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Ferries Unit
22 February 2017

Cabinet Secretary for Economy, Jobs and Fair Work
Cabinet Secretary for Finance and the Constitution
Minister for Transport and the Islands

FERGUSON MARINE ENGINEERING LIMITED - SHIPBUILDING CONTRACT TWO 100 METRES DUAL FUEL FERRIES

Purpose

1. To provide Ministers with an update in relation to progress on the two Dual Fuel Ferries that are currently under construction at the Ferguson Marine Engineering Ltd (FMEL) shipyard in Port Glasgow. To highlight Caledonian Maritime Assets Ltd's (CMAL) early concerns in regard to likely slippage in the timescale for delivery of these two vessels.

2. To respond to a recent query from the Cabinet Secretary for Economy, Jobs and Fair Work in relation to the use of Bank Guarantees and Surety Bonds in the shipbuilding contract for these two vessels and the broader issues for FMEL going forward.

Timing

3. Routine, although the narrative in the submission will be helpful background to the planned meeting between Mr Jim McColl, Clyde Blowers Capital, the owners of FMEL, and the Cabinet Secretary for Economy, Jobs and Fair Work and the Cabinet Secretary for Finance and the Constitution on Thursday 2 March 2017.

Background

4. In November 2015, CMAL placed orders at FMEL for the construction of two 100m Dual Fuel Ferries (LNG and Marine Gas Oil), currently referred to as Vessels 801 and 802.

5. The delivery dates of the vessels at contract signing were;
   - Vessel 801 – 25 May 2018 – for subsequent deployment on the Arran service to Brodick.
   - Vessel 802 – 26 July 2018 – for subsequent deployment on the Uig Triangle service, serving Tarbert, Harris and Lochmaddy, North Uist service.

6. The value of the core contract is £97m: , £48.5m per vessel. In addition to the FMEL contract costs there are other costs associated with these vessels – design, construction supervision and mobilisation relating to the CMAL supervision team and the secondment of vessel based personnel from CalMac. The total cost Scottish Ministers is forecast at £106 million.

7. There have been a number of challenges that are recognised throughout CMAL's experience with FMEL and these are outlined in more detail in **Annex A** under the following headings:-

- Quality of Built
- Payments
- Challenges
- Allowable days
- Delivery prospects in more detail
- Future Progress
- Bank Guarantees and Surety Bonds
- Broader issues for FMEL

Delivery prospects

8. There is an extremely high probability that the vessels will be delivered later than that indicated above. CMAL's view is that while it is potentially possible to deliver Vessel 801 by August 2018, with the current rate of progress this is most likely going to be missed and as a consequence the timescale for Vessel 802 will also slip considerably.

Next Steps

9. CMAL continue to be supportive of FMEL, from both a technical and a financial perspective. It is clearly in all our interests to see FMEL flourish. Clyde Blowers Capital (CBC) are to be commended in their support of FMEL, as they continue to construct these two vessels for CMAL and for the substantial investment in modernising the yard.

10. A meeting has recently been arranged between Mr McColl and the Cabinet Secretary for Finance and the Constitution and the Cabinet Secretary for Economy, Jobs and Fair work on 2 March 2017 where the matters explored in the submission can be discussed. Following the meeting with Ministers it is proposed that a delegation of Economy, Transport and Finance officials could usefully meet with FMEL/CBC to explore the Surety Bond / Bank Guarantee matters in more detail.

11. While, respecting the requirements in their contract with FMEL and protecting the public purse, CMAL have indicated to FMEL and CBC that they are willing to further assist with cash-flow but that should be tied to a realistic and detailed plan for fabrication, equipment installation, outfitting, commissioning and achieving interim milestones.

