

In Scope information

Note from CMAL setting out details of the contract award and the associated risks – attached to 08 October 2015 18:24 email.

Contract award to FMEL and the associated risks.

Ferguson Marine Engineering Limited (FMEL) became the preferred tenderer to build the new vessels following a restricted procedure procurement exercise. Tenders were received on 31st March from 6 yards in total ([Redacted]). The bids were evaluated on price (50%) and quality (50%).

The FMEL cost for each vessel was £50,247,500.00, later reduced to £48,500,000.00, after post tender negotiations, and is to be paid over 15 milestones or staged payments reflecting somewhat the outlays the shipyard will have to make to suppliers, staff and overheads.

The shipbuilding contract is an amended BIMCO standard newbuilding contract and the area of greatest debate regarding this contract has been the Builder's Refund Guarantee.

The Builder's Refund Guarantee requires the builder to put in place a guarantee, with a bank, to refund the staged payments to the buyer should the shipyard fail or the vessel's performance falls below set standards. A call on the guarantee is at the buyer's discretion and cannot be blocked by the shipyard. Normally as each stage payment is made a new guarantee is issued to cover the cost of the payment.

These refund guarantees are expensive to put in place and ultimately are paid for by the buyer through the contract price. The banks will not only require a large payment to issue the refund they will require a charge over the shipyard's assets which will be a multiple of the guarantee value. This is sometimes done through the shipyard mortgaging the vessel as it is being constructed.

This procedure protects the buyers outlays to a high level, in theory losses should be restricted to time and project costs.

An alternative way the buyer can protect their payments is not to make any, or make minimal payments, until the vessel is ready for delivery. Obviously only shipyards with sufficient capital to purchase equipment and pay their staff will be in a position to do this.

The tender documents, which were sent to the shipyards, included a draft of the shipbuilding contract which included a draft of the refund guarantee. The shipyards were invited to comment on the terms of the contract, some did and some didn't, FMEL did not. There could have been an assumption that no comment meant that the draft contract was acceptable in all areas but I doubt this would have been the reality

We are aware of a risk of procurement challenge on the basis that the contract to be awarded does not resemble the contract which was tendered. [Redacted]

We have come a long way with in our discussions with FMEL and the issue of a refund guarantee. Initially there was to be no guarantee, the first stage payment on contract order (5% of contract price) was to be deferred to delivery and the delivery payment was to be 0.5% of the contract price. This was a theoretical worst case risk of £47.5Mper ship

The current situation is that a full guarantee for all payments is not being offered, due to the structure of the financing, but a part guarantee will be put in place before first

payment is made of 25% of the contract price and that the final payment will be 25% of the contract price, a theoretical maximum risk of £24,250,000.00 per ship. Also due to the structure of the financing the guarantees expire at the end of 2018 rather than the standard 300 days or after any contractual dispute has been resolved. There is a provision in the shipbuilding contract for these to be renewed, if the vessels have not, or will not be delivered prior to the end of 2018 though these guarantees are normally issued independently of the contract.

A parent company guarantee has not been made available. In addition CMAL will have title to all of the part finished vessel as it is being constructed. This protects CMAL from insolvency but not from the risk of lateness or performance (though this is thought to be low). It is felt that the current deal, that has been negotiated with FMEL, is the best deal that can be achieved, given the financing restrictions the yard is operating under, as explained to us by Clyde Blowers Capital.

This maximum risk occurs after the vessel is launched, the last but one payment is made and the shipyard goes into liquidation. This will be 9 months before scheduled delivery but I believe the part finished vessel will have a very real value at this stage that I have estimated at £22.5M. The vessel will be afloat, all the major equipment will be installed, or if not, at the shipyard, and CMAL will have title over it. I have estimated that at this stage the total cost to CMAL of taking over the part finished ship and having it completed and including the payments already made will be £60,625,000.00, this is reduced to £48,500,000.00 after receiving the guarantee payment.

A different risk occurs earlier in the project when the vessel has reached the 50% fabrication stage and there is little equipment in the yard to take title over. It probably would not be viable to finish the vessel due to the high cost of this and I have estimated this would be a loss to CMAL of £11,875,000.00.

In summary CMAL are theoretically at risk for 50% of the cost of the vessel but in practice this reduces to an estimate of 25%.

These figures and risks assume we have a cast iron guarantee in place and this is under preparation. The guarantee will be issued [Redacted].

