FERGUSON MARINE – CASH FUNDING SITUATION

Summary of the Issue

Following an open and transparent tender exercise, Ferguson Marine Engineering Ltd (FMEL) is building 2 new ferries under a £97m public procurement contract for Caledonian Maritime Assets Ltd (CMAL – a company wholly owned by Scottish Ministers). Some 18 months into that contract the owner Jim McColl has asked CMAL and Scottish Ministers for the following:

- To review the payment schedule through to completion of the contract through cash flow acceleration. Mr McColl is looking to bring forward future payments totalling £14.55m from 2018/19 to 2017/, and

- For Scottish Ministers to underwrite a Surety Bond of around £25 million, or for CMAL to remove the contractual requirement for this entirely.

Advice from Transport Scotland, with input from SG Finance and SGLD, has been that Ministers:

- **Agree** to CMAL accelerating the payment milestones in order to ease cash flow concerns; noting that this will create a new budget pressure in 2017-18;

- **Do not pursue** Mr McColl's proposal for SG to under-write the remaining £25m surety bond given the financial, Parliamentary, legal and State aid risks set out in full in advice on 24 March. In essence, if the Scottish Government were to underwrite the Surety Bond then Scottish Ministers would be effectively "self-insuring" given their ownership of CMAL.

- **Convene a fresh meeting** between Ministers and Mr McColl, which CMAL would be willing to participate in.

Current status

Advice is with Ministers for decision.

Timeline of recent events

Ministers met Jim McColl on 2 March 2017. Mr McColl presented a paper on FMEL's cash flow situation and made 2 proposals to address this:

1) Scottish Government (SG) to under-write the £25m Surety Bond (recently agreed with CMAL as a significant concession to FMEL);

2) CMAL to reduce the final retention payment from 25% to 10% per vessel.

Mr Mackay requested advice from Finance and Transport officials on these proposals. This was provided on 24 March 2017.

Also on 24 March, Mr McColl wrote to the CMAL Chair, Erik Ostergaard, copied to Ministers, with the same requests. In that letter he also indicated that if Scottish Ministers could not underwite the Surety Bond then he would ask CMAL to remove it entirely. That would brings a different set of challenges given it exposes CMAL to a significant increased financial risk should FMEL fail to deliver the vessels, or fail to deliver them to specification.

CMAL discussed all of these issues at their scheduled Board meeting on 28 March, with [Redacted] (TS Ferries) in attendance. CMAL responded formally to Mr McColl on 30 March noting that:

- CMAL was willing to agree to an acceleration of profile payments subject to funding approval from the Scottish Government; but

- The Board could not agree to removing the Surety Bond as this would materially alter the shipbuilding contracts from those originally competitively tendered and therefore expose the procedure to challenge.

A further exchange of letters between Jim McColl (3 April) and CMAL (5 April) followed in which largely the same points were made.

On 29 and 30 March, Shauna Powell, a Partner in Clyde Blowers (Mr McColl's investment vehicle) phoned Kevin Hobbs (CMAL CEO) and then [Redacted].

Shauna Powell also offered surety over the shipyard itself, in the event of default of FMEL, as the alternative to the current Surety Bond. That would make CMAL would potentially the owner of the FMEL yard, with all the associated liabilities that might bring including TUPE responsibilities for the workforce, (potentially) contaminated land, a half-built office development, a yard under re-construction, a shipyard with no further orders etc. That would put Scottish Ministers in an entirely different space from where they are currently. It is not clear if this proposal has been considered or sanctioned by Jim McColl.

On 30 March [Redacted] provided an update to Ministers of the above, suggesting that in view of the potential seriousness of the situation, Scottish Ministers offer and reconvene a further meeting with Mr McColl. This has not been taken forward, probably given Ministerial absences during recess.

In parallel with all of this, CMAL has previously expressed concerns to FMEL at the rate of progress of the build of these vessels which are some months behind the original schedule. However, FMEL has recently taken a number of significant steps to address the previous slippage, and future progress, and hence provide some reassurance to CMAL that they will deliver these vessels on time as per the contract.

Further detailed advice taken from the submission 24 March is contained in an Annex to this note.

Transport Scotland
13 April 2017

Annex

FERGUSON MARINE – CASH FUNDING SITUATION

1) SG under-write of the CMAL Refund Guarantee

The purpose of refund guarantees in shipbuilding contracts is to protect the shipowner against non-delivery of the vessel (e.g. due to business failure) or the delivery of a sub-standard ship or one which does not meet key specifications such as speed, deadweight or other aspects of performance. The funds are there to enable the shipowner to have the ship finished to an acceptable standard either on-site or elsewhere.

