Introduction and background

1. I am instructed on behalf of the RMT, whose members staff the Clyde Hebrides ferry service. The service is operated by Caledonian Macbrayne, commonly known as CalMac (but see below for the corporate identity of the various companies involved) under a contract with the Scottish Ministers. The contract is a public service contract within Council Regulation (EEC) No. 3577/92, the Maritime Cabotage Regulation (“1992 Regulation”).

2. The current contract results from a tendering exercise initiated in 2004. RMT, along with many other interested parties, opposed that tendering exercise, preferring that the service should continue to be run directly by CalMac. The Scottish Ministers insisted that EU law, including the 1992 Regulation and State aid rules, required them to seek tenders. The Scottish Ministers remain of that view and are now in the process of re-tendering the contract, with a final ITT proposed for February 2016.

3. RMT seeks my advice on whether the Scottish Ministers’ views are correct. I am asked in particular to consider whether CalMac’s status as an undertaking wholly owned by the Scottish Ministers attracts the Teckal exemption to EU procurement rules (Teckal SrL v. Commune di Viano, Case C-107/98 [1999] ECR I-8121), so far as the exemption is applicable to the award of public service contracts under the 1992 Regulation.

4. The essence of Teckal is this. The public procurement regime does not oblige a public authority to go to the market to procure goods, works or services; but where the authority
chooses to do so, it must conduct a fair and transparent competitive tendering exercise in accordance with the rules laid down by a series of Directives. In other words the Directives leave the authority free to supply those goods, works or services itself. Where the authority makes that supply via an entity that is legally distinct but which is sufficiently under the authority’s control (the “control” test) and does not act as a market player in its own right (the “functional” test), EU law as laid down in Teckal and applied subsequently treats the situation as tantamount to the authority supplying the service itself.

5. The Scottish Ministers do not appear to have considered the Teckal exemption in 2004. Nor is there any evidence of their having done so in the current tendering exercise, until the matter was raised in a series of Parliamentary questions this June. The questions, and answers, were as follows:

"Question S4W-26112: David Stewart, Highlands and Islands, Scottish Labour, Date Lodged: 12/06/2015
To ask the Scottish Government what (a) legal and (b) other advice it has received regarding the application of the Teckal exemption to the provision of ferry services on (i) Clyde and Hebrides and (ii) Northern Isles routes.
Answered by Derek Mackay (22/06/2015):
The Scottish Government draws on oral and written legal advice as appropriate from its lawyers, from Counsel, from external solicitors and from Law Officers. However, other than in exceptional circumstances, the Scottish Government does not comment on the source of such advice, and the content of any legal advice remains confidential.

Question S4W-26111: David Stewart, Highlands and Islands, Scottish Labour, Date Lodged: 12/06/2015
To ask the Scottish Government on what dates it has discussed with the European Commission the applicability of the Teckal exemption to the provision of ferry services on (a) Clyde and Hebrides and (b) Northern Isles routes from public procurement legislation.
Answered by Derek Mackay (22/06/2015): I refer the member to the answer to question S4W-26110 [below] on 22 June 2015. …

Question S4W-26110: David Stewart, Highlands and Islands, Scottish Labour, Date Lodged: 12/06/2015
To ask the Scottish Government whether it has considered the application of the Teckal exemption to the provision of ferry services on (a) Clyde and Hebrides and (b) Northern Isles routes.
Answered by Derek Mackay (22/06/2015):
The Teckal exemption requires a challenging series of conditions to be met to avoid
European procurement regulations. Notwithstanding the applicability, or otherwise, of the Teckal exemption, the European Commission’s Maritime Cabotage Regulations still require the tendering of the Clyde and Hebrides and Northern Isles ferry services, given the provision of state aid to support these services. Consequently, the Scottish Government has not discussed the Teckal exemption with the European Commission."

6. For the reasons that follow, I advise that:
   a. If the Teckal exemption does not apply, I agree that the 1992 Regulation as interpreted by the CJEU, coupled with the State aid rules, oblige the Scottish Ministers to conduct a competitive tendering exercise for the relevant ferry services. Hence the default position is that the Scottish Ministers are correct to proceed with a re-tendering exercise along the lines proposed, as they were in 2004.
   b. In my view, however, the Teckal exemption is capable of applying to the operation of services governed by the 1992 Regulation. On the information available to me, the relationship of the operating company (Calmac Ferries Limited) with the Scottish Ministers, and the nature of its activities, satisfy the control test. On the available information about the relevant activities, the functional test also appears to be satisfied.
   c. On that basis, that neither the 1992 Regulation nor the State aid rules oblige the Scottish Ministers to hold a competitive tendering exercise before awarding that company a public service contract for the Clyde Hebrides services.

7. The subject matter of this advice is the application of rules of EU law to the particular circumstances of the Clyde Hebrides ferry operations. Although the Scottish Ministers act under devolved powers, no specific issues of Scottish domestic law are involved.

8. The rest of this advice is structured as follows:
   - The position under the 1992 Regulation and State aid rules if Teckal does not apply;
   - Applicability of Teckal to services governed by the 1992 Regulation;
- Does CalMac’s operation of the Clyde Hebrides services satisfy the Teckal criteria?
- If Teckal applies, do the State aid rules nevertheless require competitive tendering?
- Concluding remarks.

