Article 3

The United Kingdom shall promptly inform the Commission about the steps taken to implement its commitments with regard to the financing of the Gourock-Dunoon route.

Article 4

The State aid granted to NorthLink Orkney and Shetland Ferries Ltd. and to NorthLink Ferries Ltd. under the respective public service contracts for the provision of ferry services in the Scottish northern islands is compatible with Article 86(2) of the Treaty.

Article 5

This Decision is addressed to the United Kingdom of Great Britain and Northern Ireland.

Done at Brussels, 28.10.2009

For the Commission

Antonio TAJANI
Vice-President of the Commission

Notice

If the decision contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of the decision. Your request specifying the relevant information should be sent by registered letter or fax to:

European Commission
Directorate-General for Energy and Transport
Directorate A, Unit A2
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