

From: Ditchburn L (Liz) <[REDACTED]> **On Behalf Of** DG Economy
Sent: 08 February 2018 18:49
To: Cabinet Secretary for Finance and the Constitution [REDACTED] ; First Minister <[REDACTED]>; Minister for Transport and the Islands [REDACTED]
Cc: Strategic Industrial Projects [REDACTED] ollison R (Richard) [REDACTED]; Chief Financial Officer [REDACTED] Nicholls J (John) (TRANS) [REDACTED]
[REDACTED]
DG Scottish Exchequer Mailbox [REDACTED] Maxwell S (Stewart) (Special Adviser) [REDACTED]
[REDACTED] McAllan M (Mary) [REDACTED]
[REDACTED]
[REDACTED] Lord Advocate [REDACTED] McCaig C (Callum) [REDACTED] Sinclair MA (Murray) [REDACTED] Troup C (Colin) (Dr) [REDACTED]
[REDACTED] ; Cabinet Secretary for Economy, Jobs and Fair Work [REDACTED]; Beattie C (Caroline) [REDACTED]; Permanent Secretary [REDACTED] Lloyd E (Elizabeth) [REDACTED] McAllister C (Colin) [REDACTED] Twyman K (Kerry) [REDACTED] Brannen R (Roy) [REDACTED] Nicholls J (John) (TRANS) [REDACTED]; DG Economy <[REDACTED]> [REDACTED]
Subject: RE: Urgent FMEL submission - 30 January 2018 (OFFICIAL SENSITIVE – COMMERCIAL)

PS/Cabinet Secretary Finance

Mr Mackay requested a recommendation from me on the FMEL intercreditor agreement and assurance that officials have fulfilled their duties and achieved the best overall position available.

Following consideration of the issues and taking into account advice from our commercial and legal advisers, my view as Accountable Officer is that ministers can agree to CBC’s proposal subject to final legal drafting of the supporting documentation. MacRoberts have this work in hand and they do not anticipate any issues in finalising this part of the process. In recommending this, SG ministers will want to be aware that:

- In terms of the inter-creditor agreement, CBC/FMEL rejected our preferred option of the second ranking on security on the basis that FMEL may want to raise new finance, using the company’s assets as security, once HCC release their hold. So if SG were to require to take over security at that point, clearly the raising of finance would be much more difficult. I pressed our case for second ranking security with Mr McColl and am satisfied that a) his rejection has some basis and b) further pressing is unlikely to result in any movement. Even without second ranking security, our advisers assess agreeing to the request is consistent with operating in a commercial manner and that the loan arrangement would continue to meet the Market Economy Investor Principle.
- [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

[REDACTED]

- As an intercreditor agreement, typical practice would have been that negotiations would have been largely between the creditors to the business ie between ourselves and HCC. In this case, CBC/FMEL have been discussing bilaterally with each creditor and have taken an unusually active stance. It was importance for our assurance processes that SG made direct contact with HCC and this discussion took place in January.

In terms of assurance to you, I confirm that officials have fulfilled their duties in exploring all these issues and seeking to safeguard the SG's interests, and with respect to the specific intercreditor agreement, have achieved the best position available. However, you will want to note that this agreement provides only temporary relief to the company. [REDACTED] submission of this morning provided information on the financial position of FMEL; the cost escalation and FMEL's structural funding gap; and FMEL's longer term growth plans . While the inter-creditor agreement will enable the immediate release of £10.7m and allow work on the 801 and 802 to continue, on current information, **it will only allow the company to remain cash positive until April. There is yet no credible path through to the completion of the contracts. Ministers will need to make further decisions, probably within the next couple of months, about any further Government support for FMEL** and the consequences of different options in terms of the company; the delivery of 801 and 802 and wider, longer term economic issues. Officials are working with PwC to provide that advice.

It is clear that any further Government consideration of potential future support for FMEL will need to be accompanied by an injection of CBC/private sector capital too. [REDACTED]

[REDACTED]

[REDACTED] As ministers know, this process has not yet started in earnest and, given the distance between the two parties' positions, conclusion resulting in a settlement appears highly unlikely. In agreeing to CBC's request, Ministers might wish to re-emphasise to CBC/FMEL the importance of the equity commitment being realised as soon as possible and to propose a meeting with Mr McColl to discuss the longer term, once officials have provided advice.

Liz

Liz Ditchburn
Director General Economy
Scottish Government

[REDACTED]

From: [REDACTED]
Sent: 08 February 2018 08:48
To: Cabinet Secretary for Finance and the Constitution; First Minister; Minister for Transport and the Islands
Cc: Strategic Industrial Projects; Rollison R (Richard); Chief Financial Officer; Nicholls J (John) (TRANS); [REDACTED] DG Scottish Exchequer Mailbox; Maxwell S (Stewart) (Special Adviser); [REDACTED] McAllan M (Mary); [REDACTED] Lord Advocate; McCaig C (Callum); Sinclair MA (Murray); Troup C (Colin) (Dr); [REDACTED] Cabinet Secretary for Economy, Jobs and Fair Work; Beattie C (Caroline); Permanent Secretary; Lloyd E (Elizabeth); McAllister C (Colin); Twyman K (Kerry); Brannen R (Roy); [REDACTED] Nicholls J (John) (TRANS); DG Economy
Subject: RE: Urgent FMEL submission - 30 January 2018 (OFFICIAL SENSITIVE – COMMERCIAL)

First Minister
Cabinet Secretary for Finance and the Constitution
Minister for Transport and the Islands

FERGUSON MARINE ENGINEERING LTD (FMEL) – CASH COLLATERAL RELEASE

1. The First Minister and Cabinet Secretary requested an update on Clyde Blowers Capital's (CBC, owners of FMEL) request for SG to enter into an intercreditor agreement with HCC and CBC.
2. This note covers: (i) FMEL's latest cash position, (ii) cost escalation on the CMAL order and FMEL's structural funding gap, (iii) longer-term growth plans of FMEL, and (iv) the negotiation process and advice to Ministers.