**Position under the 1992 Regulation and State aid rules if Teckal does not apply**

9. I deal with this quite briefly because in my view the default position – ie. if the operation of the ferry services through CalMac does not attract the Teckal exemption – is clear. However, I begin by considering the position as it would have appeared to the Scottish Ministers at the time of the 2004 tendering exercise, because tracing developments in the law since 2004 provides a helpful background to the discussion of Teckal and the State aid rules below.

10. The key provisions of the 1992 Regulation are as follows:

a. Article 1(1) provides:

“(1) As from 1 January 1993, freedom to provide maritime transport services within a Member State (maritime cabotage) shall apply to Community shipowners who have their ships registered in, and flying the flag of a Member State, provided that these ships comply with all conditions for carrying out cabotage in that Member State …”

b. Article 4 provides:

“(1) A Member State may conclude public service contracts with or impose public service obligations as a condition for the provision of cabotage services, on shipping companies participating in regular services to, from and between islands. Whenever a Member State concludes public service contracts or imposes public service obligations, it shall do so on a non-discriminatory basis in respect of all Community shipowners.

(2) In imposing public service obligations, Member States shall be limited to requirements concerning ports to be served, regularity, continuity, frequency, capacity to provide the service, rates to be charged and manning of the vessel. Where applicable, any compensation for public service obligations must be available to all Community shipowners.

(3) Existing public service contracts may remain in force up to the expiry date of the relevant contract.”
c. Article 2(3) defines a “public service contract” as:
   “a contract concluded between the competent authorities of a Member State and a Community shipowner in order to provide the public with adequate transport services. A public service contract may cover notably:
   - transport services, satisfying fixed standards of continuity, regularity, capacity and quality,
   - additional transport services,
   - transport services at specified rates and subject to specified conditions, in particular for certain categories of passengers or on certain routes,
   - adjustments of services to actual requirements”.

d. Article 2(4) defines “public service obligations” as
   “obligations which the Community shipowner in question, if he were considering his own commercial interest, would not assume or would not assume to the same extent or under the same conditions”.

11. The Treaty base for the 1992 Regulation was former Article 80(2) EC. This appeared in Title V, Transport. By Article 80(1), that title applied to rail, road and inland waterway transport, but Article 80(2) enabled the Council to lay down “appropriate provisions” for sea transport. In Analir v. Administración General del Estado, C-205/99, [2001] ECR I-1271, the CJEU (under its former title, the European Court of Justice) treated 1992 Regulation Article 1 as establishing a principle of freedom to provide maritime cabotage services within the (then) Community, thus defining for the maritime cabotage sector the general Treaty freedom to provide services (see judgment [20]). That is of course a fundamental EU freedom, and thus the result of Analir was that as at 2004, the provisions of the 1992 Regulation, including Article 4, fell to be interpreted in the light of that freedom and the case-law principles associated with it.

12. Those principles include not only non-discrimination (which appears expressly in Article 4(1) but also transparency. The CJEU has recognised that this principle is closely related to the non-discrimination principle because it acts as a check to ensure that the latter is observed. Thus even in the absence of specific legislation expressly prescribing competitive tendering procedures (such as the public procurement Directives: see below), transparency requires the competent authority to adopt some analogous process, including
open advertisement and impartial appointment procedures. For a pre-2004 example see Telaustria Verlags v. Telekom Austria, C-324/98 [2000] ECR I-10745 (which concerned public service contracts in the telecoms sector).

13. So although Article 4(1) does not explicitly mention competitive tendering, the effect of the non-discrimination provision in the second indent is to oblige a Member State, when considering the award of a public service contract, to adopt a procedure which guarantees transparency in much the same way as a competitive tendering process. Indeed it is difficult to see how the rules might permit a process which does not share the essential characteristics of competitive tendering, *viz.* open advertising sufficient to draw the opportunity to the attention of all Community shipowners who might potentially wish to enter into the contract, coupled with an objective system for evaluating offers.

14. As at 2004, as I understand it, CalMac operated the Clyde Hebrides services under arrangements dating from at least 1995 and, apparently, having no expiry date. That raised the question whether Article 4(3) enabled the Scottish Ministers simply to continue the existing arrangements indefinitely.

15. It is not entirely clear whether the arrangements would have constituted a “public service contract” within the meaning of the 1992 Regulation when that Regulation came into force. But bearing in mind that this is the “no Teckal” scenario, the assumption must be that CalMac fell to be treated as any other Community shipowner. The difficulty for the Scottish Ministers therefore lay in a further principle, the principle of proportionality. That is, a Member State may not restrict a Treaty freedom otherwise than by a rule serving a legitimate aim and which, crucially, imposes no greater restriction on the freedom than necessary to achieve that aim. For a pertinent example see (again) Analir, judgment [25].

16. In view of the provisions of Article 4 as a whole, a measure permanently enabling a single shipowner to operate services to which the 1992 Regulation applied, thus indefinitely excluding other Community shipowners from the possibility of providing those services, restricts shipowners’ freedom to provide services in a manner likely to be
regarded of going beyond the legitimate aim of securing the continued provision of services to the islands.

