

PROJECT POSEIDON: INDEPENDENT OPERATIONAL EXPERT

EXPLANATORY NOTE

Introduction

1. The Scottish Government appointed an independent operational expert in 2018 to support Project Poseidon – the commercial loans made by the Scottish Ministers to Ferguson Marine Engineering Limited (FMEL).
2. This note covers the process of appointment of the operational expert; their identity and areas of expertise; the terms, duration and costs of the assignment; the information available to the expert from the management of FMEL and other sources; and the outputs of the contract.

Background

3. FMEL entered into a contract with Caledonian Maritime Assets Limited (CMAL) in October 2015 to provide two dual-fuel (marine diesel and liquefied natural gas) ferries: the 801 (now named MV Glen Sannox) and 802 (yet to be named), for a total contract price of £97 million.
4. Substantial difficulties that arose in the performance of this contract led to production delays, cost escalation and ultimately severe cash-flow difficulties for FMEL from early 2017 until the FMEL Directors filed a notice of intention to appoint administrators on 9 August 2019.
5. In September 2017 Ministers agreed to make available to FMEL a commercial loan facility of £15 million to support completion of the CMAL order and assist with business stability. This funding was drawn down in several instalments with the full £15 million borrowed by the end of the 2017-18 financial year.
6. In February 2018, the Scottish Government signed an intercreditor agreement whereby Ministers agreed that repayment on the £15 million loan would not begin until both CMAL vessels were completed (and the ship bonds provided by HCCI were released) or 6 March 2020 – whichever came first. The intercreditor agreement allowed FMEL to release some of its own resources (█████ million) to ease cash flow pressure.
7. A second Scottish Government loan facility for £30 million was agreed in June 2018. This facility was intended to support the yard's long-term business plan, specifically to "*assist with the long term viability and enhanced capabilities of the businesses carried on at the Property*" and for "*other general working capital purposes of FMEL, all as identified in the Business Plan and/or Financial Model*" (Clause 2.2 of the Loan Agreement).
8. The loans provided by the Scottish Government to FMEL were not contractually tied-in with the CMAL-FMEL contract explicitly and Scottish Ministers were not a direct party to the vessels contract or directly involved in the contract dispute process.

9. The conditions precedent to the June 2018 loan with respect to first and subsequent utilisations of the facility (loan drawdown) included:

- *“satisfactory assurance from the Scottish Ministers’ independent operational expert that progress of the build of the vessels known as 801 and 802 is proceeding in accordance with the overall resource program presented by FMEL on 28 and 29 May 2018 at Port Glasgow, taking account of factors that are outside FMEL’s control”.*

10. In addition to the independent operational expert, the Scottish Government contracted with PwC and [REDACTED] to provide external commercial and legal advice / due diligence on the two loan agreements and post-completion advice and financial monitoring relating to the loans.

Appointment

11. The independent operational expert was appointed via a non-competitive award process (using the Celtic Framework contracting mechanism) given the need to commence work quickly and due to the specialist nature of the services required.

12. Officials in Transport Scotland advised on suitable candidates to carry out the assignment which began with an initial task: verification of the adequacy of the updated resourcing plan – that is, the labour input – for the two vessels being constructed for CMAL by FMEL.

13. Luke van Beek was appointed to lead the initial review work supported by [REDACTED] (a former Office of Government Commerce Managing Consultant). The initial review was completed on 31 May 2018 shortly before the second loan was agreed.

14. Commodore Luke van Beek Royal Navy (Rtd) CBE is a defence procurement expert and Cabinet Office accredited reviewer (High Risk projects) with over 35 years’ experience in the defence market. He has a strong track record in shipbuilding including delivering the Type 45 Destroyers to budget and time and achieving initial contract signature for the Queen Elizabeth Class aircraft carriers. He negotiated and subsequently gained approval for the innovative contractual approach to the River Class Offshore Patrol Vessels. Well versed in shipbuilding practice and with a history of achieving value for money in his projects, Cdre van Beek offered an external and independent view.

Scope of contract, duration and budget

15. The task of the operational expert in summary was to provide operational assistance to Scottish Ministers relating the £30 million loan provided to Ferguson Marine in June 2018 with respect to the progress of the build of the vessels known as 801 and 802. The full scope of the contract is presented at Annex A.

16. The operational expert was not asked to investigate the contract issues arising from the CMAL ferry procurement or mediate in the dispute. He was asked only to be cognisant of the contractual relationship and dispute between FMEL and CMAL, and Cdre van Beek was briefed on the contractual background by Scottish Government and Transport Scotland officials.

17. The appointment began on 2 July 2018 and ran for a period of twelve months.

18. The budget allocated to the contract (that is, the phase of work starting from July 2018) was not to exceed £30,000 (plus VAT). The actual expenditure incurred was £34,452.

