The governance ofScottish ferry services

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1. Introduction

In this paper we argue that the present arrangements for review and implementation of Scottish Ferry policy are not competent and that, in particular the role and functions of Transport Scotland should be replaced by an independent regulator supported and directed by a sector-specific statutory framework. The arguments here are buttressed by reference to serious and well-documented failures on the part of this agency and its predecessor government department in dealing with the areas of ferry governance with which they have been given responsibility.

By “not competent” it is not intended to imply failures in terms of competence or performance on the part of any individual. Competence depends on context, training and perspective, the problems here are systemic and institutional and cannot be sorted by any review or reviews carried out by Transport Scotland itself. The former Home Secretary John Reid once famously remarked that his Immigration Department was “not fit for purpose”. What can be said about the present role and functions of Transport Scotland in the context of Scottish ferry policy is that they were not designed for purpose.

This paper is intended to be read in conjunction with my 2009 Fraser Commentary paper on Scottish ferry policy for which it can be treated as both an extension and update. It can however be read independently of that paper, though for reason of brevity and economy we shall avoid much of the technical and legislative detail covered in that earlier paper where possible.

2. The 2009 Fraser Ferry Policy Paper and update

In the scale of the failures in policy making with respect to Scottish ferries post-devolution, nor how unnecessary such failures have been.

Nothing that has happened since has done anything to moderate these views and indeed if anything, matters have worsened, the 2009 paper argued (as I and others had done since 2001) that whatever governance solutions were adopted as policy for Scottish ferry services that these should have as minimum specifications an independent regulator supported by a dedicated statutory regulatory framework and clearly specified operator of last resort, as tends to be standard as part of oversight provision for other UK essential public services.

None of these are in place though the Scottish Government has recently announced that it will explore the possibility of an industry regulator backed by statutory legislation, this is discussed further below.

However, the major problems that I identified in that paper still hold and in addition to the failures to put in place the regulatory safeguards that the network needs, there is still little evidence that there is proper recognition and understanding at official level of the opportunities and constraints represented by EU law in this context, in particular the roles played by public service obligations (PSOs), public service contracts (PSCs) and the Altmark principles. In turn, there is failure to fully appreciate and explore issues associated with exclusivity provisions and methods for dealing with cherry picking, all of which is provided for in EU law and associated guidelines.

The major changes since 2009 relate to the first of the three major public service contracts that are set to be decided between now and 2013. The case is that of Gourock-Dunoon and the outcome is frankly a shambles and disastrous for the public interest as it affects the taxpayer, the users, and the dependent communities.

In 2007 the Scottish Government had come to power promising to build two vehicle-passenger ferries for the Gourock-Dunoon public service route, and indeed throughout the tender process it had been the Government’s claim that they had been working towards a “town centre to town centre vehicle and passenger ferry service between Gourock and Dunoon”. The Government was aware that studies, including those sponsored by the Scottish Executive, confirmed the economic case for building these vessels and also confirmed that they would have to be built specially since suitable vessels would be unlikely to be obtained through the second hand market. They would have been aware there was no legal impediment to building and deploying these vessels as long as suitable accounting measures were put in place to make sure there was no leakage of subsidy from the foot passenger side to the vehicle-carrying side, as the European Commission had confirmed in an answer in 2007. There was no change to EU law or guidelines relating to the issues that would have made a substantive difference to these issues over the period 2007-2011.

What actually happened was a series of prevarications and confusions that at the very least demonstrated the kind of systemic failures of governance that I had argued in 2009 showed the need for major institutional reform in this area. First, the Government claimed that EU law prevented them from building new ferries for the route. This was not true and never has been true, even the most charitable interpretation is that it displays complete misunderstanding.
of EU law as it applies. Second, the Herald newspaper recently revealed that the Government made a covert offer to the private operator Western Ferries in 2007 that the Government would withdraw the CalMac vehicle-carrying public service if Western would run some of their vehicle-carrying service into Dunoon Pier. This would have reduced the potential market for (profitable) vehicle-carrying on the public service town centre route, increased the need for subsidy on the public service route, and increase the probability that the only option left for bidders for the route would be a passenger-only option. Third, the Government claimed that a survey they had sponsored showed that suitable vehicle-carrying ferries were available on the second-hand market for Gourock-Dunoon (and by implication precluding the need to build them). Freedom of Information requests showed that this was not true.