17. I gather that the Scottish Ministers also gave consideration in 2004 to the EU rules on State aid in the light of the (then) recent judgment in *Altmark Trans v. Nahverkehrsgesellschaft Altmark*, C-280/00, [2003] ECR I-7747. Prior to that decision, the Commission had published guidelines on State aid in the maritime transport sector (OJ 1997 C 205). The section entitled *Public Service Obligations and Contracts* indicated that compensation for losses flowing directly from an undertaking’s performance of public service obligations imposed on it would not constitute State aid under the Treaty provided, among other things, the contract with the undertaking resulted from an adequately advertised public tender process. One can see the rationale of this guidance: the competitive tender process ensured that the contract price, including the subsidy element, was tested against the market, which would tend to act as a check against excessive compensation, and to minimise the risk of the successful undertaking gaining an unfair competitive advantage.

18. *Altmark* concerned the lawfulness of subsidies granted to a bus company, Altmark Trans to operate services in Magdeburg, Germany. The CJEU held that a subsidy did not amount to State aid where it simply compensated the undertaking in question for the burden of meeting public service obligations, so that it did not result in that undertaking receiving more favourable treatment than competing undertakings. In its judgment the CJEU laid down four criteria that must be met in order for that principle to apply. The first three principles primarily concerned the relationship between the amount of compensation and the public service obligation in question. The fourth, at judgment [93], was:

“93. Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.”
19. Significantly, that criterion contemplates that compensation under a public service contract need not be State aid even if the contract did not result from a public tendering process, so long as the level of compensation was subject to an alternative form of check. Indeed, following Altmark the Commission issued revised guidelines containing the following advice in place of the equivalent passage in the 1997 version:

“In the field of maritime cabotage, public service obligations (PSOs) may be imposed or public service contracts (PSCs) may be concluded for the services indicated in Article 4 of Regulation (EEC) No 3577/92. For those services, PSOs and PSCs as well as their compensation must fulfil the conditions of that provision and the Treaty rules and procedures governing State aid, as interpreted by the Court of Justice.

The Commission accepts that if an international transport service is necessary to meet imperative public transport needs, PSOs may be imposed or PSCs may be concluded, provided that any compensation is subject to the above-mentioned Treaty rules and procedures.

The duration of public service contracts should be limited to a reasonable and not overlong period, normally in the order of six years, since contracts for significantly longer periods could entail the danger of creating a (private) monopoly.”

20. However, the Scottish Ministers in 2004 took the view that Altmark did not relieve them of the obligation to conduct a tendering exercise for the Clyde Hebrides services. Their press release pointed out that Altmark was confined to the question whether a subsidy amounted to State aid. The State aid rules, and the 1992 Regulation, arose from different Treaty provisions. So even if the absence of a tender process did not infringe the State aid rules, that made no difference to the requirement under the 1992 Regulation to conclude public service contracts, or impose public service obligations, on a non-discriminatory basis, and this required competitive tenders. I respectfully agree.

21. In key respects the legal position now remains much as it was in 2004. The significant provisions of the 1992 Regulation remain unchanged. The post-Lisbon Treaties make no material change to the substance of the provisions governing the freedom to provide services generally, the provisions governing transport, or the provisions about competition and in particular State aid. The relevant case-law, including that on service
concessions (see below) and related area of public service obligations, continues to emphasise the importance of transparency and non-discrimination.

22. In a further update of its guidance, the Commission issued its Communication on the interpretation of the 1992 Regulation, COM(2014) 232 final, dated 22 April 2014. Paragraph 5.4.2 advises [emphasis added]:

“5.4.2. Choice of the award procedure

Article 4 of Regulation 3577/92 requires that in awarding public service contracts Member States should not discriminate between shipowners.

The Commission takes the view that, in general, the awarding of public service contracts risks to discriminate between operators, as normally only one operator on a given route is granted the contract. It therefore considers that launching an open tender procedure is in principle the easiest way to ensure non-discrimination. An award procedure involving negotiation with the potential bidders may comply with the principle of non-discrimination provided that the negotiations between the adjudicating authority and companies having submitted bids in the tender are impartial, fair and transparent. The Commission believes that a direct award fails to respect the principle of non-discrimination and transparency enshrined in Article 4 of the Regulation……

The Commission would also point out that the choice of the award procedure has implications for the assessment in the light of State aid rules of any financial compensation granted for discharging the public service contract. In particular, in order not to constitute State aid such compensation has to respect the four conditions laid down by the Court in the Altmark judgment. In accordance with the fourth Altmark criterion, the compensation offered must either be the result of a public procurement procedure which allows for selection of the tenderer capable of providing those services at the least cost to the community, or the result of a benchmarking exercise with a typical undertaking, well run and adequately provided with the necessary means. The Commission considers that the simplest way for public authorities to meet the fourth Altmark criterion is to conduct an open, transparent and non-discriminatory public procurement procedure. As a consequence, provided that remaining conditions laid down in the Altmark judgement are met, such procedure will also generally exclude the existence of State aid.”

23. So the position remains – on the “no Teckal” assumption – that Article 4(1) requires the services for which CalMac was awarded a public service contract under the 2004 exercise to be re-tendered in a sufficiently fair and public competitive exercise. That is so even if
compensation is benchmarked in the way contemplated by Altmark and the Commission’s 2014 guidelines, such that the payment does not constitute State aid.