12. Ministers are asked to note this update in relation to;

- **progress on the construction of the two vessels currently being built at FMEL and CMAL's early concerns in regard to likely slippage in the timescale.**

- **note the latest update in relation to the use of Bank Guarantees and Surety Bonds and the broader issues for FMEL going forward.**

[Redacted]
Ferries Unit
22 February 2017

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constit Interest	General Awareness
Cabinet Secretary for the Rural Economy and Connectivity			x		x

DG Economy
DG Finance
Roy Brannen, CE TS
[Redacted]
Gordon Wales, Director of Financial Management
TS Directors
[Redacted]
Richard Rollison, Innovation, Industries and Investment
Mary McAllan, Directorate For Economic Development
[Redacted]
Liz Lloyd, Special Adviser
John McFarlane, Special Adviser
Kate Higgins, Special Adviser

Annex A

FERGUSON MARINE ENGINEERING LIMITED - SHIPBUILDING CONTRACT TWO 100 METRES DUAL FUEL FERRIES

Quality of Build

1. It should be noted that the quality of the workmanship that CMAL has witnessed at FMEL to date is very good. This is seen as a significant positive indication, particularly for the subsequent reliability and longevity of the vessels.

2. The Minister for Transport and the Islands visited CMAL's offices on 12 December 2016 to hear more of CMAL's work in relation to vessels, piers and harbours. Following a briefing on the construction of the two vessels by CMAL senior personnel, highlighting a number of the messages in this submission, the Minister, TS officials and CMAL senior personnel, visited and toured FMEL's yard. We understand the Minister was reassured by FMEL's commitment to the two vessels and was impressed by the parallel work on the re-construction and modernisation of the shipyard.

Payments

3. Within CMAL's contract with FMEL, there are various milestone payments that are required to be made at certain stages of the construction. To date the milestone reached has been up to and including milestone No. 8 (50% of the Hull fabrication). There were also some early payments made in regard to major component parts such as Main and Auxiliary Engines, Bow Thrusters and Stabilisers. CMAL has promptly paid FMEL all of these monies.

4. The total payments made up to and including the 50% fabrication milestone is £58m. That leaves a further £39m to be paid by CMAL to FMEL over the remainder of the construction period.

5. In relation to further interim payments, at the 100% fabrication stage there will be an additional £7.55m due for payment. At the launch of the vessels, there are further payments due in regard to painting and join up, amounting to a further £7.2m. Taken together there are payments due amounting to £14.75m. The launch milestone for Vessel 801 is 24 August 2017 and for Vessel 802 is 12 January 2018. No other payments are due to FMEL over this 12 month period.

6. It is considered that this is a long period for FMEL to finance the level of expenditure that they will be putting into what will be an intense construction period for the two vessels, including employing some 350 staff and shipyard workers.

Challenges

7. There have been a number of challenges that are recognised throughout CMAL's experience with FMEL as outlined below.

- The ship yard has a new owner as it was effectively in administration prior to Clyde Blowers Capital (CBC) stepping in.

- Whilst CBC are well versed in the manufacturing environment the ship building business was not known to them previously.

- The ship yard has a new management team and Board of Directors.

- There has been significant investment in the yard in terms of new build facilities, machinery, processes and IT of circa £25 million.

- There have been delays in vessel construction as various areas of the yard have been in refit and therefore unable to be fully utilised for ship building.

- The vessels are technically complex and planning has proved a difficulty for the yard.

- Fifteen months into the contract: FMEL has yet to issue a detailed plan for fabrication, equipment installation, outfitting and commissioning.

8. The net result of the above is that the original schedule envisaged has "slipped", as indicated below:-

- Milestone No.9 for 75% fabrication of Vessel 801 is not be expected to be achieved for another 2 months; 4 months later than originally scheduled.
- the same milestone for Vessel 802 is not be expected to be achieved for another 4 to 5 months; 6 to 7 months later than originally scheduled.

9. It is considered unlikely, if not impossible, for the delays incurred to date to be recovered. Going forward, it is considered likely that further delays will be incurred by FMEL, given the recent and current rate of progress and the complexity of the vessels. The current hull construction phase is considered to be a relatively easy task compared to the "outfitting" phase which is yet to come.