There were other prevarications such as Fol-refuted claims by the Government that they were in active discussions with the European Commission and attempts to persuade the European Commission to extend the deadline for the new tender on what could only have been spurious grounds. In the end the winning tender for the town centre public service route was announced just after the May 5th Holyrood election, and as was widely expected was a passenger only option. At a stroke this will degrade the options open to users on the town centre route, heavily increase subsidy unnecessarily compared to what would have been needed if the modern vehicle-passenger ferries needed for the route had been built and made available for the tender, create a vehicle-carrying private unregulated monopoly over a strategically important transport route, and impact heavily and adversely on dependent local economies and communities.

However that is only one part of the Scottish ferry network, what is happening on Gourock-Dunoon is set to be a model that could destabilize much of the Scottish ferry network and fragile dependent communities. That is only one part of the risks and threats to the public interest that failures at governance and policy level are creating here.

3. How we got here
Domestic ferry services in most countries are treated as essential services and administered appropriately. On a straight mile-for-mile basis ferry travel can be one of the most expensive forms of transport modes and where ferries are used it is typically because there are few, if any, practical options. They tend to have natural monopoly characteristics and often high levels of externalities with respect to local regional economic development. For those reasons, most countries subject their domestic ferry services to careful and systemic control, either through state ownership or regulatory oversight.

Nationalization was the standard UK solution to an industry with these economic characteristics until Margaret Thatcher’s privatization programme in the Eighties replaced state control with regulatory oversight in most of these cases. The pattern was fairly standard; a nationalised industry would be replaced by a competitive tendering resulting in a series of privately-owned companies with an independent regulator and a sector-specific statutory framework. Each case incorporated necessary checks and balances such as provision for an operator of last resort should any incumbent operator default or otherwise threaten breaches of its contract.

With post-war domestic Scottish ferry services being dominated by one large nationalized ferry operator Caledonian Macbrayne, this fitted into the first part of the story of how such natural monopolies came to be administered in the UK. Where the story parted company with the standard script in the Thatcher era of transformation through privatization and regulation was that Scottish ferry services remained for the most part in state-owned hands.

In my 2009 paper on Scottish ferry policy in the Fraser Commentary, I covered some of the background to this anomaly which to a large extent revolved around the fact that while ferry services were an integral part of much of the Scottish transport network in the north and west of the country, this was simply not a major issue south of the border apart from the very localized case of the Isle of Wight ferries which were already run by private companies.

A contributory problem here is that while air, rail, and road policy is highly visible to transport policy makers and commentators who may depend on (or at least observe) these services themselves, much of what happens on domestic Scottish ferry services tends to impact on peripheral, scattered and isolated communities. The debacle of the Edinburgh trams has received high levels of coverage in the Scottish media and there is high public awareness that there are major public interest issues at stake here - even if there is less awareness of exactly what the issues are. However, there was far little coverage and public awareness of the fact that the first Northlink ferry contract serving the Northern Isles (Orkney and Shetland from Aberdeen) effectively collapsed with forced retendering in 2004 after the operator receiving a multi-million pound bail out following its threats to withdraw from the route. Yet these ferry services to the Northern Isles are essential public services with many communities and businesses in Orkney and Shetland dependent on them for their survival. And no matter what can be done to salvage the Edinburgh trams project it is highly unlikely that it will ever achieve the status of essential public service.

Similarly, at the end of this month the CalMac Gourock-Dunoon town centre to town centre vehicle-passenger service will end after several decades of operation and be replaced by a passenger-only service. This leaves by default an unregulated private firm (Western Ferries) as monopoly operator of vehicle-carrying ferry services over the Clyde Estuary, the road option involving a detour of 84 miles. While the traffic numbers on The Clyde Estuary are of course much smaller than across the Forth Estuary, in
A further problem is at the level of individual markets like Gourock-Dunoon, the scale of any possible market distortion is likely to fall below the radar of the OFT, even though they may have profound effects on local economies and communities. However, in the aggregate the failures of successive governments to put in place a coherent (or indeed any) statutory framework for regulating Scottish ferry services means that the system is simply unable to deal competently and coherently with standard problems that regulators of other essential services face on a regular basis, such as monopoly pricing and delivery of services, market entry, cherry picking, exclusivity, public service obligations (PSOs) versus public service contracts (PSCs) and operator of last resort.