Applicability of Teckal to the services governed by the 1992 Regulation

24. As noted above, the rationale of the Teckal exemption is that the contracting authority provides a service through the medium of an entity which is legally separate, but in substance amounts to a department or agency of the authority itself. The key questions to be considered when ascertaining whether the exemption applies concern the nature and degree of control the authority has over the entity, and the nature of the entity’s activities. But before reaching those matters in relation to CalMac, I must first deal with the question whether the Teckal exemption is capable of applying at all to the provision of the ferry services to which Article 4 of the 1992 Regulation relates.

25. That is important because the Scottish Ministers in their Parliamentary answers of 22 June 2015 appear to adopt an ambivalent position; and moreover they suggest that regardless of the applicability or otherwise of Teckal, the 1992 Regulation still requires competitive tendering of the Clyde Hebrides service because of the provision of State aid to support the service.

26. As a starting point, it is helpful to chart certain further developments in EU law since 2004.

27. First, Regulation (EC) 1370/2007 on public passenger transport services by rail and road (“2007 Regulation”) has come into force. The 2007 Regulation is significant because it shares a common Treaty base – what is now Title VI (Transport) of the Treaty on the Functioning of the EU – with the 1992 Regulation. Indeed by Article 1(1) of the 2007 Member States have a discretion to apply it “to public passenger transport by inland waterways and, without prejudice to [the 1992 Regulation], national sea waters”.

- 10 -
28. In a scheme remarkably redolent of *Teckal* itself, the 2007 Regulation provides that the competent authority of a Member State may provide public passenger rail services in two ways:

1) by providing the service itself, or through a public service contract with an entity which it controls, known as an “internal operator” (Article 5(2)), or

2) by procuring those services in the market through a public service contract with a rail operators, in which case the general rule is that the award must be preceded by a competitive tendering exercise, subject to various exceptions which provide for a direct award to an operator (Article 5(3)-(5)).

29. The wording of Article 5(2) is of particular interest [emphasis added]:

“(2) Unless prohibited by national law, any competent local authority, whether or not it is an individual authority or a group of authorities providing integrated public passenger transport services, may decide to provide public passenger transport services itself or to award public service contracts directly to a legally distinct entity over which the competent local authority, or in the case of a group of authorities at least one competent local authority, exercises control similar to that exercised over its own departments. Where a competent local authority takes such a decision, the following shall apply:

(a) for the purposes of determining whether the competent local authority exercises control, factors such as the degree of representation on administrative, management or supervisory bodies, specifications relating thereto in the articles of association, ownership, effective influence and control over strategic decisions and individual management decisions shall be taken into consideration. In accordance with Community law, 100 % ownership by the competent public authority, in particular in the case of public-private partnerships, is not a mandatory requirement for establishing control within the meaning of this paragraph, provided that there is a dominant public influence and that control can be established on the basis of other criteria.

…”

30. Next, the reform of EU public procurement legislation has altered the relationship between public service contracts and the general EU procurement rules. The former Public Procurement Directives 2004/17/EC and 2004/18/EC have been replaced with two new Public Procurement Directives 2014/24/EU and 2014/25/EU (applying to the award of public contracts for goods, works and services) together with an entirely new Service Concessions Directive 2014/23/EU. The latter applies to contracts for service
As the Commission’s 2014 Guidance points out (para. 5.4.1), most public service contracts under the 1992 Regulation are likely to be service concessions because the operator retains commercial risk in relation to revenues (since typically the contract will not guarantee revenue to the operator, but rather will provide compensation to the operator for the cost of taking on public service obligations that it would not have assumed in free market conditions). However, where a public service contract is not a service concession but falls under the Procurement Directives, those Directives now apply with their full force. That is because under the previous regime waterborne transport services were “non-prioritary” services to which only a restricted set of requirements applied; but the new Directives abolish the distinction between “prioritary” and “not prioritary” services.

The Directives now contain express provisions codifying the Teckal exemption in their respective spheres. In the case of service concessions the relevant provisions are in Article 17. Member States must transpose the 2014 17 June 2016.

It is important to recall that the 1992 Regulation is fundamentally an instrument dealing with shipowners’ freedom to provide services. Its provisions are designed mainly to prevent a Member State from restricting owners based elsewhere in the EU from operating cabotage services in its domestic waters, except as provided by the Regulation. The public service contract provisions have to be viewed in that light. Because a contract imposing public service obligations derogates from ordinary conditions of free competition between operators, it has the potential to deter or hamper commercial operators from providing cabotage services. It is for that reason that the general rule is for compensation for public service obligations to be limited to the additional cost to the operator of taking on services that it would not provide commercially. That feeds into the State aid rules, since compensation exceeding those limits is likely to benefit the
undertaking or undertakings in question in a way that could further distort competition in the internal market.

34. To that extent the 1992 Regulation is a liberalising measure. But the question is whether it goes further, acting as a divestment measure prohibiting a State from carrying on activities falling within Article 4 through its own public authorities. It seems to me impossible to read the Regulation in that way. The rules in Article 4(1) indicate what is to happen where a Member State enters into a public service contract with, or imposes public services obligations on, a shipping company. It does not stipulate that the only way in which the State can bring about the operation of the services in question is by entering into such a contract or imposing such obligations. The State may, in other words, simply provide the service itself. If it does so, the rules in the second indent of Article 4(1) are simply never engaged.