The guarantee does not just protect the buyer from shipyard liquidation but also from lack of performance of the vessel e.g. if the vessel fails to meet its contract speed it can be rejected and a claim made on the guarantee. Without guarantees for all payments made there is a substantial risk.

A further risk reduction measure will be put in place in that FMEL will require major suppliers to provide refund guarantees for payments made. These refund guarantees will have CMAL as payee if the supplier entered into liquidation hence protecting these payments.

The main areas of technical risk are:-

The vessel is heavier than estimated and hence cannot carry the specified weight of cargo (deadweight). This risk is thought to be low as the weight, compared to other tenderers estimates, is similar and they have a good correlation with other existing vessels in the fleet. The shipyard has also included margins in their estimates as have CMAL in their requirements.

The vessel cannot meet its contract speed and hence cannot meet its timetable requirements. This is thought to be a very low risk, before finally selecting the main engine rating a model will be tested to ascertain the required power. The currently specified engine can meet the speed at 65% of rated power and this is with a 17% margin.

There are various other areas of risk including passenger, car and freight numbers, ability to carry dangerous goods, meeting stability requirements etc. These requirements are all included in the technical specifications and in the shipbuilding contract and will have to be managed by CMAL and FMEL design and supervision staff.

In general it is thought that the vessels' failing technically to perform as require is unlikely and if it was to occur would have a medium to low impact on the routes they are to serve (the vessels as specified have a greater capacity in practically all respects than the vessels currently operating on the routes).The Board of CMAL are very concerned at the risks this contract basis presents in placing orders at FMEL without full refund guarantees in place and the position this could leave the company in if the ship failed to perform or the shipyard went into liquidation. It would be unlikely to be able to repay the loans, and the interest on the loans, it had taken out to pay the shipyard. Under normal circumstances it is probably unlikely that a company of the size of CMAL would take on this risk.

The Board would wish the Minister to be appraised of these risks and to acknowledge to the Board that he fully understood the potential risk of assigning a contract to FMEL under these circumstances. The Board feel it is their absolute duty to point out the risks to their shareholder and in that respect would expect approval, should SG wish this project to proceed, and to receive direction to that effect.

For clarification the stage payment refund guarantees are to cover for three possible eventualities.

1. The vessels are late being delivered and the buyer wishes to cancel the contract and have their payments refunded.

This is always a possibility but unless it became ridiculous would CMAL wish to do this? Procedures will be in place to allow monitoring of progress against plan from an early stage. Liquidated damages are payable for late delivery.

2. The vessels fail to perform and the buyer wishes to cancel the contract and have their payments refunded.

Again this is a possibility but there are built in margins for speed and deadweight. There will be model tests undertaken at a very early stage, it will be a requirement that early submissions are made to MCA regarding stability, carriage of dangerous goods and passenger evacuation. The FMEL tender submission on these areas shows a good correlation with other tenderers' submissions and the existing vessels. Liquidated damages are payable for lack of performance.

3. The shipyard is declared bankrupt and the buyer wishes to have their payments refunded.

Stage payments are being made to the shipyard for the purchase of items of equipment that should ensure they do not have cash flow problems. CMAL will have title over equipment delivered into the shipyard thus protecting it from a liquidator. Down payments on major items of equipment will have refund guarantees in place with CMAL as payee. If cash flow problems should occur in the latter stages of construction CMAL will have title to the part completed

vessel and all items delivered into the yard. 25% of the cost of the vessel is not payable until the vessels are successfully delivered.

Please also reference Erik Ostergaard's email of 26th September sent at 14.41
Please also note all the figures mentioned are for one vessel and should be increased two fold for both vessels.

Erik Ostergaard's email of 26 September attached to 08 October 2015 18:24 email.

From: Erik Østergaard
Sent: 26 September 2015 14:42
To: Tom Docherty; John Nicholls;
Subject: SV: Follow up to this morning

Tom,
Thanks for the note.

