

From: [REDACTED]
11 December 2018

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

FMEL LOAN: A RESPONSE TO CBC

Issue

1. We are now in a position to recommend a counter commercial proposal for Ministers to consider as SG's substantive response to Clyde Blowers Capital's (CBC) request to alter the terms of the £30 million commercial loan facility for Ferguson Marine Engineering Limited (FMEL), as agreed in June 2018. DG Economy has cleared the recommended counter proposal.
2. We provided written advice to Ministers on 2 and 14 November and met with you to discuss options for a response to CBC on 15 November. Taking your steer on handling from our last meeting (note at Annex A), DG Economy met with Jim McColl on 28 November to understand better CBC's intentions with respect to the loan agreement and FMEL (note at Annex B).
3. Jim McColl signalled strong commitment to the business and a willingness on behalf of CBC to move on their original request to alter the agreement. He has outlined some positive developments around new assets and contracts which could enhance the prospects for FMEL as a sustainable commercial operation. Making a counter offer may therefore be worthwhile, while maintaining our clear red lines.

[REDACTED]

Timing

5. Urgent. FMEL has sufficient cash to trade through the next couple of weeks (i.e. to 21 December 2018) but as the Directors have no visibility on working capital funding post-Christmas they are now taking action to cut costs by halting supplier payments and this is expected to further delay delivery of the CMAL vessels.

Recommendation

6. Essentially, the proposal (summarised below and further described at Annexes C and D) is to negotiate a change to the basis of CBC's first [REDACTED] of new investment in FMEL from equity to debt with the status of the subsequent CBC equity of [REDACTED] remaining unchanged. This preserves the core features and advantages of the agreements made in June. Importantly, CBC would remain contractually committed to invest a further [REDACTED] as equity in FMEL Holdings by next

June to enhance the capability of FMEL [REDACTED]
[REDACTED]

7. The counter proposal shows a willingness to address CBC's challenges but crucially maintains commerciality (MEIP compliance) through co-investment on equivalent terms with CBC. It holds to our red lines (i) that SG must receive some benefit if it agrees to modify the agreement and (ii) consequential amendments to the detail and documentation must not prejudice the existing rights of SG.

8. Indications we have received suggest the counter proposal will be acceptable to CBC though they may object to some of our new asks. Where scope remains to negotiate around our asks that is identified below.

9. Finalisation and documentation of an amended agreement will take some time, perhaps several weeks, and Ministers' final approval for a revised agreement will be sought before any change completes and funds flow.

Features of the counter proposal (Annex C)

10. [REDACTED]
[REDACTED]
[REDACTED]

- reminds CBC that our existing loan agreement entitles SG to be repaid ahead of CBC in certain solvent scenarios – for example, if FMEL is successful in its expected contract price claim against CMAL;
- signals our intention to appoint a Board observer as permitted by the existing loan agreement;
- seeks confirmation that FMEL cannot be refinanced with another funder or other external investment obtained; and
- [REDACTED]
[REDACTED]

In addition, our proposal seeks to strengthen SG's position in two respects via:

- i. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
- ii. agreement to streamline the process for valuing the business such that the value of the business is £1 until 802 is delivered.

11. Of these two points, only the first is an absolute red line in our view and in the view of our commercial advisers.

12. The second ask, the altered valuation methodology, would be a benefit to SG compared with where we are today (where it may take up to 30 days to get the value

of the shares agreed and this poses some risks to the business) but it is not an absolute requirement to achieve.

13. In an insolvency, SG's and CBC's security linked to the debt would be ranked equally – [REDACTED] In this scenario, SG retains the ability to acquire FMEL at fair value, however, CBC's £3m debt will remain payable by FMEL.

Risks and contingency options

Cash flow

14. [REDACTED]
[REDACTED]
[REDACTED]

15. The cash shortfall post-April 2019 through to completion of 802 in early 2020 is not addressed by this proposal. It will require to be addressed by further support from SG or CBC, via the contract price claim against CMAL or through substantial new orders for FMEL.

