From: Kevin Hobbs [Redacted]
Sent: 06 May 2017 10:04
To: Nicholls J (John) (TRANS) [Redacted]
Cc: [Redacted]
Subject: RE: Meeting 4th May at VQ - TS/CMAL/FMEL

John

Please find the amendments requested.

Best Regards,
Leis gach deagh dhùrachd,

Kevin Hobbs
Chief Executive Officer
Árd-oifigear

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[Redacted]

From: Kevin Hobbs
Sent: 05 May 2017 18:12
To: John.Nicholls
Cc: [Redacted]
Subject: Meeting 4th May at VQ - TS/CMAL/FMEL
Importance: High

John

Please find below a summary of the meeting and notes that relate to matters under discussion

Meeting – TS/CMAL/FMEL
Place – VQ
Time – 1615hrs
Present – John Nicholls TS
Present – Kevin Hobbs, [Redacted] CMAL

Present – Gerry Marshall, Tom Cousins FMEL//CBC

General Introductions were made and the context was set by JN.

There were 4 elements that were made clear at the outset

- The Surety Bond as it stands (which replaced the original Bank Guarantee) would remain in place
- Consideration was being given to bringing forward payments totalling £14.55m which was 15% of the Contract total for 801/802. This amount is brought forward as it was a component part of the final delivery payment of 25%.
- As a result of the above the final delivery payment would be reduced to 10% of the Contract value therefore £9.7m compared to that in the Contract at £24.25m
- Any Agreement would need to be ratified by Scottish Government and would also need to be covered in an Addendum to the Contract

FMEL explained that for cash flow purposes they required the full final payment amount of £24.25m and if this could not be achieved then there would be a funding gap of circa £10m.

JN advised that there was a separate parallel meeting taking place with Senior SG Colleagues to explore ways that the gap could be addressed.

KH advised that for the purposes of the meeting the discussion was related to the reduction of the final payment to 10% (£9.7m) and the additional funds that could potentially be applied early was £14.55m, in other words within the 2017/18 budgeting period. This amount would need to be made available from TS which meant that it would be brought forward into the 2017/18 budget and CMAL could draw it down to assist the cash flow of FMEL.

Significant Financial information had been collated by FMEL and shared with CMAL prior to the meeting (and there is to be a further meeting at 0830hrs on Monday 8th May 2017).

CMAL would require full transparency in regard to any monies that were paid to FMEL and proof that the funds had been applied to the major equipment that was due for payment and awaiting dispatch – FMEL agreed to this

GM advised that the cash situation was critical and that there are a number of Major Items that were ready for dispatch from the Suppliers but would not be released until payments are made. A total of £8.5m of equipment was due for payment in April 2017 and a further £6m was due to be paid in May and June 2017. Therefore the £14.55m would be transferred during May and June 2017 should agreement be reached.

TC advised that a total of £15.44 was still held as cash collateral in Escrow and this would be released in the following manner

- Launch 801 - £5.2m
- Launch 802 - £5.2m
- Delivery 801 - £3.0m
- Delivery 802 - £2.0m

The Launch of the vessels would release cash into the business. Given the point at which these aforementioned escrow releases will occur the major items, in the main will be purchased and delivered (that is where the CMAL monies will be applied)there is likely to a 50/50 split between paying sub-contractors and the FMEL workforce. It should be noted that in the event that additional work is not secured by the yard the number of employees at FMEL will be reducing.

JA confirmed that all of the original milestone payments would remain as originally envisaged and that the adjustment related purely to the delivery payments which would reduce from £24.25m (25%) to £9.7m (10%). Therefore there were regular payments to the shipyard upon attainment of the milestones.

GB advised that analysis of the cash flow in isolation (in other words no new work won by FMEL) showed that there was an overall loss predicted in regard to these vessels amounting to some £11m – this was confirmed by TC.