Information sources

19. The June 2018 loan agreement stipulated that on reasonable request, following the expiry of a reasonable period of notice and no more than (i) once in any rolling period of 20 Business Days until the loan is fully drawn and (ii) once per quarter until the loan repayment date, FMEL shall:

- allow an independent operational expert nominated by the Scottish Ministers to meet with the Chief Executive Officer of the Group (whether by telephone conference or otherwise), and
- provide such independent expert with information as may be reasonably requested by him, provided that such meeting/call or information is in connection with the vessel build progress for the vessels known as 801 and 802, and
- such meeting/call is for no longer than one working day in duration.

20. In practice, Cdre van Beek's reports were informed by regular discussions with the Managing Director of FMEL, his senior staff, full visibility of the programme plan and the developing risk register. On most occasions when Cdre van Beek visited the shipyard he toured the site and the ferries in build allowing him to form his own view of progress and build maturity.

21. The operational expert also had regular access to Scottish Government and Transport Scotland officials and the Government's external commercial advisors (PwC) for further information and advice.

22. In addition, the expert had the opportunity to liaise with senior representatives of CMAL to gather information on the vessels plan and progress. The expert was bound not to share any commercially sensitive information provided by FMEL with CMAL, including the status of the loan facility in any detail. He also met with a representative of CalMac Ferries who provided an insight into operational issues surrounding in the ferry fleet, required ferry capabilities and condition of the current ferry fleet.

23. Transport Scotland and Scottish Ministers received regular updates on progress from CMAL as client for the contracts but these reports were not shared with the operational expert. Between the vessel contract sphere and the loans sphere "Chinese Walls" were maintained and the expert did not see the contract for the vessels, for example.

Outputs and disclosure

24. Cdre van Beek produced a total of eight written reports relating to the Ferguson Marine assignment: one initial construction review, five loan drawdown reports and two quarterly reviews. He also provided oral updates to the Director-General Economy (Scottish Government) and Chief Executive of Transport Scotland in December 2018 and to the Cabinet Secretary for Finance, Economy and Fair Work in April 2019 (Annex B).

25. Key points raised in the reports prepared by Cdre van Beek include:

- the viability of FMEL as a commercial shipyard throughout the period covered;
- initial confidence in the programme resulting from an investment in infrastructure, recruiting of new senior management and a new approach to planning investment (reference A) ;
- a well-executed plan to increase manpower to the necessary resource level which had been delivered by the end of September (references A and C);
- difficulties resulting from emerging specification change (references A, C and D);
- failure of the design process to keep pace with the build programme (reference D);
- challenges associated with sub-contractor engagement including liquidity and cash flow, deliberate decisions to delay engagement (references B, D, G and H);
- a deteriorating relationship between FMEL and CMAL (references D, E, F, G, H and I); and
- worsening cash flow (references D, G, H and I).

References

- A) Construction review (31 May 2018)
- B) Loan drawdown report (20 July 2018)
- C) Loan drawdown report (11 Sept 2018)
- D) Quarterly Review (4 October 2018)
- E) Meeting with Transport Scotland (25 September 2018)
- F) Loan drawdown report (6 November 2018)
- G) Quarterly Review (13 December 2018)
- H) Loan drawdown report (23 January 2019)
- I) Loan drawdown report (8 March 2019)

PROJECT POSEIDON COMMERCIAL LOAN: INDEPENDENT OPERATIONAL EXPERT ADVICE

Background

1. The Scottish Government has provided a commercial loan facility to the shipyard Ferguson Marine Engineering Limited (FMEL) at Port Glasgow: the Project Poseidon Commercial Loan.
2. The purpose of the loan is to fund FMEL to “assist with the long term viability and enhanced capabilities of the businesses” and for “other general working capital purposes of FMEL, all as identified in the Business Plan and/or Financial Model”.
3. The loan will deliver a range of benefits including support for delivery of vessels for Caledonian Maritime Assets Ltd (CMAL), protection for employment and provide a platform for the shipyard to thrive in the longer-term.
4. The loan will be available for drawdown until 30 June 2019. Loan payments will be made within 5 Business Days of each drawdown notice prepared by FMEL provided the conditions precedent are met. One such condition – the focus of this assignment – is:

“satisfactory assurance from the Scottish Ministers’ independent operational expert that progress of the build of the vessels known as 801 and 802 is proceeding in accordance with the overall resource program presented by FMEL on 28 and 29 May 2018 at Port Glasgow, taking account of factors that are outside FMEL’s control.”

