From: [redacted]
20 December 2018

Cabinet Secretary for Finance, Economy and Fair Work
Cabinet Secretary for Transport, Infrastructure and Connectivity

FMEL LOAN: DISCUSSIONS WITH CBC

Issue

1. With your agreement DG Economy wrote to CBC on 13 December (Annex A) to indicate that SG would be prepared to consider amending the terms of the loan agreed in June 2018 to facilitate the injection of CBC's committed investment, subject to agreement of acceptable commercial terms.

2. Since then officials and our external advisers have engaged with CBC via several conference calls culminating in CBC's response (at Annex B). The key points of CBC's latest offer being:

- [redacted]
- [redacted]
- [redacted]
- [redacted]

Timing

3. Urgent.

Recommendation

4. Based on the advice of our commercial advisers (at Annex C) our recommendation is that we reply to CBC immediately to signal our broad acceptance of CBC's offer in relation the £3 million, subject to agreement of legal terms, and on the explicit basis SG will accept no further conditionality or delay on any part of CBC's funding.

5. Our proposed response to CBC makes clear that while Ministers remain committed fully to the purposes of the SG loan facility further drawdown against the facility (access to the remaining £13 million of SG funds) will be frozen until revised terms are agreed and documented (see draft letter at Annex D).

6. CBC bears full responsibility for the present cash flow challenges of Fergusons that result directly from their breach.

Potential for limited drawdown against the SG loan

7. [redacted]

8. The First Minister's response our 2 November submission stated that no further funds should be released to FMEL until we have resolved the situation surrounding CBC's breach.

9. We are sticking to that line in the proposed response. However, if FMEL's cash flow challenges are worse than we know or if unpaid creditors / suppliers are seen to take action that would damage SG's interests or if there is some other compelling reason that necessitates a reappraisal of our position on drawdown, we will bring forward further urgent advice to Ministers.

Ferries delivery programme

10. In the past week, we have received the second quarterly review of build progress against the declared ferries construction plan prepared by our independent operational expert, Luke van Beek (Annex E).

11. Luke highlights further slippage in the vessel delivery schedule which is attributed by the FMEL management to their current cash flow problems. The programme has slipped by a minimum of a further three months (possibly five months) and delivery timelines will require to be reassessed and confirmed once the business is again in funds and supplier / sub-contractor agreements can be reset. The Directors of FMEL understand that the current block on drawdown against the SG loan arises solely from CBC's breach and they are aware that the two funders of the business have been meeting to develop a solution that would allow the flow of funds to recommence.

12. However, without greater certainty that agreement can be reached soon between SG and CBC, the Directors of FMEL have initiated steps to reduce future commitments by postponing material purchases and cutting contactor labour costs.

13. For example, the business has decided that 65 short-term contractor personnel will not be re-employed from this Friday 21 December. These specialist contractors were hired to fit pipes and valves and the delay to this part of the schedule has stopped work in numerous compartments. Luke notes that these particular specialist roles are critical to the programme and their re-hire may not be immediate once funding improves as such skills are in high demand elsewhere.

14. We are planning for Luke to visit FMEL again in mid-January to review the revised programme in light of the current cash flow issues, reduction in labour input and postponement of some scheduled activity.

FMEL's published accounts

15. Ferguson Marine Engineering (Holdings) Limited has filed its statutory accounts to 31 December 2016 and these have been published on the Companies House website.

16. Although the accounts relate to the period to end-2016 the accounts reference post balance sheet events, including the SG loans and the key terms of those loans such as the rate of interest, [redacted]

17. The loss for 2016 amounted to £61.4 million. The provision made for the losses expected to be incurred to complete contracts 801 and 802 is £39.5 million and the fixed assets of the business have been impaired to zero value. The FMEL Directors attribute unforeseen costs on the CMAL contract to variations, interference and disruption caused by the customer.

18. The Directors of FMEL have commissioned independent claim specialists to review the 801 and 802 contracts. The accounts state that the Directors are encouraged by the initial findings in support of a claim for a contract price increase and on that basis expect to submit the claim in the next month. In fact, we understand the claim will be submitted to CMAL today in hard copy.

19. The accounts forecast cash shortfalls to arise post-April 2019 even if the remainder of the SG loan is available and CBC provides its full £8.5 million. Funding shortfalls are noted from April to May 2019, peaking at £3.5m in May, and October 2019 to March 2020, peaking at £5m in February 2020 *if* further cash generative work is won and *if* there are no further delays to 801/802.

20. However, if new cash generative orders are not secured and the delivery of 801 and 802 is delayed by 3 months FMEL's forecasts show a cash shortfall from April 2019 to June 2020, reaching an expected peak of £11.7m in May 2020.

21. Publication of FMEL's accounts has attracted media attention and may have an adverse effect on their credit terms thus exacerbating cash future flow challenges.

Conclusion

22. We would be grateful if Ministers could consider this advice and agree to the recommendation and draft response to CBC, as shown at Annex D.

[redacted]
Economic Development, [redacted]

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constit Interest	General Awareness
First Minister					X
Deputy First Minister					X
Minister for Business, Fair Work and Skills					X
Minister for Energy, Connectivity and the Islands					X
[redacted]					X
Permanent Secretary					
DG Economy					
DG Scottish Exchequer					
Chief Financial Officer					
Derek Glover					
Roy Brannen					
Mary McAllan					
Fran Pacitti					
Callum McCaig					
Stewart Maxwell					
[redacted]					
Richard Rollison					

ANNEX A – LETTER FROM DG ECONOMY TO CBC DATED 13 DECEMBER 2018 – RELEASED ON SCHEDULE

ANNEX B – LETTER FROM CBC TO DG ECONOMY DATED 18 DECEMBER 2018 – RELEASED ON SCHEDULE

ANNEX C

ADVICE OF PWC

We have considered CBC's letter of 18 December 2018 and, as discussed, we are not aware of any reason that CBC should delay its funding beyond the signing of the agreement. The timely introduction of CBC funding is key to the commerciality of the amendment.

Whilst the following are matters that need to be covered in the legals, we have not reflagged them in our proposed draft response to Shauna:

- if the business is nationalised the CBC debt should not have rights, such as enforcement rights, that would give CBC leverage to extract value from SG when SG is unable to extract value from FMEL; and

- the latest projections envisaged the injection of the [redacted] from CBC to fund working capital in Q1 of FY19. CBC is no longer envisaging this investment and so it is not clear what the funding shortfall will be or how it will be met.

In summary, the commercial balance for agreeing the amendment is:

- £3m of CBC's investment will move up from equity to pari passu debt; and

- The CPI claim will now be partially be paid to CBC if it is received, but only in the ratio of these latter funds i.e. 3:30.

- **But in return** FMEL will now receive the £3m investment from CBC immediately on signing of the agreement;

- The timescale for nationalisation will be reduced by agreeing now that the business valuation is [redacted] if it is insolvent until 801/2 is delivered, rather than the mechanism previously agreed in the Subscription and Shareholders Agreement (effectively accelerating the process from c. 4 weeks to immediate);

- [redacted]

ANNEX D – PROPOSED LETTER FROM DG ECONOMY TO CBC DATED 21 DECEMBER 2018 – RELEASED ON SCHEDULE

ANNEX E – RELEASED IN FOI/201900003779