At Mr McColl's request, and with Ministers' agreement, CMAL previously enabled the release of 60% of the cash tied up in the original bank guarantee by replacing it with a surety bond. Mr McColl did not propose to Ministers the removal of the remaining £25m surety bond but was seeking SG under-writing of this which would enable him to release the cash[1].

Advice from SG Finance and TS Finance is that such a guarantee from the Scottish Ministers to FMEL would be likely to create a new contingent liability. This could not be considered "normal course of business" as it would be a change to an existing commercial contract and move risk from the contractor, FMEL, to the contracting authority, CMAL (and therefore by extension to the Scottish Ministers as CMAL's owner).

The contingent liability would therefore need to be approved by the Scottish Parliament Finance Committee on the basis of a written proposal from Ministers and following questioning of one or more of the responsible Ministers by the Committee. Whilst Parliamentarians could support the intention of the measure, the procurement and risk transfer issues would be expected to receive close scrutiny from MSPs and also draw attention from wider interests including the media and, potentially, one or more of the unsuccessful bidders for these shipbuilding contracts.

The proposal that Scottish Ministers provide a private company with a guarantee directly linked to the delivery of a contract being funded by the Scottish Ministers is highly unusual. Even if supported by the wider policy implications of seeking to see FMEL established on a solid foundation as an internationally competitive shipyard, the transfer of risk from FMEL to the Scottish Ministers and the confusion of roles and interests in the contractual relationship make this proposal appear fundamentally unsound and likely to attract considerable scrutiny. This is because contingent liabilities are taken on by government in order to effect additionality and are ultimately in favour of a third party for the purposes of achieving something that might not otherwise be possible.

Additionally, the issue of a Guarantee (if not compensated by a market-rate premium) would constitute a State aid to FMEL, and is likely to raise significant procurement issues (as FMEL would be relieved of the Surety Bond charges) such

[1] However in his letter of 24 March 2017, Mr McColl goes further and proposes either full release of this £25m or (as previously) an SG under-write. We will discuss the full release option with CMAL and provide a further update.

that it is highly unlikely CMAL would countenance this option, and it is not one which Scottish Ministers could support.

It would be more appropriate to review the level of Surety Bond required at future key milestones in the delivery of the contracts, with reference to the purpose of that Bond and the level of risk it is required to cover. This could be considered alongside Mr McColl's second point around the level of the final contractual payments as similar issues arise around the scale of risk and the appropriate level of mitigation required.

<u>2) CMAL to reduce the final retention payment from 25% to 10% per vessel.</u>

The overall value of the 2 contracts is £97m of which 25% (£12.125m per vessel) is retained until final (satisfactory) delivery. Mr McColl has proposed that this is reduced to 10% per vessel and the remaining £14.55m released at earlier milestones.

CMAL are already in discussions with FMEL around creating additional interim milestone payments which reflect measurable progress towards the milestones already in the contracts to assist with the shipyard's cashflow. £59.2m (61%) of the total contract price has already been paid, which leaves only £13.55m (14%) in remaining payments ahead of the £24.25m (25%) on-delivery payments.

In terms of policy objectives and the management of risk, the closer FMEL progress towards completion of the vessels, the lower the technical risk of non-delivery or sub-standard delivery. Therefore, logically, the lower the funding required for completion by a third party should the risk materialise. The launch of each vessel marks a significant step in risk management – from that point, with ownership already vested in CMAL, the vessels can, technically, be towed away and completed elsewhere should the need arise. The current scheduled launch dates are 24 August 2017 for the first vessel and November 2017 for the second.

Many of the risks identified by CMAL at the commencement of the contracts have already been mitigated by the considerable and ongoing physical and IT investment in the yard, the creation of an in-house design team, the recruitment of management and staff, and CMAL's reporting that work to date has been of a high standard. The most recent report from CMAL, received today, is that following his meeting with Ministers, Mr McColl has put additional senior project management resource into the shipyard giving an already evident fresh impetus.

Against that, CMAL await confirmation of a revised programme showing how the yard will recover time lost during fabrication and still meet delivery deadlines. 75% of the fabrication work on the first ship, and 50% of the second, has been completed whereas the original contractual schedule foresaw 100% fabrication completed by January 2017. FMEL have explained that they have changed their methodology to one of "advanced outfitting" so that the milestones for simple steelwork fabrication established in the contract are no longer meaningful. CMAL recognise this and, subject to confirmation, this could provide a sound technical basis for reviewing the milestones at which payments are triggered.