Services

5. The Scottish Government has identified the need for ongoing operational expert advice relating to the Project Poseidon Commercial Loan. This is to monitor FMEL’s performance against its vessel delivery programme and resourcing plan in order to provide assurance that loan conditions and expectations are being met.
6. The loan agreement states that FMEL will provide the following information for review:

“a build update report on the build out of vessels 801 and 802 plus cost overruns and other issues, details of cost estimations in connection therewith and any such other information as relevant to the delivery of the vessels and to the running of the business”

and will allow:

“an independent operational expert nominated by the Scottish Ministers to meet with the Chief Executive Officer of the Group (whether by telephone conference or otherwise) and provide such independent expert with information as may be reasonably requested by him, provided that (i) such

meeting/call or information is in connection with the vessel build progress for the vessels known as 801 and 802, and (ii) such meeting/call is for no longer than one working day in duration.”

Contract deliverables

7. After the first drawdown of the loan is made in June 2018, the operational expert will review the information provided by FMEL and prepare:
 - i. A brief assurance report relating to the condition precedent (see paragraph 4 above) for each subsequent drawdown notice prepared by FMEL;
 - ii. A quarterly review to monitor build progress against the declared plan;
 - iii. Assistance as required to the Scottish Government to support and improve the future commercial strategy of the FMEL shipyard.
8. Within one month of the date of contract award the Scottish Government and the operational expert will agree a reporting template to be used for deliverables i) and ii).

CMAL

9. There is an ongoing contract dispute between FMEL and CMAL concerning the costs of completing two vessels 801 and 802 for the CalMac fleet. The Scottish Government is not a direct party to the vessels contract or directly involved in the contract dispute. However, the appointed operational expert must be cognisant of the dispute and the contractual relationship between FMEL and CMAL. The expert will have access to Transport Scotland officials who can offer further information and advice on this matter.
10. In addition, the appointed expert will have the opportunity to liaise with CMAL to gather information on the vessels plan and progress. The expert will not share any commercially sensitive information provided by FMEL with CMAL. The Scottish Government – and by extension the appointed expert – does not have the permission of FMEL to disclose any of its financial or commercial information to CMAL, including the loan facility in any detail.

Responsibilities

Duty of confidentiality

11. Any information disclosed to the Scottish Government and shared with its appointed operational will be sensitive and confidential. The appointed expert for this assignment will be bound by a duty of confidentiality and will not – except with the prior written permission of FMEL and the Scottish Government – disclose any information gathered through this assignment to third parties.

Contract management

12. Economic Development Directorate of the Scottish Government is responsible for Project Poseidon and Mary McAllan is the lead Director.

13. Routine contact management and liaison with the operational expert will be the responsibility of [REDACTED] and [REDACTED].

Start date and duration

14. The contract is expected to commence on 2 July 2018 and run for a period of twelve months. The contract will be reviewed after twelve months and may be extended for a further twelve months at that time.

Contract value

15. The contract value will not exceed £30,000 plus VAT in the first twelve months.

OFFICIAL SENSITIVE – COMMERCIAL

CALL BETWEEN CABINET SECRETARY FOR FINANCE, ECONOMY AND FAIR WORK AND LUKE VAN BEEK**23 APRIL 2019, 13:15 to 13:45****Participants**

- SG: Derek Mackay MSP, Stewart Maxwell, [REDACTED] Richard Rollison and [REDACTED]
- VATIS Limited: Commodore Luke van Beek CBE

Purpose

- An opportunity to hear Commodore van Beek's observations on the dispute between Ferguson Marine (FMEL) and CMAL; to get his impartial advice around potential ways to address the situation; and to consider steps that can be taken now to mitigate matters.
- Luke is the independent operational expert who advises SG in relation to the drawdown of the £30 million SG loan to FMEL.

Luke's observations

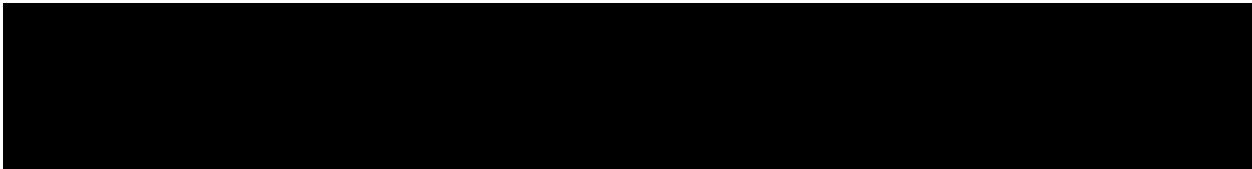
- Luke had been engaged by Economic Development Directorate to provide independent assurance in relation to drawdown of funds against SG's £30 million loan to Ferguson Marine. He had visited the yard on a number of occasions since last June, forming the view that Ferguson's is working well day-to-day and is a competent, well-managed shipyard.
- Luke observed that ferries are not essentially difficult to build but the addition of LNG has introduced complexity. However, the yard has experienced problems with the delivery of its contracts for CMAL (two LNG-hybrid ferries) due to a poor contract and a deteriorating relationship with CMAL. Cash flow problems have been an ongoing concern compounded by the delayed schedule.
- Luke has formed the view that the quality of FMEL's work is good although he acknowledges the situation at the earliest stages of the contract may have been different (e.g. the yard's handling of change issues).
- The most pressing issues since last November have been (a) cash flow linked with delayed payment of the SG loan, which has caused significant non-linear slippage in the programme, and (b) the lack of any productive dialogue between the contracting parties.
- Luke acknowledged that the contract dispute has 'two sides' and he felt the yard had not always responded well to design and contract challenges but had worked hard to recover from earlier difficulties.