The problem with the governance of Scottish ferry service is that for the last decade it has been mis-specified as a problem by government. It has been largely defined and seen as a transport sector where subsidised public services would now have to be made subject to competitive tendering to be made compliant with EU law. While this is correct as far as it goes, this has helped obscure the fact that the self-regulatory function that nationalisation had filled now left a regulatory gap that would have to be replaced for these essential services if matters were not to fall apart. But the supposed urgency of the need to comply with EU regulations meant government since 2000 brushed aside such arguments arguing that matters were too urgent for such luxuries as proper regulatory oversight. In 2000, the Executive stated they were “aiming to have the first tender in place by Spring 2001 with implementation to follow” a time horizon which was never realistic as I and others pointed out. In the event the first CalMac tender for Clyde and Hebrides ferry services began in October 2007, the imminent (though ever-receding) deadline for tendering effectively capping and neutering any chance of reasoned debate.

In 2001 when the issue of need for an Independent Regulator of competitively tendered ferry services was raised by me and others to the then Scottish Executive and the Scottish Parliament, the response was that “The Transport Minister when questioned on (the subject of an Independent Regulator) continues to state that it is not needed since the Maritime and Coastguard Agency is responsible for safety”. While of course it is the Minister who is held responsible and accountable for not knowing that the term ‘independent regulator’ generally refers to an agency with an economic function. It was such a briefing from officials which made it impossible to make headway on this issue with successive ministers, despite it being raised repeatedly by me and others to the Executive and Parliament, including in invited evidence to Inquiries into ferry tendering held in each of the first three sessions of the Scottish Parliament.

4. Where we are now

Two statements by Scottish Cabinet Secretaries with respect to the Gourock-Dunoon tendering issue in recent weeks reinforce the above points. First in response to the Gourock-Dunoon debacle, the Government news release quoted John Swinney, Cabinet Secretary for Finance and Sustainable Growth:

“the Government is now examining the scope for introducing a statutory ferry regulator which could have strong powers to ensure there is no predatory commercial activity on any Scottish ferry route”

While it may be seen as something that, at least, there is at last official recognition of the need for a regulator with statutory powers here, albeit ten years late, the reasons given for it reflect further misunderstanding of the scale and nature of the economic problem here. Predatory behaviour or predation in economics refers to anti-competitive behaviour such as pricing below cost to drive rivals out the market. This was not an issue on Gourock-Dunoon where the market distortions were largely created by government intervention rather than corporate action, nor is it likely to be one of the major issues for a regulator in the markets under discussion here. Indeed, the problems created and buttressed through government restrictions on the Gourock-Dunoon on Gourock-Dunoon were the opposite of predation with the dominant position already achieved for the private sector operator allowing it to achieve operating margins averaging about 27% in recent years.

Just talking about creating a regulator without first having a clear sight of what, how, and who he is she is supposed to be regulating is rather like appointing an umpire without giving them a rule book. Even who they would regulate needs to be made clear – for example, does it include private unsubsidized firms plying routes that are classifiable as public service routes under EU law? Eleven years after the issues of competitive tendering of nationalised ferry services first appeared on the political map there is no evidence that such questions are appearing on the agenda, let alone being answered.

The second statement regarding Gourock-Dunoon was by Alex Neil Cabinet Secretary for Infrastructure and Capital Investment to the Scottish Parliament June 2nd 2011

Alex Neil: “The origin of the contract and tender was essentially the European Commission. The Scottish Government had no option other than to tender the service. We had to take decisions on the basis of the tenders that were returned, and we took the option that involved the absolute minimum number of redundancies. Had we taken any other option, the number of redundancies involved would have multiplied by four. I take it
that all members in the chamber will welcome the Government’s policy of minimising redundancies in such situations."

While some members and interested parties might indeed welcome a policy and decision under competitive tendering that was taken on the basis of minimising redundancies, such a policy raises serious questions under competitive tendering and extant law as it relates to these issues. It is perhaps a reflection of the low level of awareness of these issues that this point does not seem to have been picked up and subjected to further discussion and investigation, whether in or out of Parliament.