16. To protect the business now, the Directors of FMEL have stopped all payments to suppliers and paused further commitments to expenditure beyond the year-end. According to FMEL, this is impacting the revised delivery schedule for the CMAL vessels (801 and 802) as elements on the critical path such as dry docking and the start date of key sub-contractors have been postponed.

Drawdown against the SG loan

17. In order to limit cash flow impacts on the CMAL ferries programme SG has the potential to continue to provide funding on a commercial basis to FMEL to allow the business to trade while we either (a) formalise an amended loan agreement along the lines described above or (b) further consider options in light of CBC's breach – e.g. while we develop a business case for public ownership.

18. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

19. 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. On the assumption that an agreement in principle can be reached quickly, we will push for CBC's funds to go in before or alongside SG's funds.

Contingency options

20. Officials and advisers have reviewed a range of contingency options. A recently updated paper prepared by PWC on options for FMEL, associated pros and cons and illustrative costs, has been attached to the covering email.

21. Due to CBC's default Ministers have attained the right to buy FMEL now – to bring the business into public ownership – at fair value without any CBC debt. We have reserved our rights and our putting forward a counter proposal does not negate those rights.

22. Notwithstanding Ministers' contractual right to acquire FMEL at fair value, there is a risk under the current loan provisions that FMEL could take steps during the period of valuation to frustrate that process, for example by creating a position of insolvency. The proposed counter offer would mitigate that risk by agreeing the value of any future valuation at £1, giving Ministers greater agility to act quickly in the event that they seek to exercise their right to acquire. Further advice is being prepared on practical and policy issues associated with possible SG acquisition.

CMAL contract

23. CMAL has, through discussion with Transport officials, already exhausted all contractual levers to encourage timely performance of the contract to deliver vessels 801 and 802, including restructuring payment dates. No further contractual changes could be made without unreasonably removing any remaining contractual protections for CMAL, or without breaching procurement rules which may lead to challenge.

24. Officials would recommend that any revision to the terms of the loan agreement should incentivise contract performance – measures which provide greater visibility and control of progress and mitigate further slippage in timescale for delivery of vessels 801 and 802. This may include encouraging FMEL and CMAL to work to a shared commissioning programme and risk register.

Handling and transparency

25. The cash flow challenges of FMEL and SG's loan facilities have attracted considerable attention from media, Parliamentarians, Audit Scotland and members of the public via FOI requests. While protecting commercially sensitive information we have been open about the purposes of the loan facilities for FMEL.

Consistency

26. With interest and scrutiny surrounding Fergusons high, we have reviewed Ministers' public comments on the loans and do not believe the amendment proposed conflicts with any previous Ministerial statement relating to FMEL.

27. Mr Mackay wrote to the Finance and Constitution Committee in April and June this year to inform Parliament in confidence of the two loan facilities. There was no obligation to inform the Finance Committee but the Cabinet Secretary wrote in the interests of transparency. The correspondence described the purpose of the loan

facilities, the size of the loan facilities and highlighted links to the CMAL ferry contract, but did not provide specific details of the terms of the agreements:

- The letter of 24 April 2018 stated:

“In July 2017 the Scottish Government was made aware that FMEL were experiencing cash flow challenges due to increased costs to deliver the 801 and 802 ferry contracts. To help mitigate this, and with the support of our commercial and legal advisors, the Scottish Government provided FMEL with a loan of £15m on 4 September 2017. This loan was provided on commercial terms, with a market rate of interest and time frame for repayment.”

- The second letter of 27 June stated:

“The Committee will recall that I previously wrote in confidence on 24 April 2018 to outline the provision of a £15m commercial loan from the Scottish Government to FMEL. As this loan was provided on commercial terms I notified the Committee in the spirit of transparency.”

“Since I last wrote to you the Scottish Government has been working to secure the long term future of the business and, consequentially, the commercial shipbuilding sector in Scotland.”