35. In that respect there is a powerful analogy with the 2007 Regulation. It is plain from Article 5(2) that an award of a public service contract to a commercial operator, as envisaged by Article 5(3), is not the only method by which Member States can provide passenger rail services. It is understandable that the 2007 Regulation, in contrast to the 1992 Regulation should, in Article 5(2), spell out detailed rules on control in the case of an internal operator, since the 1992 Regulation pre-dated the Teckal decision. The very fact that the (then) Community legislature in 2007 consider it a proper exercise of power under Title V (now Title VI) to provide that a Member State could, subject to Teckal-like controls, operate rail services in the public sector without going to the market (and thus using competitive tender procedures) at all provides a strong indication that Title V contemplates that Member States may provide maritime passenger services in similar manner, so long as rules comparable to those in Article 5(2) ensure that any resulting restriction on commercial operators’ (ie. Community shipowners’) freedom to provide services remains proportionate overall. The Teckal criteria provide precisely those rules.

36. That is reinforced by the power Member State have under the 2007 Regulation to apply that Regulation to maritime transport in national sea waters. So far as I, and those
instructing me, have been able to ascertain, the UK Government has not exercised its power to apply that Regulation to maritime cabotage. But it is unlikely that the EU legislator would have permitted the application of the 2007 Regulation to maritime cabotage at all if it had understood Article 4 of the 1992 Regulation as producing a result wholly incompatible with the discretion Member States have under the 2007 regime as to who provides services.

37. The fuller integration of maritime cabotage services into the general EU procurement rules is also significant. The Teckal exemption owes its very origins to the procurement Directives. It is improbable that the exemption from those rules recognised in Teckal, and now codified in the Directives, is entirely disapplied to services within the scope of Article 4. However, because the 1992 Regulation remains the lex specialis for public service contracts in the field of maritime cabotage, I will have to consider later the specific way in which Teckal may apply to those contracts.

38. Finally, applicability of Teckal to the 1992 Regulation is consistent with what is now TFEU Article 106 (ex TEC Art. 86), the well-known stipulation that:

   “2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union.”

39. For those reasons I have no difficulty in concluding that the Teckal exemption is in principle capable of applying to maritime passenger services falling within the 1992 Regulation.

Does CalMac’s operation of the Clyde Hebrides services satisfy the Teckal criteria?

40. The Teckal case itself laid down two requirements: control by the public authority “which is similar to that which it exercises over its own departments”, and the entity must carry out “the essential part of its activities” solely with the controlling authority or authorities.
41. As noted earlier, the 1992 Regulation is the lex specialis for public service contracts in the field of maritime cabotage. Since it does not contain provisions expressly codifying the operation of Teckal, it cannot be assumed that arrangements that would satisfy the exemptions set out in the Public Procurement and/or Service Concession Directives (which in any event are not yet transposed in Scotland) would necessarily provide an exemption for the purposes of Article 4. I advise here on the basis that the Teckal criteria, as developed judicially, must be satisfied before the implied obligation in Article 4 to conduct a public tendering exercise is displaced.

42. The control test in particular has been extensively developed by CJEU case-law since 1999, with much attention focusing on the implications of company law rules about ownership. In essence, it is necessary for the entity to be wholly owned by a public authority (or several authorities acting jointly) and to have no outside commercial ownership. But that is not always sufficient. The corporate arrangements must enable the owning authority or authorities to exercise decisive control over the entity’s strategy and management. Too broad a discretion vesting in the entity’s board of directors will fail the test.

43. The position was helpfully summarised in this passage from the judgment of Lord Hope in the UK Supreme Court in R (Risk Management Partners Ltd) v. Brent London Borough Council [2011] UKSC 7, [2011] 2 AC 34:

53. I would sum up my conclusions on the control test, in the light of the guidance offered by these authorities, as follows. Individual control is not necessary. No injury will be caused to the policy objective of the Directive if public authorities are allowed to participate in the collective procurement of goods and services, so long as no private interests are involved and they are acting solely in the public interest in the carrying out of their public service tasks. Asemfo shows that the decisive influence that a contracting public authority must exercise over the contractor may be present even if it is exercisable only in conjunction with the other public authorities. This was confirmed by the last sentence of para 46 of Coditel [2008] ECR I-8457 and re-affirmed in Sea Srl v Comune di Ponte Nossa [2009] ECR I-8127, paras 54-57. Where such a body takes its decisions collectively, the procedure used for the taking of those decisions is immaterial: Sea Srl, para 60.

54. These points illustrate the strength of the presumption referred to in Carbotermo, para 37 and Asemfo, para 57 that applies where the contracting authority holds, alone or together
with other public authorities, all of the share capital in a successful tenderer. The fact that two or more public authorities have collaborated to secure a service which is designed exclusively for the performance of their public functions, as in *Commission v Germany* where they did not hold any share capital in the cleansing department, carries at least as much weight. The argument that the control test was satisfied failed in *Carbotermo* because the broadest possible discretion was conferred on the boards of the parent company and its subsidiary for their ordinary and extraordinary management. No control was given to the commune to enable it to restrict the board’s freedom of action, in the form of specific voting powers or otherwise. It would have been otherwise if the commune had had power to give directions.”