At this point it should be noted there is a Ferries Review which has been conducted over most of the life of the last Parliament and is publicised by the Government as intended to provide a basis for “a long-term plan for ferry services to 2022”. This will not shed much light on the issues that matter here, indeed it has the potential to not just have wasted much public money but to make things even worse.

The Review has been set up to heavily reflect the views of “stakeholders” which in the way it has been conducted more reflects commercial interests rather than those of the public and the communities seen to be served. This is rather like inviting the foxes to participate in the design of the chicken coup. By all means observe the reactions of creatures of a vulpine persuasion to your first efforts at a chicken coup and be prepared to modify your efforts in the light of these observations. But an effective chicken coup, just like an effective regulatory framework should first start with the experience of others who have faced similar problems, whether it is farmers in the case of stock protection or regulators in the case of essential public services. And the Summary of consultation questions asked in the Review confirms that the quality and content of answers received will unfortunately reflect the quality and content of questions asked (how is anyone supposed to phrase a meaningful reply to “Do you agree that the ferry service should be designed to meet the most important needs of the community?”).

So where do we stand now in terms of Scottish Ferry Services? We have a rag bag of pricing, investment, public procurement and public infrastructure policies that not only vary between contracts but sometimes even within contracts (such as the RET “trial” applied for several years so far to parts of the Clyde and Hebrides network but not others). The Gourock-Dunoon contract has finished in a shambles, the Northlink tender is due for retendering in 2012 and there is no sign that the Government has learnt the lessons that matter from the previous fiasco that resulted in bail out and forced retendering here (my efforts to persuade the then Scottish Executive that this proved the need for an operator of last resort was rebuffed by officials).

But then in 2013 comes the retendering of CalMac and the Clyde and Hebrides contract again. This, more than anything else, reflects the crossed fingers and head-in-the-sand approach to these issues by government.

There are two possible scenarios from the tendering of CalMac in the form of the Clyde and Hebrides contract every six years under EU law. The first depends on CalMac (holding company state-owned David MacBrayne) winning the contract in perpetuity every time it comes up for retendering. In a level competitive playing field that is a bit like throwing a dice and betting on the same number coming up every time. It might happen, but then other parties might want to have a look at the dice, or at least question whether it is worthwhile tossing the dice at all. But if the “CalMac in perpetuity” scenario does hold and goes unchallenged, the only major cost is the unnecessary waste down the years of millions of pounds of public and private money spent on retendering process and a time horizon for operators and policy makers dictated by the time of the next retender. But if this scenario holds, then whatever it is, it is not competitive tendering and this would inevitably become clear to potential operators and the EC.

The second and more dangerous scenario is that eventually CalMac loses its contract to another EU bidder. At this point, if there was a coherent regulatory framework in place as for other essential services then at least there is potential to guard against problems from moral hazard, adverse selection, opportunistic behaviour, technical or financial failure on the part of the incumbent operator. But obviously these safeguards would have to be in place before the tender process takes place, you do not start re-writing the rule book once the game has started and you are worried about who is winning, just as you do not start looking for an operator of last resort when you need them to start tomorrow.

The dangers of such a scenario would be great enough even with a coherent regulatory framework in place with one single private operator dominating Scottish ferry services. Without such a framework there would be numerous potential threats to the public interest, most obviously from opportunistic behaviour on the part of the new incumbent, as any experienced industry regulator would almost certainly advise. And with CalMac having been presumably been wound up since it had lost its contract and only business, there would be no obvious alternative open to the Scottish Government in the event of such problems. Even if Northlink as another subsidiary of state-owned David Macbrayne was still available in principle, the scale and diversity of the CalMac network is at much greater levels than that faced by Northlink. I simply do not know what would happen if a private operator that had won the Clyde and Hebrides contract from CalMac started acting opportunistically and threatened to withdraw unless the government paid up, but much more importantly it is fairly clear the government does not know either, or at least does not want to think about it. The lesson from other regulated industries involving essential services is that the crossed fingers and head-in-the-sand approach does not work with
operators whose obligations are to their shareholders, you have to anticipate how the operators might exploit any loopholes or other forms of advantage and set up regulatory safeguards in advance, not deal with them from a blank page once they arise.