Reading it it seems to me that FMEL don't get the point. Where we are at present is not a matter of "words to overcome the drop dead feature". The issue is that the level of refund guarantee is not sufficient. At present, the bulk of the possible engagement with a newly established shipyard with no track record at all of building ferries of this size, is an unsecured risk of (100% less guarantee of 25% less final payment of 15%) equal to about £ 60 million which is totally off the track of what is normal practice for the shipping industry in respect of contracting for newbuildings - i.e. https://www.bimco.org/~media/Chartering/Document_Samples/Sundry_Other_Forms/Sample_Copy_NEWBUILDCON.ashx and especially clauses 14(b), 15 and Annexes A. There is no way that the board can recommend the SG through CMAL to take this level of unsecured risk on its shoulders.

If FMEL don't get back with substantially improved conditions in this respect the board of CMAL have no other option than once again reject the deal. This will imply

- a) Shelving the project until further
- b) Re-opening the contract negotiations with [Redacted] (with whom we have a track record of doing business) or even a second yard in parallel while continuing negotiations with FMEL

You will recall that we had a meeting with our Minister at the time, Mr. Keith Brown, on the 5th. of August 2014 in respect of the delays of the Loch Seaforth where the Minister highlighted our obligations - also in respect of future newbuilding contracts - to thoroughly exercise due diligence to safeguard part that future vessels were delivered on time, on spec and at the stipulated costs and with proper penalties and guarantees. [Redacted]

Unless of course, that SG have substantially changed their view in this respect and can accept this level of unsecured risk (which we would need to have confirmed in writing) the message to FMEL on Monday is not doing legal word exercises on the

wording on the 25% guarantee but to come back with something that meets our original requirements i.e. a refund guarantee that safeguards all our instalments should the yard fail to deliver (on time and spec). In my opinion the best option would be to bin the present result and start from scratch on the basis of our initial requirements based on the Bimco terms.

You are welcome to convey this message to FMEL and their lawyers on Monday. If the message fails to penetrate I would be happy to speak to the relevant representative to make sure the message gets through.

Best regards
Erik

-----Oprindelig meddelelse-----

Fra: Tom Docherty
Sendt: 25. september 2015 18:38
Til: Erik Østergaard; John Nicholls;
Emne: Follow up to this morning

After a fairly brisk afternoon of calls from [Redacted] and [Redacted] of Clyde blowers and the respective lawyers on why the current proposals on refund guarantee have been rejected by the Board, we have all agreed to meet face to face on Monday at Brodie's office in Glasgow to further discussions.

[Redacted] has reiterated that there are no more funds available to improve on the quantum of the guarantee but she is confident words can be found to overcome the drop dead feature of the current offer come 31/12/18.

[Redacted]

We'll update you after the meeting on Monday and [Redacted] will provide a risk matrix of whatever we end up with.

Regards
Tom

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Your ref:

Our ref:

Date:
9 October 2015

Contracts for the construction of two 100m dual fuel passenger ferries

1. Following a Caledonian Maritime Assets Limited (CMAL) Board Meeting dated 25 September 2015 I understand that a number of concerns and reservations have been expressed by the Board members in connection with the proposed award of contracts to Ferguson Marine Engineering Limited (FMEL) for the construction and delivery of two 100m dual fuel passenger ferries (the Vessels) with a proposed contract price of £48,500,000 per vessel (the Contracts).
2. I have seen [Redacted] paper entitled “Contract award to FMEL and the associated risks” emailed to Transport Scotland, and the CMAL Board, on [6 October 2015]. The Scottish Ministers have also seen and understood that paper and have noted and accepted the various technical and commercial risks identified and assessed by CMAL and have indicated that they are content for CMAL to proceed with the award of the Contracts.
3. I note that the commercial risks set out in [Redacted] paper arise largely because the guarantees that are to be available under the Contracts are materially different in the protections offered and in their value as compared to those sought by CMAL and offered by FMEL in the tender process in anticipation of the Contracts. I further note that these terms were arrived at after prolonged discussion and negotiations between CMAL and FMEL and their respective advisors and that these were substantively improved following the discussion I had with the CMAL Board on 25 September.
4. I note that CMAL has sought and carefully considered specialist legal advice in relation to the risks that have been identified. I further note the assessment of the likelihood of these risks arising set out in [Redacted] paper.
5. CMAL have sought confirmation from the Scottish Ministers on how the risks arising as a consequence of the award of the Contracts to FMEL will be managed.
6. In their capacity as CMAL’s sole shareholder, pursuant to and in accordance with the “Management Statement / Financial Memorandum for Caledonian

Maritime Assets Limited – May 2015”, the Scottish Ministers hereby approve the award of the Contracts to FMEL. The Scottish Ministers, both in their capacity as CMAL’s sole shareholder and more generally, also confirm that CMAL is authorised to enter into the Contracts and any associated documentation.

