APPENDIX

KEY CONSIDERATIONS RELATING TO THE PROPOSAL TO THE SCOTTISH MINISTERS FROM CBC IN RELATION TO THE PROVISION OF FURTHER FUNDING TO THE FMEL GROUP

The following is a short summary of the advice, discussions and considerations previously shared with the Scottish Ministers. It aims to highlight some of the key elements relating to the proposal from CBC and the main challenges to be overcome.

1. State Aid considerations

One of the key challenges presented by the CBC proposal is overcoming the recognised State Aid implications of further intervention by the Scottish Ministers. The key arguments put forward by CBC/FMEL in their proposal in support of Scottish Ministers accepting an MEIP basis for proceeding, are set out below. The comments in italics below the CBC view, are what are considered to be the key challenges relating to that aspect of the proposal.

[redacted]

[redacted]

2 Contract modification – Procurement Rules

In addition to the State Aid challenges outlined above, there are also significant challenges posed by the procurement rules.

The CBC proposal states that the CMAL/FMEL contract is <u>not</u> being amended on the basis that all that is happening is that FMEL is sub-contracting the work to a Newco with the approval of CMAL and therefore the procurement rules are not relevant.

[redacted]

[redacted]

3 Other considerations

3.1 *Existing Scottish Ministers right to buy*

An MEIP compliant £30m loan was provided from Scottish Ministers to FMEL Holdings. CBC/FMEL agreed to this loan on the full understanding that if CBC did not inject it [redacted] cash, or if the business was facing insolvency, then Scottish Ministers would have the ability to acquire the shares of FMEL Holdings at fair value. Whilst Scottish Ministers do not *have to* purchase the equity of FMEL Holdings, there would need to be a clear reason as to why they do not (e.g. the other options would need demonstrate better value for money and also be legally permissible).

There is also a broader consideration for Scottish Ministers of the precedent that would be set by taking an alternative course of action in these circumstances.

CBC point out that the test for MEIP compliance is through considering the facts today and not reflecting on the past. The facts today however, are that Scottish Ministers are in a position where they have the economic benefit of acquiring FMEL Holdings and cannot see sufficient commercial rationale for not exercising that right. CBC's view is that the commercial rationale is that they are the best person to deliver value to the FMEL Group and that the Scottish Ministers would not be in a position to deliver value out of the wider opportunities and pipeline of work that might be available.

3.2 *Cost to complete continue to grow*

Whilst CBC/FMEL assert they are the best party to oversee delivery of the 801 and 802 vessels as efficiently and economically beneficial as possible, the facts of the situation appear to present an alternative picture:

TIMELINE OF COSTS TO COMPLETE

Date info received	Source	Costs to complete	Total build cost
28 June 2019	Shauna Powell (CBC) 2nd draft of proposal	**Total - £64.9m** 801 - £24.8m 802 - £40.1m	**Total - £196.9m** 801 - £103.5m 802 - £93.4m
24 June 2019	Shauna Powell (CBC) 1st draft of proposal		**Total - £188m** (limited info provided)
31 May 2019	"1904 PwC Report" Provided by Laura Stewart (FMEL) for April 2019 monitoring report	**Total - £37.4m** 801 - £11.5m 802 - £25.9m	**Total - £149.8m** 801 - £79.1m 802 - £70.7m
9 October 2018	"August 2018 PwC report" Provided by Tom Cousins (FMEL)	**Total - £37.2m** 801 - £11.6m 802 - £25.6m	**Total - £136.1m** 801 - £71.2m 802 - £64.9m

3 August 2018	"FMEL June 18 Actuals" Provided by Tom Cousins (FMEL)	**Total - £36.6m** 801 - £13.4m 802 - £23.2m	**Total - £125.8m** 801 - £67.0m 802 - £58.8m

DELIVERY DATES

Date info provided	**Source**	**801 forecast delivery**	**802 forecast delivery**
28 June 2019	Shauna Powell (CBC)	26 October 2020	30 May 2021
2 May 2019	FMEL letter to the Scottish Ministers	Q2 2020	Q4 2020
26 February 2019	FMEL budget	October 2019	July 2020
September 2018	FMEL September 2018 forecast	June 2019	March 2020
May 2018	FMEL May 2018 forecast	June 2019	> December 2019
February 2018	FMEL February 2018 budget	March 2019	June 2019
August 2017	FMEL management to PwC IBR team	June 2018	August 2018

Whilst there are often cost overruns and timetable delays in any construction contract, the above table demonstrates why CMAL has little confidence in the FMEL's estimations of costs to complete.