Meanwhile, cherry picking and unrestricted market entry can proceed to undermine public service contracts quite unaffected by these contractual issues. Cherry picking has had varying degrees of success in different parts of the Scottish ferry network; it is fewer routes, that have been and will be, typically targeted for cherry picking. More segments of routes such as vehicle carrying, short crossings, freight and livestock, with high season cherry picking also being a possibility but not yet really in evidence. Cherry picking in the context of Scottish ferry services can cream off the profitable segments of the joint product provided by vehicle/freight/passenger vessels, leaving any high cost (mostly crewing levels for safety reasons) and low revenue loss-making passenger-only public service to bear a higher level of subsidy if it is to be provided at all. The dangers of cherry picking in ferry services are arguably greater than for most other essential services such as postal services since local natural monopoly characteristics reduce or more likely eliminate the chances of competition amongst cherry pickers. Also in general these tend not be contestable markets once entry has been achieved and incumbency established because of typically limited access to suitable vessels and/or infrastructure.

The failure to realize these issues is reflected in the possibility raised in the current Ferries Review consultation

“As a first step, we could test some routes by tendering them singly. This would encourage the commercial ferries market to provide services wherever possible leaving only the services which are unlikely to attract operations on a commercial basis (i.e. without subsidy) to be funded through the public purse.”

But if there are any routes on the Scottish ferry network which could be profitable providing a full complement of user services, including what are usually loss-making services for foot passengers, a market entrant could potentially make even more profit by cherry picking the profitable segments of that market, such as vehicles. There is no exclusivity provision at the moment to stop market entry outside existing or projected public service contracts (part of the reason for the Northlink tender collapse), which is also exactly what happened in the case of Gourock-Dunoon. Why should any firm tender for a public service contract when it can cherry pick the time, level and form of entry that suits it and simply crowd out any similar services that are offered by the public service operator? Indeed just a few weeks before the Scottish Government’s Ferries Review was asking questions last year as to whether Ardrossan-Brodick was one of the routes that should be considered for single route tender. Western Ferries had announced their intention to enter into direct competition with CalMac on Ardrossan-Brodick using a similar market entry strategy to that employed in Gourock-Dunoon; “we are looking to take to Arran those elements of that model which have allowed Western Ferries to run a commercially successful service against a heavily subsidised service provided by CalMac.”

If anything could be taken to epitomize Government’s current ferry policy it is the contrast between the unreality of what they think could happen here and the reality of what the market was and is actually planning. This was visible to see for anyone who picked up a national newspaper, and not just in 2010; Western Ferries also has had a long-standing and publicly expressed interest in entering the Bute market using a similar business model to Gourock-Dunoon.

5. What should be done?

The model (if it can be described as such) for governance of the Scottish ferry network is simply unsustainable. Either faith is placed in the likes of CalMac winning its tender indefinitely (an expensive and highly improbable outcome with competitive tendering and assuming a level playing field), or we face the unacceptable dangers of the major part of the Scottish ferry network and the associated essential public services being eventually captured by a commercial interest that is not subject to the normal checks and constraints that are standard practice in other essential public services in the UK. Further, even in the absence of the worst case of capture by a poorly regulated commercial interest, the network as a whole faces progressive disintegration and erosion through unrestricted and unregulated cherry picking. It is not as if government has been unaware of the dangers of cherry picking, there has been public discussion of the dangers by the Scottish Executive and the Scottish Parliament since 2001. But it has proven difficult or impossible to convince policymakers that focusing only on routes does not get to the roots of what cherry picking will target. Just as in postal services they will seek low cost or high value services of individual routes and be willing, indeed delighted, to leave the high cost and low value segments of any route for a public service and the tax payer to pick up.