44. Lord Hope summarised the function test as follows:

58 This issue can be dealt with quite shortly. The question where several public authorities control an undertaking, as the court made plain in *Carbotermo* [2006] ECR I-4137, para 70 and *Asemfo* [2007] ECR I-2999, para 62, is whether that undertaking carries out the essential part of its activities with all of the public authorities together in the consortium. As was explained in *Asemfo*, paras 62 and 65, this does not necessarily have to be with any one of those authorities individually. It is enough that it is with the same authorities collectively as exercise control over it. This is because, if this test is satisfied, it shows that implementation of the co-operation between the public authorities is governed solely by considerations and requirements relating to the pursuit of objectives in the public interest by those authorities. The absence of private capital and private customers is another important indication that the co-operation is for that purpose only, and that there is no risk of putting any private undertaking at a disadvantage vis-a-vis its competitors: *Commission v Germany* [2009] ECR I-4747, para 47.

45. The Supreme Court held that LAML, the dedicated insurer jointly owned and established by the authorities, satisfied both the control and function tests. As regards control, the company’s articles gave the directors the usual powers of management, but the shareholders (the authorities which together wholly owned the company) had a power of specific direction to the board by resolution passed with a 75% majority. Annexed to the articles were rules governing the classes of insurance the company could write, which were to be as determined by a majority of the members in general meeting. Claims were handled on the usual arm’s length basis between a participating authority and the company. Lord Hope held:

57. ... It is true that, when it came to claims, the nature of the relationship between each participating member as insured and LAML was essentially one between independent third parties. But, as I have already said, individual control is not required. Collective control over strategic objectives and significant decisions was with the participating members at all times. They controlled a service which was designed exclusively for the performance of their public functions. No private interests whatever were involved. On these facts I would hold that the *Teckal* control test is satisfied.”
46. It is notable that the Supreme Court’s approach chimes with the factors cited in Article 5(2)(a) of the 2007 Regulation: “degree of representation on administrative, management or supervisory bodies, specifications relating thereto in the articles of association, ownership, effective influence and control over strategic decisions and individual management decisions” (above, para. 29).

47. As regards the function test, Lord Hope at [59] noted that the company was confined to offering insurance to the constituent authorities and was prohibited from doing so for anyone else (except in very restricted circumstances). As he pithily summarised it, “LAML existed only to serve the insurance needs of its members.”

48. How do these principles apply in the case of CalMac?

49. My instructions, together with the documents I have considered, reveal the following.

50. The Scottish Ministers own all the shares in the main holding company, David MacBrayne Limited (“DML”). Since at least 1990, the trading operations have been undertaken through one or more subsidiaries.

51. In 2002, one such trading subsidiary – a joint venture between CalMac and RBS, trading as Northlink -- was awarded the contract to run the subsidised Northern Isles services. Subsequently in 2006 that contract was re-tendered. Another CalMac subsidiary, this time wholly owned, was formed to bid for the contract, which it won. However, on the 2012 re-tendering exercise, Serco won the contract for those services.

52. Meanwhile in about 2006, for the purpose of bidding for the Clyde Hebrides contract pursuant to the tendering exercise initiated in 2004, the other CalMac trading operations were divided between two new wholly-owned subsidiaries of DML. These were Calmac Ferries Limited (“CMFL”), which would operate the services, and Caledonian Maritime Assets Limited, which took over ownership of the vessels and other fixed assets. CalMac
Ferries Limited won the tendering exercise and has operated the Clyde Hebrides routes since then.

53. As already noted, CMFL is in substance wholly owned by the Scottish Ministers through their wholly-owned holding company, DML. I note that both companies share a registered office address at Gourock. The Articles of Association of DML include the following provisions:

a. Article 3.6 requires any newly issued shares to be offered in the first instance to existing holders of paid-up shares (that is, in practice, the Scottish Ministers); only the Scottish Ministers may waive that requirement, by consent in writing.

b. Article 11 gives the Scottish Ministers a series of overriding powers of appointment and removal of directors, issue of new shares, and the scope of the directors’ powers:

   “11.1 The following provisions shall apply to the Scottish Ministers, and to the extent of any inconsistency, shall have overriding effect as against all other provisions of these Articles:
   (a) the Scottish Ministers may at any time and from time to time appoint any person to be a director or remove from office any director howsoever appointed…
   (b) notwithstanding the terms of sections 89(1) and sections 90(1) to (6) of the Act, no unissued securities or Shares shall be issued or agreed to be issued or put under option without the consent of the Scottish Minister; and
   (c) any or all powers of the directors shall be restricted in such respects and to such extent as the Scottish Ministers may be notice to the Company from time to time prescribe.”

   ...

   ...

c. Article 12 enables the Scottish Ministers to appoint an assessor:

   “12.1 The Scottish Ministers shall be entitled to appoint one assessor to the Company who may be removed from office only by the Scottish Ministers. Any appointment or removal of such assessor shall be in writing… The assessor shall be entitled to received notice of, attend and speak at, but not vote at, any meeting of the Company, its Directors or of any committee of sub-committee of the Directors. …”
54. The controls in Article 11.1 are transmitted down the ownership chain to CMFL by virtue of Article 13 of that company’s Articles, which provides [emphasis as original]:

“13 Special article

13.1 Whenever a company wherever incorporated (hereinafter called the “Parent Company”) shall be the holder of not less than 90 per cent of the Shares of the Company the following provisions shall apply and to the extent of any inconsistency shall have overriding effect as against all other provisions of these Articles:

(a) the Parent Company may at any time and from time to time appoint any person to be a director or remove from office any director howsoever appointed…

(b) no unissued securities or Shares shall be issued or agreed to be issued or put under option without the consent of the Parent Company; and

(c) any or all powers of the directors shall be restricted in such respects and to such extent as the Parent Company may by notice to the Company from time to time prescribe.”