“Therefore, the Scottish Government has determined to offer the business financial support. This will take the form of working capital which will improve the cash flow position of the yard, facilitate the long-term viability of the business, and ensure the delivery of the CMAL vessels.”

“The precise details of the commercial loan package will, rightly, remain commercially confidential. However, in the spirit of transparency, I wish to inform the Committee that the Scottish Government has provided FMEL with a further commercial loan facility of up to £30 million.”

28. The SG news release on the June 2018 loan facility is attached at Annex E; again, this provided no specific details on the terms of the agreement.

Continuing interest

29. Ahead of the imminent release of FMEL’s statutory accounts for 2016 and 2017, which will inevitably show heavy losses against the CMAL contract, CBC have sought to control the narrative on the contract dispute. Jim McColl’s interview with STV last week in which he discussed problems with the CMAL contract and FMEL’s intention to pursue a legal claim was picked up in other media and reported widely.

Conclusion

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

[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]					
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[REDACTED]					
Richard Rollison					

ANNEX A

FMEL LOAN: OPTIONS FOR A RESPONSE TO CBC

Meeting Note – 15 November 2018

Present: Cabinet Secretary for Finance, Economy and Fair Work, Cabinet Secretary for Transport, Infrastructure and Connectivity (by phone), Fran Pacitti, ██████████, ██████████, Liz Ditchburn, Gordon Wales, Mary McAllan, Callum McCaig, ██████████, ██████████

- Ministers had received advice dated 14 November outlining options for a substantive response to CBC's request to amend the loan agreement made in June 2018. The meeting was convened to agree the manner and content of SG's response to CBC.
- We confirmed Ministers' objectives around the delivery of the CMAL vessels, retention of jobs at FMEL and preservation of shipbuilding capacity. Mr Matheson was clear that the timetable for vessel delivery was vitally important and our option choice should be guided by the need to avoid further slippage. It would be important in that regard to mitigate the risk that CBC/Directors of FMEL take any adverse action that slows vessel production following SG's response; careful handling would be required.
- The issue of the long-term commercial sustainability of FMEL is crucial in any future scenario, including public ownership. The business as currently configured is overly reliant on new build ferry work from CMAL, it has struggled to achieve major private orders, and it lacks some capability to secure higher margin ship servicing and repair work. Public ownership (even temporary) is one way to secure Ministers' objectives and SG will require to base its option choices on thorough analysis.
- The underlying demand for ferry usage in Scotland is strong (passenger numbers rising) and the CalMac fleet has a substantial ongoing requirement for replacement vessels and regular ship servicing and repair expenditure. Governance arrangements for the public ferries landscape are under review and that work will have some bearing on the commercial options for FMEL.
- In terms of the SG response to CBC's request to alter the June agreement, the two primary options are: (i) to reject CBC's proposal and signal an intention to assess fully the case for early public ownership or (ii) to amend the agreement to accommodate new CBC debt (rather than equity) on terms advantageous to FMEL and SG.
- The second option on its own would not provide a durable or sufficient solution to the issues of FMEL's financial sustainability as the combined cash injection (£8.5m from CBC and the balance of the SG loan of £13m) will only sustain the business until around October next year. The Finance Cabinet Secretary said he would expect to engage with the Finance Committee in the event that the FMEL loan agreement is altered.

- Reading CBC's intentions and in particular their expected path towards exiting their investment in FMEL is difficult. As an alternative to a possible protracted exchange of correspondence with CBC on FMEL a quicker and more interactive option was to seek further dialogue led by DG Economy.
- This engagement should take place at the earliest opportunity and DG Economy would have the authority of Ministers to negotiate draft terms based on the steer taken at the meeting.
- SG has held to its obligations under the June agreement and CBC retains the option still to do the same by meeting its obligations to subscribe for shares in FMEL. Rather than advance a counter SG proposal at this stage, we agreed that DG Economy should engage with CBC (Jim McColl if possible) next week.