3.3 ***Consideration of how other investors would act***

An argument put forward by CBC/FMEL is that other commercial entities would "follow their money" with the hope of completing the vessels and then having a profitable business at the end. They used the term "in for a penny, in for a pound".

Whilst there is no 'one size fits all' answer, typically you might find the following approach taken:

(i) a commercial lender would typically look to mitigate its financial exposure against the risk of the situation and would accept that its first loss is its best loss (i.e. it would not make the exposure larger if it did not have a reasonable degree of certainty that it would get its money back);

(ii) a customer for such a large project may want to take control of the situation either through preferring to work with an administrator to get the project completed (and hence exert more control) rather than continue to work with existing management where there is a breakdown in confidence and trust (as CMAL are expressing) or from taking control of the whole group.

3.4 *Bonds (Refund Guarantees)*

CBC have not provided any justification or reasoning as to why CMAL should not call the bonds or at least seek a negotiated settlement – other than that CBC is best placed to finish the vessels and to deliver on all the other opportunities that might arise so that the £30m loan will be repaid at some point in the future based on this success.

3.5 *CMAL cooperation is required as part of the Proposal*

Under the CBC proposal, CMAL are required to consent to the subcontract to Newco. In the circumstances, it is difficult to see a basis for the Directors of CMAL to consent, consistent with their fiduciary and other duties as Directors.

3.6 CBC minority stake

Under the CBC proposal, CBC would retain a 5% stake in the "old" FMEL. As the Scottish Ministers would be investing £48m for 95% of FMEL, it is not clear what support there is for Holdings retaining 5%. It could be challenging for the directors of "old" FMEL going forward to assess whether, and to what extent, any actions had a possible impact on the minority shareholder and whether the directors were acting in accordance with their obligations to treat all shareholders fairly and in the best interests of the company more generally.

3.7 *Value of business and assets which would be transferred*

There has been no justification, or process for justification, of the value of the assets and liabilities that would be acquired from "old" FMEL by Newco for [redacted]

3.8 Value for money - protections

The previous value for money proposition surrounding the further £30m loan was based on the protections offered to the Scottish Ministers (including the right to buy). There is no further protection offered for the further proposed equity investment other than CBC being in control offers the greatest chance of recovery of the £30m loan.

3.9 Future pipeline and viability of business excluding 801/2

CBC's proposal is founded on an assumption that the current Scottish Ministers' loan has the best chance of being repaid if the business remains under the control of CBC and in the private sector. Whilst there are logical arguments around the business having the potential for greater success in the private sector, this must be balanced against the actual performance of the business over the past years in securing new work and the likelihood of future work wins from its pipeline. There remains significant uncertainty around the future viability of the business excluding the 801/2 contract. This risk then should be considered against (i) the option of re-privatising the business at some point in the future when there is a reasonable market (such as the Type 31 contract) and (ii) the ability of the Scottish Government to award its wholly owned subsidiary a ferry pipeline, in a non-competitive and Teckal compliant manner.

4 Value for Money considerations

4.1 Summary table

This table compares the total cost to Scottish Ministers under the six different scenarios described below.

All £m Scenario Description:	Note	Bonds expire A	Bonds settlement negotiated B	 C	Bonds called (insolvency) D	 E	Retender F
			High cost	Low cost	High cost	Low cost	
Costs to complete	1	(64.9)	(64.9)	(64.9)	(64.9)	(64.9)	(100.0)
Cash receipt from bonds	2	-	24.3	24.3	24.3	24.3	24.3
Potential ransom payment to HCC / administrator	3	-	(19.5)	(14.7)	(24.3)	(14.7)	-
FMEL cash held in escrow re bonds	4	4.5	-	-	-	-	-
FMEL cash at bank	5	4.0	4.0	4.0	4.0	4.0	4.0
Realisation from SG security	6	?	?	?	?	?	?
Realisation from incomplete 801/2	7	-	-	-	-	-	?
Trade creditors	8	(1.2)	(1.2)	(1.2)	(1.2)	(1.2)	-
Potential liquidated damages claims	9	(3.0)	(3.0)	(3.0)	(3.0)	(3.0)	-
Potential cost to public sector of delay	10	-	-	-	-	-	(10.0)
Contingency for unknown costs	11	?	?	?	?	?	-
Total		**(60.6)**	**(60.3)**	**(55.5)**	**(65.1)**	**(55.5)**	**(81.8)**

This is based on financial information provided by CBC on 28 June 2019.