55. On the basis of Risk Management Partners and the CJEU case-law cited in it, it is by no means excluded that control in the ordinary company law sense could be sufficient, even in the absence of special powers of the sort observed in LAML, to satisfy the control test. As Lord Hope pointed out, the position emerging from decisions such as Carbotermo (Carbotermo SpA v. Comune di Busto Arsizio, C-340/04, [2006] ECR I-4166) is that such control creates at least a presumption that the test is met. Here, however, the articles contain examples of precisely the kind of extraordinary powers, exercisable for the purpose of the owning authority’s public functions, that evidently led the Supreme Court to conclude that LAML satisfied the test.

56. In particular, at the apex of the chain of control are the Scottish Ministers named as such (and indeed defined in Article 1.1 of DML’s Articles by reference to the Scotland Act 1998, s. 44(1)). Their ownership and control over DML, and thus the wholly owned subsidiaries under it, are in no sense merely incidental to their shareholding in the way one would associate with an ordinary company in which a public authority happens to acquire a stake – even a controlling one. The provisions of Article 11.1 of DML’s Articles, and of Article 13.1 of CMFL’s, confer very specific powers of direction and
intervention in the companies’ management and operations. These expressly override all other provisions of the Articles, and the resulting relationship contrasts sharply with the ordinary position in company law under which shareholders are prevented from taking any step which interferes with the directors’ right and duty to manage the company (ie. the kind of relationship which led the CJEU in Carbotermo to find that the control test was not met).

57. The actual public service contract awarded to CMFL may well be thought to resemble an arms-length commercial transaction, in much the same way as the insurer-insured relationship between LAML and its constituent authorities under individual policies written by the company. But that does not detract from the relationship of control: see Risk Management Partners at [57].

58. I therefore consider the control test to be satisfied.

59. The functional test is less straightforward. At this point it is necessary to recall the distinction between a contract for works, goods or services on the one hand, and a service concession on the other. Under the former, the contracting authority procures services exclusively for itself; it is in that sense the sole “customer” of the contracting entity, for the purpose of performing its public functions. Under a service concession, the authority procures services which are performed for others – viz. members of the public -- albeit that securing that performance of the service forms part of the authority’s public functions.

60. Here, ferry passengers, rather than the Scottish Ministers, are the immediate “customers” of CMFL. That raises a question as to how one reads and applies the dicta in eg. Risk Management Partners to the effect that the authorities were LAML’s only “customers”, and more generally the requirement that the entity perform “the essential part of its activities” with the contracting authority.

61. There were formerly some speculative comments in the CJEU’s Caselaw as to whether Teckal could apply at all to service concessions. Any such doubt is resolved by the 2014
round of legislation: see in particular Article 17 of the Service Concession Directive. That provision, when it comes into force in Scotland, will prescribe slightly different criteria according to the particular nature of the concession arrangement in question, and where it does impose a functional test it is not in quite the same terms as the judge-developed version of that test: see eg. Article 17(4)(c): “the participating contracting authorities or contracting entities perform on the open market less than 20 % of the activities concerned by the cooperation”.

62. As things stand I consider that the correct approach to the grant of a service concession in the field covered by the 1992 Regulation, consistently with ordinary principles of EU law, is to apply the Teckal functional test in a way that is sensitive to the underlying purpose of the procurement regime, and in particular the rules for contract awards under the Regulation, namely to avoid discriminatory and disproportionate restrictions on the freedom to provide services, and adverse effects on competition between operators exercising that freedom.

63. In recalling the arguments – in particular the proportionality argument – against the indefinite continuation of the previous arrangements with CalMac in 2004 (above, para. 16), it is important to understand the implications of the “no Teckal” assumption. An argument premised on the freedom to provide services presupposes that we are dealing with an ordinary market in which private operators would in principle compete with each other to run those services commercially. But where a service is made viable only by virtue of the Member State authorities’ decision to secure it through a public service contract or public service obligations, the essence of the position is that private operators, acting commercially, would not otherwise seek to run the service at all. The only meaningful “competition”, in other words, is between operators bidding to run such subsidised services as the Member State authorities decide ought to be secured in the public interest.

64. As already noted, nothing in the 1992 Regulation requires Member States to create that kind of competitive “market”. As in the case of the closely analogous 2007 Rail
Regulation, Member State are perfectly entitled to perform the service themselves without recourse to commercial operators. The obligations of non-discrimination and transparency designed to ensure competitive conditions in the award process (rather than in a wider commercial market) only apply where the authorities choose to go to the market to procure the service.

65. It seems to me, then, that when applying the functional test to determine whether the entity to whom the State entrusts services (instead of going to the market) is Teckal-compliant, the real question is whether that body is in substance acting commercially in a way that prevents or distorts whatever competition between private operators that would otherwise be present. That is consistent with the way the Supreme Court put the matter in Risk Management Partners (“no risk of putting any private undertaking at a disadvantage vis-a-vis its competitors” – above, para. 44).

66. A useful way of testing that is to consider whether in fact the contracted Clyde Hebrides ferry services seek to compete commercially with operators on any of the proposed contract routes, since if so that would tend to indicate the existence of a commercial market.