Action: DG Economy to seek early dialogue with CBC

ANNEX B

NOTE OF MEETING BETWEEN DG ECONOMY AND JIM MCCOLL (28 November)

2 December 2018

Cab Secs FEFW, TIC

As requested, I met with Jim McColl last week to try to understand better CBC's intentions with respect to the loan agreement and FMEL. I met with Jim McColl in St Andrews House, with [REDACTED] present, for around an hour and a half on Wednesday 28th November.

I was clear that I was not authorised to negotiate, but that this was an opportunity to better understand each other's perspectives. I explained for our part that ministers were clear, that, if necessary, they would invoke the provisions within the contract for public ownership, and that it was highly concerning that CBC no longer viewed their responsibilities under the recently agreed loan agreement as viable. Our starting point was that we had signed the agreement in good faith, and did not see that circumstances had changed materially since then. We expected CBC to honour their obligations. Ministers' priorities remained the ferries, the jobs and the yard.

[REDACTED]
[REDACTED]
[REDACTED] [REDACTED]
[REDACTED]
[REDACTED]

[REDACTED] I asked Jim if CBC were looking to exit from the business by this route. Jim was adamant that this was not the case, and he cited two positive developments that demonstrated CBC's continuing interest in the future of FMEL. One was the signing of a further contract (in addition to the hoverbarge described when I last met him), a fisheries vessel for Inverlussa. A second fisheries vessel contract was imminent. [REDACTED]

[REDACTED] [REDACTED]
[REDACTED]
[REDACTED] [REDACTED]
[REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

[REDACTED] I reminded Jim that SG had to maintain compliance with state aid requirements and to protect tax payers' interests. Jim intimated that he would be prepared to consider CBC debt ranking alongside ours, *pari passu*.

Jim rehearsed his familiar concerns with the ferries contract, describing FMEL as "a sound business with a good future burdened with a bad contract". I reminded Jim of all the previous discussions about the contract, and that, if as he repeatedly stated,

there was a evidenced claim for further costs from CMAL, then FMEL needed to finalise that claim and submit it. As he was aware, a claim for the amounts that he had been suggesting had not yet been made. Jim confirmed that their claims advisers were still working and that they expected to be in a position to make their claim soon. He reiterated his request that SG as CMAL shareholder be actively involved. I reminded him that the contract is between CMAL and FMEL, and that CMAL had always been clear that, as with any contract, they would consider any claim made to them. It was, of course, open to FMEL to take a claim to the commercial courts.

In returning to the issue of the loan agreement, Jim confirmed that accounts were due to be published in the week of 4th December, and that these would show full provisioning for losses on the contract and the SG debt. I reminded him that it was open to CBC to take themselves out of breach by putting in (currently) [REDACTED] as equity; the alternative implied by the contract was that we begin the process of valuation. If CBC believe as strongly as implied in the future of the business and the strength of the claim, this seemed a very modest outlay to secure CBC's position with regard to the business. I confirmed that while CBC remained in breach, it was hard to see that we would be able to authorise any further drawdowns (there is an outstanding request from FMEL). I said that, in the event that ministers might be willing to consider any modification to the loan agreement, SG would need to see a compensating benefit for any reduction in our rights or relative rankings. I asked Jim what areas he could offer any benefit in. He said he could not immediately see any options but that he might be able to support a less onerous request – potentially seeking only a change to the nature of the [REDACTED] equity, making that as debt and ranking along ours (as referred to above) with the status of the subsequent equity of [REDACTED] remaining unchanged. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

I said that I would report back to ministers following this meeting and that we would be in touch. I made no commitment that we would consider any modifications to the loan agreement but said that it had been useful to understand CBC's position better and where there might be room for manoeuvre from CBC.