4.2 Scenario descriptions Scenario	**Description**
A – Bonds expire	In this scenario Scottish Ministers take FMEL into public ownership and completes the existing orders 801-5 without taking any action on the bonds. The funds in escrow are released to FMEL. Additionally there are funds in hand that are used to support the business, assuming an early transaction.
B/C – Bonds settlement negotiated	Again Scottish Ministers take FMEL into public ownership but seeks an agreement with HCC to obtain value from the bonds prior to their expiry. The high cost scenario assumes that an insolvency outcome could result in £4.8m in net realisations and therefore a negotiated outcome would need to be greater. The low cost realisation scenario shows a net realisation of £9.6m: a better outcome could be targeted but would appear to be unrealistic given current information.
D/E – Bonds called (insolvency)	In this scenario Scottish Ministers would still take FMEL into public ownership but only after calling the bonds which would crystalise an insolvency. Scottish Ministers would seek an early deal with the administrator to buy the assets and continue trading. The high cost scenario assumes that HCC would obtain its full claim in ransom payments. A low cost scenario shows the same outcome to a negotiated settlement.
F - Retender	This scenario assumes CMAL calls the bonds and procures a new 801/2 from scratch from a third party i.e. FMEL does not complete 801/2. FMEL's directors would likely be forced to appoint administrators and CMAL would liaise with the administrators to obtain their assets i.e. the part built 801/2 and

	Scottish Ministers would rank as second ranking secured creditor in the administration.

4.3 Notes

Note	Description
1	**Costs to complete per FMEL -** The table uses FMEL's estimate of costs to complete in all scenarios. The costs to complete used in the table are based on the CBC contract statement provided on 28 June 2019. PwC have provided Scottish Ministers with a summary of the movement of total costs (on 1 July 2019). PWC have asked CBC for an explanation on the rise in costs. **Costs to complete in a retender -** Transport Scotland have estimated the costs of a retendered 801/2 to be in line with the original cost but with a small increase for prudence.
2	**Cash receipt from bonds –** based on PwC report of 15 May 2019 (p42).
3	**Potential ransom payment to HCC / administrator -** PwC report noted net realisation of £4.8m being £24.3m value less £4.5m escrow less HCC ransom claim of £15m. Ransom shown are £14.7m low and £19.5m or £24.3m high.
4	**FMEL cash held in escrow re bonds** PwC report has presented these values as netted off against the ransom payment but it is shown gross here for comparability.
5	**FMEL cash at bank** – based on FMEL's management information presented on 30 May 2019. Forecast cash balance week commencing 1 July 2019.
6	**Realisation from Scottish Ministers security -** In each scenario Scottish Ministers remain a secured creditor but do we not have sufficient information on the realisable value of the assets to estimate the recovery for Scottish Ministers.
7	**Realisation from incomplete 801/2 -**In a retender CMAL would have title to the incomplete 801/2 vessels. CMAL may be able to offer a view on any value.
8	**Trade creditors** – FMEL April 2019 reporting pack presented 30 May 2019.
9	**Potential liquidated damages claims**
10	**Potential cost to public sector of delay -** Transport Scotland have estimated costs of £2.5m for each of the 4 years it would take to deliver a retendered 801 and 2.
11	**Contingency for unknown costs -** Other costs may arise in the course of Scottish Ministers completing 801/2 or from 803,4,5 or from operating the yard.

5. Conclusion

As the above summary indicates, the CBC proposal falls clearly short of compliance with the MEOP, i.e. a private sector market economy operator would not accept the CBC proposal because it is not the most commercial approach in the circumstances, when compared to exercise of the existing right to purchase Holdings.

[redacted]

[redacted].

[redacted]

MacRoberts LLP

PricewaterhouseCoopers LLP

2 July 2019