It would seem appropriate, therefore, subject to financial and legal considerations, for CMALto be asked to review the payment profile in light of the changed circumstances at the yard and as work proceeds towards completion. At key milestones, starting with (e.g.) the launch of the first vessel, it could therefore be possible for CMAL to release additional cash to FMEL without undermining CMAL's financial ability to have the vessels completed. The cash could come from bringing forward a portion of the final on-delivery payments or from a release of cash from the surety bond, or a combination of the two. Any agreement to reprofiling along these lines should be linked to the approval by CMAL of a credible recovery and delivery plan provided by FMEL – something CMAL have been seeking for some time.

Any reduction in the final payment or the surety bond would represent a transfer of risk from FMEL to CMAL. In that circumstance, CMAL would be likely to seek appropriate cover from Ministers. This should be covered by the existing letter of comfort provided by TS to CMAL prior to the signing of these contracts which could, if necessary, be updated.

Legal issues

[Redacted]

Financial implications

However, there would be financial implications to this. There is at present no call from FMEL for an increase in funding, simply an acceleration of payments, so the total cost to TS remains £97m. However any change which relieves FMEL of costs (either the charges associated with the surety bond or interest payments on borrowing for cashflow) represents a benefit to FMEL which ought at least in principle to be reflected in an amendment to the overall contract price for example by applying a standard discount factor to payments made ahead of schedule.

Potentially more significantly for TS, although the overall contractual costs (£97m) have been approved by SG Finance, the Budget allocation for 2017/18 is set according to the payment profile of £11.45m set out in the contracts.

The changes proposed by Mr McColl would create a new (accelerated) capital pressure of £14.55m in financial year 2017/18. This would need to be managed within Transport Scotland.

We would strongly recommend that the terms of any agreement between CMAL and FMEL make absolutely clear that there will be no renegotiation of the total contract price of £97m.

Alternative approaches

Looking ahead, there are 2 areas where further work is either underway or could be taken forward:

1) Mr McColl has made the case that FMEL is disadvantaged when bidding for shipbuilding contracts which require refund guarantees in competition with yards from some other EU Member States which have governmental guarantee schemes in place.

Although, for reasons set out above, it would be difficult for SG to provide guarantees to FMEL for delivery of SG contracts, this could potentially be considered for FMEL bids for contracts with other shipowners subject to detailed consideration of the implications, e.g. around State aid – though we are aware that schemes in place elsewhere in the EU do seem to have received State aid approval by the EC.

The issue of bonds/guarantees has been raised by Jim McColl and FMEL with Ministers, Scottish Enterprise and UK Export Finance (UKEF) on a number of occasions. Industry Directorate's discussions with senior officials at UKEF, suggest that UKEF has also provided significant support to FMEL and was instrumental in securing guarantee insurance for FMEL's contract with CMAL. More broadly we understand that UKEF can provide guarantees for bids/orders outwith the UK and stood ready to do so for a potential contract with Iceland that FMEL ultimately did not bid for.

As previously advised, as part of the new research underway, SMEs are being contacted to build a detailed understanding of the surety and performance bond market and potential need for public sector intervention. This work is nearing completion.

Officials would be willing to offer a further roundtable meeting with FMEL, including Scottish Enterprise (and possibly UK Export Finance), to sit down with the company to review the potential need for future investment, including guarantees, to strengthen the financial position of the company;

2) Potentially more within Ministers' gift, Mr McColl is likely to lobby against the inclusion of a requirement for full refund guarantees in future shipbuilding contracts awarded by CMAL. At present, we are aiming to put proposals for future contracts to Ministers ahead of this summer's spending review with a view to CMAL running a procurement exercise this year and awarding a contract in April 2018.

The absence of any firm sign of future government shipbuilding procurement (from CMAL, or Orkney Islands Council) has been noted by Mr McColl and a clear commitment to such orders in the coming months should provide some confidence to Mr McColl.

CMAL will continue to advise Ministers to require refund guarantees to protect significant investments of public money against the risk of shipyard bankruptcy or poor performance. There are alternative approaches, some of which CMAL have adopted in the past with Fergusons (previous and current owners).

We will discuss options, and associated risks and consequences, with CMAL and report back to Ministers. In a competitive procurement exercise, whatever arrangements are put in place would apply equally to all bidders. There is more likely to be a challenge if CMAL's procurement process appears to be favouring a single Scottish shipyard consistently.

<u>Conclusion</u>

In conclusion, we would:

- advise Ministers against under-writing the refund guarantee (surety bond);

- propose to invite CMAL to review payments (and risks) and report back

- continue work on wider support for FMEL

- come back with options for future shipbuilding procurements

Transport Scotland
24 March 2017