67. I am instructed that there are elements of commercial competition on certain island routes not comprised in the current contracted, or proposed re-tendered, Clyde Hebrides service, but overlapping geographically with elements of its network. Those instructing me have found only two examples. Argyll Ferries operates foot passenger only services between Gourock and Dunoon, in competition with private operator Western Ferries which provide car and freight as well as foot passenger services. Kintyre Express, which runs commercial ferry services between Northern Ireland and Campbeltown on Kintyre, provides passenger crossings between Islay and Mull.

68. On the CHFS network as comprised in the proposed re-tender but not part of the present contract, there appears to be only one route attracting private operation. That is the Oban/Kerrera route where a single private operator receives public subsidy. This is a
short route operated by a vessel carrying up to 12 passengers. In December 2012, Transport Scotland’s *Ferries Plan 2013-2022* observed:

“...we will consider intervening where there is market failure and the service is considered to be lifeline. It has become clear that the commercially run service for Kerrera does not meet the needs of the community and is not sustainable either now or in a form that would meet the needs of the community. We have therefore been working to plan a package of measures for the continued provision of ferry services on the island. We are pursuing a solution in relation to this with Argyll and Bute Council. In the meantime, we are working with the Kerrera community and current ferry operators to provide short-term grant support for ferry operation and urgent improvements to infrastructure. We anticipate this support will continue for around 18 months to 2 years, until a longer term solution is found.”

69. While the evidence is therefore limited, the overall picture is one in which there is no indication of an actual or supressed market for commercially operated services for which private operators might be expected to compete in the absence of the subsidised Clyde Hebrides services. Significantly, the only apparent examples of (presumably) profitable commercial services are on routes which – arguably quite properly – the subsidised Clyde Hebrides service does not operate. Rather, the situation has the appearance of the State intervening, in the public interest, by carrying out an activity where the market is unable to sustain the required services. In this sense, then, CMFL carries out “the essential part of its activities with” the Scottish Ministers. In other words it is not, in any significant respect, carrying out commercial activities as a market player. On that basis, the functional test appears to be satisfied in respect of CMFL’s operation of the current and proposed Clyde Hebrides services.

**If Teckal applies, do the State aid rules nevertheless require competitive tendering?**

70. I deal with this issue only because, as noted earlier, the term of the Scottish Ministers’ Parliamentary answers appear to convey the view that even if the Teckal exemption applies to CMFL’s operation of the Clyde Hebrides service, a tendering obligation remains because of the provision of State aid to support the service. I address the point briefly because in my view it is clear that once an entity attracts the *Teckal* exemption by satisfying the control and functional tests, the funding of those of its operation that fall within the scope of the exemption does not constitute State aid.
71. In general terms the State aid rules (see Article 107 TFEU) apply where a Member State provides valuable assistance, in whatever form, to an undertaking. As noted, the rationale for the rule is that competition between undertakings is liable to be impeded or distorted where a particular undertaking or category of undertakings is undulyfavoured by State financial support. But in principle the rules have no application to expenditure by the State on services provided by its own organs and departments. Since the essence of *Teckal* is that the separate entity through which the service is provided is treated as an organ or department of the State, the funding of the service out of the public purse is simply the disbursement of public expenditure by and through the State itself.

72. However, things are not always quite as straightforward as that. Where a public sector body begins to act commercially in a way that makes it a market player so as potentially to distort competition, its funding arrangements may attract the State aid rules. The Commission decisions underlying *Stichting Woonpunt and others v. Commission*, C-123/12P (which technically dealing with procedural issues concerning admissibility and standing for the purpose of appeals against Commission State aid rulings) deal with this issue, which arose on rather complex facts involving grant aid to Dutch social housing foundations.

73. But as noted above, the essence of the functional test, as it applies to arrangements of the kind covered by the 1992 Regulation, is precisely that the entity through which the service is provided essentially acts to carry out the public interest functions of the relevant State body, rather than undertaking significant activity of a commercial character. It is significant that the concern expressed by the Commission, in the 2004 version of its State aid guidance on the 1992 Regulation, related to the possibility of subsidies in certain circumstances creating a private monopoly (above, para. 19). Thus it is an error to read the present Commission guidance as indicating that a competitive tendering process is required in order to avoid the application of State aid rules where services are provided through a *Teckal*-compliant body such that the 1992 Regulation imposes no requirement to conduct a tendering exercise.
Concluding remarks

74. I am sure that those instructing me will not hesitate to contact me if they have any comment or query arising out of this advice.

Gordon Nardell QC

39 Essex Chambers
39 Essex Street, London WC2R 3AT
DX 298 Lon Ch Ln
Tel: +44 (0)20 7832 1111 Fax: +44 (0)20 7353 3978
e-mail gordon.nardell@39essex.com

24 November 2015
NATIONAL UNION OF RAIL, MARITIME AND TRANSPORT WORKERS

PROPOSED RE-TENDERING OF CLYDE HEBRIDES FERRY SERVICES BY THE SCOTTISH MINISTERS

ADVICE ON APPLICATION OF THE TECKAL EXEMPTION TO CALMAC

Thompsons Solicitors LLP
Manchester

Neil Todd
Tel. 02616 819 3528
Fax 0161 832 1676
NeilTodd@Thompsons.law.co.uk