7. The Scottish Ministers have committed to providing loan funding to the value of £106m. This is set out in the Voted Loan letter from [Redacted] to Tom Docherty dated [6 October 2015 (attached)] which clarifies that “loan repayments will commence on the first scheduled repayment date after the date of entry into service of the vessels”. Therefore, if any of the identified risks materialises prior to delivery of the vessels, CMAL will not be required to repay any loan drawn down unless or until the position is resolved to allow the vessels to be completed.
8. I note that the provisions of the Voted Loan letter do not, in themselves, mitigate the risks around in-built performance deficiencies. This particular risk can be most effectively mitigated through the robust project management arrangements that CMAL will put in place.
9. If any of the identified risks arise and, despite the best endeavours of CMAL to mitigate and manage their consequences, additional costs are incurred by CMAL then the Scottish Ministers will look favourably on requests by CMAL for additional resources. I note in this context that the Scottish Ministers intend for CMAL to receive sufficient funding for the company to continue to operate in accordance with its statutory obligations and contractual requirements and to deliver the tasks entrusted to it by the Scottish Ministers through the Management Statement / Financial Memorandum. Funds will be provided as they are required in order for CMAL to meet its debts as they fall due and maintain the company as a going concern.
10. I confirm that the Scottish Ministers have considered and approved the contents of this letter.
11. I would welcome confirmation from you, on behalf of the CMAL Board, that you are content with the assurances from the Scottish Ministers provided above.

John Nicholls
Director

ANNEX B

Exceptions under regulations 10(4)(e) (internal communications), 10(5) (e) (confidentiality of commercial or industrial information) and 11(2) (personal information of a third party) of the EIRs apply to some of the information you have requested.

An exception under regulation 10(4)(e) of the EIRs (internal communications) applies to some of the information you have requested because it is internal communication between policy officials pertaining to legal advice to Scottish Government Ministers about procurement processes.

This exception is subject to the 'public interest test'. Therefore, taking account of all the circumstances of this case, we have considered if the public interest in disclosing the information outweighs the public interest in applying the exception. We have found that, on balance, the public interest lies in favour of upholding the exception. We recognise that there is some public interest in release as part of open, transparent and accountable government, and to inform public debate. However, there is a greater public interest in high quality policy and decision-making, and in the properly considered implementation and development of policies and decisions. This means that Ministers and officials need to be able to consider all available options and to debate those rigorously, to fully understand their possible implications. Their candour in doing so will be affected by their assessment of whether the discussions on a contract award will be disclosed in the near future, when it may undermine or constrain the Government's view on future contracts.

Regulation 10(5) (e) – the confidentiality of commercial or industrial information where such confidentiality is provided for by law to protect a legitimate economic interest

An exception under regulation 10(5) (e) (confidentiality of commercial or industrial information) of the EIRs applies to some of the information you have requested. This exception applies because disclosure of this particular information would, or would likely to, prejudice substantially the confidentiality of commercial information provided by Caledonian Maritime Assets Limited (CMAL) and thus cause substantial harm to their commercial interests and to the unsuccessful bidders involved in the NEWBUILDCON procurement process.

This exception is subject to the 'public interest test'. Therefore, taking account of all the circumstances of this case, we have considered if the public interest in disclosing the information outweighs the public interest in applying the exception. We have found that, on balance, the public interest lies in favour of upholding the exception. We recognise that there is a public interest in disclosing information as part of open and transparent and accountable government, and to inform public debate. However, there is a greater public interest in protecting the commercial interests of companies when substantial harm can be made to their commercial interests.

Regulation 11(2) – To the extent that environmental information requested includes personal data of which the applicant is not the data subject and in relation to which

either the first or second condition set out in paragraphs (3) and (4) is satisfied, a Scottish public authority shall not make the personal data available.

An exception under regulation 11(2) of the EISRs (personal information of a third party) applies to some of the information requested because it is personal data of a third party and disclosing it would contravene the data protection principles in Article 5(1) of the General Data Protection Regulation and in section 34(1) of the Data Protection Act 2018. This exception is not subject to the 'public interest test', so we are not required to consider if the public interest in disclosing the information outweighs the public interest in applying the exception.