Comment

It was clear that CBC, or certainly Jim as a key player in CBC, is not seeking an exit from FMEL. He appears to be making significant personal efforts to develop the business. It was also clear from some of his comments that CBC is unlikely to be a cooperative seller. I also took from his tone that Jim remains personally invested in the future of shipbuilding and associated ports infrastructure, and is considering options to pursue those interests while potentially isolating the part of the FMEL business relating to the ferries contract. That would not be consistent with the intention of our loan to support diversification but also means that there may be a continued viable private sector interest in the sector. Given all of that, and the potentially positive new developments around new assets and contracts, ministers may wish to explore whether an acceptable modification to the loan agreement can be made, for example, restricting CBC debt to the [REDACTED] and asking for the full [REDACTED] to be made immediately (rather than on [REDACTED]). I took from the discussion

that CBC may be prepared to move from their original request to us and that making a counter offer may therefore be worthwhile, while maintaining our clear red lines.

Next steps

Officials to offer more detailed advice on alternative counter offers and proposed red lines following more work by our advisers, and also an update on their assessment of routes to public ownership.

Liz

DG Economy

OFFICIAL SENSITIVE – COMMERCIAL [REDACTED]

**ANNEX C – LETTER FROM DG ECONOMY TO CBC DATED 13 DECEMBER
2018 - RELEASED ON SCHEDULE**

ANNEX D

PWC NOTE ON AMENDING TERMS OF COMMERCIAL LOAN

This note is part of the advice under our engagement letter dated 27/11/17.

The advice is commercially confidential.

Background

Options – SG has asked us to provide comments on CBC’s proposal. The note relates to loan amendment only: we have separately provided our contingency planning report that covers options available to SG. However, SG should be aware that amending the commercial loan appears to be the only way to get non SG funding into the business. In the other options, SG appears to be the only funder available to meet the build costs of 801/2, whether or not they increase beyond the forecast level.

Forecasts – The latest medium term forecast included a £10m cost increase in the completion of 801/2. These forecasts assume the full £30m SG facility is drawn down (£17m drawn to date) [REDACTED]

[REDACTED] they also assume significant new work wins but no inflow from a cost price increase claim on 801/2. We believe that it is probable that the final cost for 801/2 will increase further but the quantum is unknown.

[REDACTED]

Urgency – You will be aware that prompt action is required from all parties on this matter as, based on FMEL continuing to trade at the level in its forecasts, FMEL will run of cash by 21 December 2018 and it has stated that it has now stopped paying suppliers and stopped placing certain orders. FMEL is pursuing the draw down request it has submitted. The loan amendment discussions are also relevant for the directors’ ongoing duties as they have stated they need comfort that FMEL has adequate funding and to allow them to finalise discussions with their auditors on the statutory accounts that are considerably overdue.

CBC’s proposal

In June 2018, as part of the agreement whereby SG provided a £30m loan facility, CBC agreed to:

- [REDACTED]
- [REDACTED]

This agreement was robustly negotiated at the time to ensure it was commercial.

CBC are now seeking to renegotiate this loan based on their explanation as follows:

- CBC cannot put additional equity cash into FMEL on the terms previously agreed as they consider they now cannot make the financial return expected by their investors; and
- CBC are now stating that they always considered the loan agreement to be fundamentally flawed in terms of its commerciality (even though its investment committee approved the loan terms at the time the loan was entered into).

CBC are now requesting that the loan agreement is amended as follows:

- the £3m will now be a loan (and not equity) and have the same ranking and return as SG's loan; and
- [REDACTED]

Follow up between CBC and SG

SG has corresponded with CBC and met with them on 17 October 2018 to discuss the position. [REDACTED]

[REDACTED] G met with CBC again on 28 November 2018.

Response

Given the loan was robustly negotiated over an extended period of time, we do not believe there is considerable scope for amendment and a commercial lender may reject any proposed amendments. However, if SG was strongly minded to explore the limits of what was possible, we would expect that a commercial lender would seek to obtain some benefit in return for amending the agreement and certainly the overall position of SG would not be worsened compared to the original loan.

When considering the ability of a commercial lender to amend the terms of the loan in this situation we are viewing this mainly through the lens of how a customer may act since SG will ultimately fund the costs of the vessels.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

We noted that SG asked for the full [REDACTED] to be injected immediately but this was strongly resisted by CBC.