Allowable Days

10. There are a total of 80 allowable days within the contract for delays without penalties. The key challenge is that these "allowable days" will certainly be used and in all likelihood exceeded. That means that the "best case" scenario that CMAL can foresee is as follows:-

- the delivery of Vessel 801 will be in August 2018 (compared to 25 May 2018 envisaged at contract signing), and
- the delivery of Vessel 802 will be in October 2018 (compared to 26 July 2018 envisaged at contract signing).

Delivery prospects

11. There is an extremely high probability that the vessels will be delivered later than that indicated above in the “best case” scenario at paragraph 10 above.

12. CMAL’s view is that while it is potentially possible to deliver 801 by August 2018, with the current rate of progress this is most likely going to be missed.

13. Vessel 802 is a different matter as CMAL cannot foresee a delivery gap of only 2 months between Vessel 801 and Vessel 802, given the physical constraints that currently exist at FMEL. In CMAL’s judgement there will be at least a 6 month gap between the delivery of the two vessels, so Vessel 802 could potentially be delayed until February 2019 or thereabouts

14. While the narrative at paragraph 10 above represents the “best case” scenario, the “more likely case” scenario that CMAL can foresee is set out below. It should be noted that CMAL consider it is not unrealistic for FMEL to slip further on the “more likely case” scenario set out below:-

- the delivery of Vessel 801 in late autumn 2018 to early winter 2018/19 (compared to 25 May 2018 envisaged at contract signing), and
- the delivery of Vessel 802 in early 2019 (compared to 26 July 2018 envisaged at contract signing).

15. [Redacted]

Future Progress

16. The CMAL CEO has had two recent meetings with the CBC lead Director to discuss how CMAL can work even more closely with the FMEL Team to achieve a genuine programme of works and milestones that all sides can fully believe in. The CBC lead Director is very aware that milestones have slipped and continue to do so. In CMAL’s view this is driven by unrealistic targets set by the FMEL Management Team.

17. CMAL will continue to have further meetings with FMEL, to look closely at the planning and address any issues that are expected to arise. CMAL confirm that they will continue to work closely with FMEL in all respects. The situation in relation to the delivery dates for Vessels 801 and 802 is an evolving one, but CMAL and Transport Scotland officials wish to highlight these concerns at this juncture to Ministers.

18. In the meantime, CMAL stand ready to provide any further immediate information to Transport Scotland and Scottish Ministers. Transport Scotland regularly discuss this important issue at CMAL Board meetings and in the monthly TS / CMAL Liaison Meetings. The most recent of these was on Thursday 16 February.

19. CalMac Ferries senior officials and Board members are also being kept fully informed by CMAL given the implications for CalMac in terms of vessel mobilisation, crew training, vessel deployment and service timetables for the Clyde and Hebrides ferry services.

20. Transport Scotland officials are also monitoring progress with a particular emphasis on financial planning and profiling and the interactions with associated planned pier and harbour infrastructure works for the Arran service and on the Uig Triangle. Transport Scotland officials will liaise closely with CMAL on this matter.

21. The contract between CMAL and FMEL stipulates penalty payments of £10,000 per day for every day a vessel is delivered late beyond the allowable days. It would be normal practice to pursue those penalties. In the meantime, CMAL will of course be mindful of how, and if, these penalties are applied in this instance given the need to balance an appropriate delivery date for the vessels with the financial wellbeing of FMEL going forward.

Bank Guarantees and Surety Bonds

22. The Cabinet Secretary for Economy, Jobs and Fair Work has had several exchanges in relation to the use of Bank Guarantees and Surety Bonds in the shipbuilding contract for these two vessels and the broader issues for FMEL going forward. Jim McColl advised the Cabinet Secretary for Economy, Jobs and Fair Work of his dissatisfaction with this situation at the Council of Economic Advisers meeting several weeks ago and he has now asked for an update on the position.

23. This follows on from previous advice that the Surety Bond proposal from Clyde Blowers has been accepted and agreed on Wednesday 2 November. We also advised that we believed that all sides were content with the revised arrangement and that CMAL CEO would shortly seek to confirm that Clyde Blowers consider matters satisfactorily resolved.