- Luke has proposed in his written and oral reports to Transport Scotland from last September that a fundamental examination of the contracting relationship between the parties was required. He also recommended a design freeze and open collaborative discussion around the risk register and programme. To his knowledge no such discussions had taken place and the relationship between FMEL and CMAL has become increasingly difficult. Negotiation between the two now appears impossible and this is making any progress on the project extremely difficult.
- In terms of a way forward, Luke's considered view was that a negotiated settlement has the greatest potential of the options under consideration to deliver the two ferries at lowest cost, in the shortest time and with the least impact on the workforce.

Discussion

- Mr Mackay said Ministers are concerned greatly at the prospect of redundancies at the yard and their impact. The Government's strategic priorities have not changed but the lack of progress between the contracting parties and the likelihood of a significant redundancy announcement on Friday 26 April necessitated fresh thinking and the rapid development of a clear plan.
- The Cabinet Secretary sought Luke's view on the basis for a contract negotiation and the limitations of such a course – can the contract terms or value be modified?
- Luke indicated that the priority focus now should be to agree a time and price for the future work as a basis for the yard's continuing work on the contracts. He pointed out that the contract had already been significantly amended (capability and time) and, whichever option is adopted, the contract will require amendment to take account of actual progress. And if, for example, the business entered receivership or was nationalised CMAL would be forced to renegotiate terms to secure completion.
- The introduction of an expert, independent of both FMEL and CMAL, could help with the process of agreeing the time / price of the work to completion of the vessels. For clarity, the independent expert role Luke envisaged was not standard arbitration but something more facilitative.
- Luke had already proposed several actions that could mitigate risk in the ferries programme but he thought there could be more. As an example, he believes plans to commission the LNG system in vessel 801 should be delayed until the shore side fuel bunkering is in place. This action would save time and cost now with little or no operational impact.
- The Cabinet Secretary highlighted the need for strict legal compliance on any options pursued in relation to potential contract amendments and said he was open to considering whether CMAL's client position could be changed as a corporate decision, informed by independent advice.

- The Cabinet Secretary asked Luke if he felt FMEL's claims of unwarranted client interference in the build process were justified; if they rang true to him based on his interaction with the parties and his time spent at the yard. Luke said his experience supported FMEL's position and he believed the client had made many changes to the design and on occasion failed to take decisions promptly. That said, Luke also observed that FMEL had not stood-up to CMAL robustly enough in handling change requests.



- Mr Mackay made it clear that the approach described does not in any way match with the objectives of this project or of Scottish Ministers. Ministers are supportive of the business and the workforce and are concerned at the prospect of any redundancies at the yard.
- Given Luke's comments on the poor state of the relationship between the contracting parties, Richard asked him whether in his view the build contract could be managed by a body other than CMAL and what difference that might make. Luke thought SG should consider taking over the contract (for at least 801) and involve the eventual operator of the vessels (CalMac) in taking decisions on the programme and delivered capability. CMAL had had the option to sit down with FMEL and agree a negotiated settlement but had refused to do so. They appeared resolute in their position that the dispute could only be addressed via the courts.
- If a new time, cost and capability plan for the vessels required some changes (and potential comprises) to the design of the ferries then CalMac, as operator of the vessels, would be well-placed to provide assurance that the vessels remained 'fit for purpose' and to ensure that no operational issues were overlooked.
- The Cabinet Secretary expressed his deep concern for the state of the FMEL-CMAL relationship and the potential consequences of the breakdown. He was aware that FMEL was contemplating large imminent job losses and was conscious of the direct damage that such a step would cause to the CMAL order and wider impacts and cost implications.

Actions

- The Cabinet Secretary felt FMEL would not easily recover from large-scale redundancies and asked officials to:
 - agree the meeting note with Luke van Beek and confirm his statement on CMAL's strategy;
 - prepare urgent advice to the First Minister on options to avoid redundancies at FMEL; and
 - [REDACTED]