Latest position

3. SG officials and PwC visited the yard yesterday (7 February) to meet with Gerry Marshall (FMEL's Managing Director) and [REDACTED] (CBC's Investment Director). We reviewed FMEL's current trading performance and cash flow, the 2018 Budget and FMEL's 5-year outlook.
4. Gerry Marshall described FMEL's cash situation as "beyond critical". Presently the business has somewhere between £200,000 and £300,00 at the bank and has ring-fenced a further £700,000 to pay wages at the end of the month.
5. Gerry was at pains to explain his legal duties as a company Director of FMEL. He has no option but to take urgent action now to address the situation. FMEL has already stopped payments to 50 suppliers with up to another 50 suppliers demanding upfront payments from FMEL. We understand the cash situation is also impacting the pace of work on the CMAL ferries order.
6. FMEL has requested SG assistance to release its own cash and ease the immediate cash flow pressure. SG is not being asked to commit further SG funds at this stage. Over £15 million of FMEL's cash (that is, money invested in the business by CBC investors) is held by its surety bond provider HCC. HCC retains this cash as collateral against the two guarantees (surety bonds) they provide to FMEL.

7. HCC has agreed to weaken its security position by releasing £10.7 million of FMEL's cash *if* SG enters into an intercreditor agreement that (a) makes clear that HCC's debt ranks in priority to the SG debt and (b) blocks repayment to SG until any liability to the surety is discharged fully.

8. The release of the £10.7 million cash collateral now would allow the business to remain cash positive until April but it will not address the structural funding need that stems directly from the significant cost overrun being incurred on the current CMAL contract.

Cost escalation and FMEL's structural funding gap

9. FMEL has submitted a £14.7 million claim for a 'Price Uplift' on contracts 801 and 802 based on, according to FMEL, unforeseen complexity in constructing the vessels and the novelty of the design plus issues stemming from the development of new standards for LNG vessels. CMAL has contested the claim leading to a mediation process. We understand that due to the mediator's availability the mediation will not proceed in earnest until mid-April.

10. FMEL's latest financial forecasts suggest their 'break-even' project price for the two vessels would be an additional £12.7 million on top of the £14.7 million claim – that is, an expected combined cost overrun of £27.4 million on the CMAL contract. Achieving a break-even situation for FMEL on the CMAL contract would not by definition generate funds to pay back the SG loan of £15m.

11. By end of April it is possible, indeed probable, that without (a) an injection of cash from CBC, (b) full settlement of FMEL's 'Price Uplift' claim or (c) a further substantial loan from the SG the business could face insolvency and, at that point, the surety bonds would likely need to be called. As of yesterday FMEL had no firm contingency plans in place should they not achieve the contract price increase. CBC has stated it will only commit fresh equity to FMEL once the price dispute is settled.

Longer-term growth plans of FMEL

12. Gerry remains very positive about the longer-term prospects of the yard and its diversification and expansion plans. The business needs to diversify beyond ship building work alone (that work is too peaky and the margins low) and Gerry outlined to us a range of opportunities in terms of:

- Innovation of new technologies – e.g. the HySEAS III project (FMEL was part of a successful application for EU Horizon 20202 funding - ██████ for FMEL)
- Defence work (MOD Type 31e frigate and submarine blocks) – FMEL is very confident of receiving block building work from MOD with a potential value of £20 million a year from 2019
- Ship repair and servicing (for CalMac, Serco and Western Ferries) – CBC is considering investing in new assets (e.g. dry dock capacity) to support this work
- Major fabrication (renewables and construction)

- Recycling – from a number ageing ships that require to be broken up.

13. FMEL's 5-year Outlook shows total revenues rising from the 2017 estimate of £41.9 million to the 2022 forecast of £88.1 million. Based on the assumption that FMEL is (a) successful in winning significant new orders (including future CMAL orders) and (b) diversifies successfully, FMEL's Outlook shows margins and profits picking up from 2019 through to 2022 such that SG's loan could be paid back in this period. Clearly there are uncertainties and risks that the projected acceleration in FMEL's revenues may not keep pace with FMEL's projections.

14. CBC have invested c. £22 million in the yard to improve capability and efficiency. The yard employs around 300 people – 172 permanent employees.

Negotiation process and advice to Ministers

15. Ministers received the advice note I submitted to DG Economy on 30 January setting out the background to CBC's request and the options under discussion. Since then officials have engaged further with CBC, including direct dialogue between DG Economy and Jim McColl, and yesterday's meeting to review the latest financial position and projections. We have sought further advice from SG's expert commercial and legal advisers and explored many options to reach an agreement with CBC.

16. We do not believe SG's position in relation to the intercreditor deed can be enhanced through further dialogue with CBC at this stage, whereas further delay in releasing the cash collateral is damaging the business. Should SG agree to the intercreditor deed the legal documentation will require to be finalised with CBC and HCC so any release of cash to FMEL will not be instantaneous.

17. DG Economy will chair a meeting today with policy and finance officials to review the latest financial information from CBC with the aim of formulating a final advice note that lays out the updated financial context, the options and risks and benefits of the options, and the accounting officer and PAO considerations. The current expectation is that a submission will then come forward to Ministers for a decision.

Regards,

[Redacted]

[Redacted]

[Redacted]

[Redacted]

Innovation, Investment and Industries

Directorate for Economic Development

Scottish Government, Atlantic Quay, 150 Broomielaw, Glasgow G2 8LU

[Redacted]

[Redacted]