Meeting Ended at 1730hrs

Comments and observations

- FMEL has run out of cash
- Major Equipment and Materials that were due for payment in April have not been paid – circa £8.5m
- Suppliers will not dispatch Equipment and Materials until payment is made (this is normal practice post 2008 crash)
- Major Equipment and Materials due for payment in May and June will not be paid unless agreement is reached to release the £14.55m
- This will have a significant impact on the launch and delivery of the vessels if it is not addressed promptly
- The full amount of £14.55m will be required to make payments for April/May/June 2017
- If payment is not agreed then the construction of the vessels will cease
- Looking at the FMEL cash flow (GB Analysis) there is a continuing shortfall of between £6m and £9m even with the application of the £14.55m
- Therefore there needs to be additional support given to FMEL to address this shortfall hence the parallel Meeting with SG/J McColl
- The additional £10m is required an addition to the £14.55m payment acceleration from CMAL
- CMAL have a good working relationship with FMEL and agreement has been reached whereby there will be transparency
- CMAL would be able to assure SG that the accelerated payments are being used for Major Equipment and Materials by developing a close and transparent working relationship with FMEL.
- In 2018 the cash position deteriorates further peaking at £16m in April 2018 and then recovering partially by Dec 2018 to a shortfall of £10m
- We have questioned the overall losses accumulated and have not been given any credible assurance about the 2018 position – other than they anticipate other contractual work and also additional investors.

We should be under no illusions that FMEL are struggling and that if we do not assist in the manner set out then the Project has a high likelihood of failure – under the stewardship of FMEL.

The cash flow acceleration of £14.55m needs to be accompanied by a parallel agreement to secure funds of £10m. This will mean that FMEL is cash positive (only just) throughout 2017 but will thereafter from Jan 2018 be negative once more.

There is a high likelihood that FMEL/CBC will continue to press for the Surety Bond and Delivery payments to be scrapped.

I would also anticipate that they will request additional payments at some point in the Contract

JN Note – 2 questions (highlighted in yellow)

To explore Mr McColl's points on the procurement process and in particular the arrangements for agreeing the payment schedule and assurance bonds conditions underpinning the contract.

FMEL attained leading bidder status. It was apparent that there was significant naivety in relation to the ship building industry.

It was evident that the normal 5 staged payments of 20% backed at each stage by a bank guarantee was not feasible for FMEL. The milestone adjustments that took place addressed this matter (or so we thought at that time). This is evidenced by very significant payments in the early stages of the contract which in the range 22nd – 31st Dec 2015 amounted to £29m for steel cutting (£2.8m) and procurement of long lead time items (£26.2m). This was accompanied by CMALs insistence that the vessels and the component parts were vested by CMAL and that there was a single bank guarantee amounting to 25% of the Contract value. All of this was to the favour of FMEL!!!

Post Contract discussion are normal practice with the "Lead Bidders" as the level of detail becomes more transparent. What FMEL have requested introduces unacceptable risks as laid out below

- The Surety Bond is released – this would mean that in event that the yard does not complete the vessels there are no funds whatsoever to complete the vessels. All costs for completion would fall to CMAL (TS/SG). [Redacted]
- All of the monies are paid over at the point of launch of 801/802. The shipyard at that point would have all of the money for the project with 9 months (or more) to delivery. Our Cash Flow Projections show a cash deficit at April of £16m and the early payment of £9.7m does not resolve the fundamental problem of cash. This is an unacceptable risk.

- TS to ensure they have tested the limits on payment profile in terms of timing of purchase/ownership of materials to accelerate cash flow to the earliest feasible point

In very simple terms the amount of £14.55m will be required in a 2 month period of May and June 2017. We are able to identify and will monitor on a weekly basis where the funds are applied. Upon dispatch and thereafter delivery to FMEL we will vest those items.

Industry norm is a final payment made upon delivery of 20%. The final delivery payment, with the implementation of this agreement, reduces this to 10% which is not optimal. However there is still an amount of 10% of the contract value (£9.7m) retained upon deliver; this is less than desirable but deemed necessary to support the ship yard

One final comment is that both CMAL and SG have been very supportive and accommodating but all of these changes introduce additional risk. In terms of where we are today it is not recommended to make any further changes. However we should anticipate further pressure from FMEL in the coming months.

Best Regards,
Leis gach deagh dhùrachd,

Kevin Hobbs
Chief Executive Officer
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