24. We have since spoken again to CMAL and they confirm that the Surety Bond initiative, released more than 60% of the cash that was tied up in the Bank Guarantee arrangement that was in place previously. Since the Surety Bond was signed in November 2016 there has been no contact from FMEL or Clyde Blowers that indicated there was a continuing problem. CMAL understood that Clyde Blowers were content. The latest exchange with Jim McColl was the first indication that all is potentially not well.

25. To underscore that point, we recently met with the following:-

- the CBC lead Director;
- an FMEL Board member; and
- the Managing Director of FMEL.

They did not raise or express any concern from CBC or FMEL regarding the Surety Bond.

26. Given his comments to Mr Brown, we assume that Jim McColl remains generally unhappy about the principle of providing bonds or financial guarantees/cover in shipbuilding contracts, notwithstanding the fact that Clyde Blowers / FMEL signed up for a Surety Bond for the 2x100m vessels only a matter of a few months ago.

27. In an ideal world it is self-evident that Mr McColl, CBC and FMEL would not want to have any Bank Guarantees or indeed Surety Bonds. However, from the vessel purchaser's perspective (in this instance CMAL), Bank Guarantees and Surety Bonds are essential from a financial assurance perspective to mitigate the risk of the shipyard getting into financial difficulties part-way through the construction phase. Mr Brown will recollect that this has been the case in the two most recent ship yards that CMAL has contracted with, namely:-

- [Redacted] (MV Loch Seaforth in 2014), and
- Ferguson Shipbuilders under the previous ownership regime (MV Lochinvar in 2013).

28. [Redacted]

29. In the case of the Vessels 801 and 802, given the £97 million of public money involved, it is considered that appropriate financial assurance is in place to mitigate the risk of financial difficulties. The monies that would be provided from a Bank Guarantee or Surety Bond, that would be paid back to CMAL, would allow them to make alternative arrangements to have the vessels completed – either at another yard or at FMEL's yard under a different yard ownership or management model.

30. CMAL understands, and have been told, that CBC did not fully understand the nature of the Shipping Market and Ship Building Contracts when they bought the Ferguson Shipbuilders business in 2014. That may explain Mr McColl's continued frustration in relation to a Bank Guarantee or Surety Bond.

31. Notwithstanding any of that, it is anticipated that Jim McColl will keep making the point that there is no need for Bank Guarantees or Surety Bonds, given they represent a cost to FMEL and CBC and/or tie up monies over the duration of the ship-building contract.

32. Clearly Scottish Government cannot provide government backed assistance where Scottish Ministers are themselves the customer as there would be no risk transfer. However, if FMEL are bidding for work for private customers in Scotland, or private / public customers outside of Scotland then some form of Scottish Government backed guarantee would be likely be helpful to FMEL. A meeting has recently been arranged between Mr McColl and the Cabinet Secretary for Finance and the Constitution and the Cabinet Secretary for Economy, Jobs and Fair work on 2 March 2017 where such the matters can be discussed. Following the meeting with Ministers it is proposed that a delegation of Economy, Transport and Finance officials could usefully meet with FMEL/CBC to explore the Surety Bond / Bank Guarantee matters in more detail.

Broader Issues for FMEL

33. The global ship building market is very weak. Worldwide, new build orders in 2016 are only at a level of 5% of the equivalent position in 2006. Shipyards are closing

all over the globe due to lack of orders. Those shipyards that remain are aggressively chasing what little works remains – both in terms of the low prices being offered to buyers and acceding to the buyers' demands in relation to the terms and conditions associated with the contracts. It is undoubtedly a very competitive and difficult market place.

34. FMEL want to be "world class" and "secure global contracts" so it is likely that they will have to accept the normal practice of offering Bank Guarantees or Surety Bonds to secure such business. No commercial ship owner will place orders at FMEL without appropriate Bank Guarantees.