The problem is that there is absolutely no evidence that any of this is on the Scottish Government’s radar. There is a debate to be had, and reasoned arguments on both sides, as to whether most of the Scottish ferry network should be run by a single state-owned holding company or whether most of it should be in private hands, much of it awarded through public service contracts. There is also a debate to be had, and reasoned arguments on both sides, as to whether or not some routes should be tendered separately rather than as part of the main CalMac bundle, effectively to institutionalize cherry picking and bring in a degree of oversight by government. Indeed these very debates were encouraged in the current Scottish Ferries Review. The problem is that the debates are irrelevant, a waste of time
and even counterproductive since they are not predicated on a real understanding of commercial logic and interests, let alone what EU law permits and prohibits in this context. In the absence of coherent oversight the market will provide its own solutions and one of the first lessons students learn in Economics 101 is that you cannot just rely on crossed fingers to ensure that private interest aligns with the public interest.

While the present outcomes for ferry services in Scotland are not sustainable, there are alternatives which are, and these include alternatives already put before the Scottish Executive and the Scottish Parliament. One example was in fact the default option which had been the outcome of discussions between the Scottish Executive and the European Commission in 2000 and included splitting the CalMac Clyde and Hebrides networks into 3 or 4 separate bundles and tenders. Advantages of this option included the fact that provision to act as operator of last resort for other tenders in the network could be simply included as a clause (with appropriate provision for compensation) in each tender agreement. Disadvantages included any possible sacrifice of economies of scale that could have been achieved through a single tender. Other options include the one which I submitted to the Scottish Executive and the Scottish Parliament in 2005 and which is discussed in more detail in my 2009 Fraser Commentary paper. This option provided for the operation of public services including the CalMac network by a single state owned body without the need for expensive regular retendering and under compliance with EC guidelines as reflected in the Altmark principles.

As discussed in my 2009 Fraser Commentary paper, the Executive rejected my proposal in 2005, advising the Scottish Parliament that the Altmark principles were not applicable to Scottish ferry services. Three years later in 2008, the European Commission opened up a State aid investigation of Scottish ferry services on the basis that the services had to comply with the Altmark principles and there were grounds for suspecting that the government had failed to ensure this.

Reading these last two sentences together should have been sufficient evidence that policy here was not being framed in a competent and coherent manner. However it made no visible or discernable difference as to who handled policy here or how it was handled.

How can this be changed? The first thing to recognize that what is completely missing from the governance of ferry services in Scotland is a set of institutional guidelines embedded in a statutory rule book similar to other essential services. What is needed here is a process by which ways for dealing with these problems can be set up. If the problem is defined properly by Parliament as “the provision of competitively tendered essential ferry services under EC law” this problem could be considered by a small, say 6 members, Independent Expert Group in which the core would be experienced experts from regulated essential services (such as energy, postal services, telecoms) with input from experts in relevant EC law and ferry services. The terms of reference of the Group would be to frame institutional and regulatory options for ferry services in Scotland.

How to pursue this? The normal procedure and default option would be for such a Group to be set up by the Scottish Government. But that brings us back full square to where we started with these problems. There have been three full sessions of the Scottish Parliament since 1999, there have been Inquiries into the tendering of Scottish ferry services in each one of them, and I and others have given invited expert evidence to each of these three Inquiries. The pattern has been fairly standard so far: evidence given by me and others; followed by polite, patient, and informed questioning by MSPs on the appropriate Committee; followed by representations and/or questions by the Committee to the Scottish Executive / Scottish Government; followed by explicit or implicit rejection of points for possible reform or re-assessment of policy by the Executive/Government; followed by another Inquiry into the tendering of Scottish ferry services in the following session of parliament about 3 or 4 years later.

Proposals for such an Independent Expert Group have been made by me before through a Scottish Parliament Transport Committee Convener and suffered the same fate that most sensible proposals for reform have suffered once they faced neutralizing by advice and intervention of officials. This is understandable and quite rational, it takes a lot to expect any institution or group to objectively evaluate and advise on proposals that are based on the premise that the group or institution in question does not have the commences required to adequately perform the tasks with which they have been entrusted.

The only real opportunity that such an Independent Expert Group would have of being formed with the right skills on board and with resources and opportunities to do their job properly would be if it was truly independent of official interference in its formation and operation. For that you would need a strong Parliament and/or a strong Minister. I must say that my experience over more than a decade has led me to advise caution and against over-optimism on these counts but there is no choice other than to hope.

Endnotes

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And in which context I must declare an interest as a user of the ferry services here

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