Other funders and completing 801/2 – We have previously discussed whether other lenders or other owners could be identified for the business. We are not optimistic that this is possible but we believe it is appropriate to ask CBC to confirm its views and thereby build an audit trail that CBC agree the financial standing of the business and that there are no other options available to SG.

At the meeting of 25 October, we noted your concern that FMEL should be encouraged to complete 801/2 promptly. [REDACTED]

[REDACTED]

[REDACTED]

Management and monitoring – At our meeting of 25 October SG also noted that all possible efforts to enhance management should be taken. We discussed the following:

- The loan agreement allows a board observer to be appointed to FMEL now. This may not significantly improve SG's position given the monitoring currently in place but it appears sensible that this option should be invoked now to provide additional visibility on the key decisions of the board of FMEL.
- The CPI process is underway (FMEL expects a report in December) and FMEL has refused to provide information on it. The outcome of the process may significantly alter FMEL's financial position and therefore it is important that SG understands the status and possible outcome. FMEL may have concerns about sharing such information given it relates to a potential action

against CMAL but measures can be put in place to protect confidentiality such as only providing the information to SG's advisers.

- The appointment of an independent senior operational person to support the FMEL management team to deliver 801/2, particularly given the unexpected recent cost overruns of c.£10m, was raised by SG. We noted that FMEL expressed great concern when negotiating the £30m facility when we discussed appointing a SG proposed independent consultant / manager / director to provide operational support. We believe FMEL will express similar concerns at this time, notwithstanding the fact that we see this type of appointment used by other commercial lenders in similar circumstances. SG was keen that this was not seen by FMEL as further monitoring or supervision and that it was not an executive director position – instead it is intended and should be viewed as management support to complete 801/2 and to work with CMAL to ensure fewer problems going forward.

Nationalisation – SG should continue to reserve its rights to be clear that SG may still nationalise FMEL if it becomes insolvent as allowed by the existing loan agreements.

Timeline – We believe that any amendments to the agreements should be agreed in principle by 7 December 2018, agreed in detail by 14 December 2018 (with all parties seeking to keep suitable amendments to a minimum) and funds available from both funders by 21 December 2018, in order that FMEL's position can be regularised.

Conclusion

The principle is that if SG gives up something of value, then it will need to get something back.

We would note that one factor supporting the commerciality of the loan when it was first provided was that CBC (a private sector body) was prepared to invest £8.5m. CBC remains willing to make this investment.

If CBC were to agree to the response set out above, it would bring forward the £3.0m funding and SG would still be repaid in first in all but an insolvent scenario. In an insolvent scenario, SG retains the ability to nationalise the business. The loan agreement will require amendment to retain this right in non-insolvent scenarios.

ANNEX E

SG NEW RELEASE

27/06/18 16:30

Support for Scottish shipbuilding

Loan to help Clyde shipyard diversify business.

The Scottish Government will support commercial shipbuilding with a £30 million loan to provide working capital, alongside investment from Clyde Blowers Capital, to help Ferguson Marine Engineering Limited (FMEL) diversify its business.

The loan will enable the shipyard to target investment in repair and maintenance capability and to win business opportunities in areas like ship servicing and repair, low carbon marine projects and decommissioning work.

Finance Secretary Derek Mackay said:

“Commercial shipbuilding on the Clyde has a long and proud history, and it is essential that we continue to support this important industry and help it reach its full potential.

“This investment allows FMEL to further diversify their business by moving into innovative areas, like low-carbon marine projects, and target decommissioning work.

“The loan is a strategic investment in our industrial capability as both the marine engineering sector and commercial shipbuilding have vital roles to play in Scotland’s future.”

Background

Ferguson Marine Engineering Ltd (FMEL) is a commercial shipbuilder and marine engineering firm operating on the Clyde.

- FMEL were brought out of administration by Clyde Blowers Capital in 2014, and subsequently won the contracts for design and build of the vessels known as hulls 801 (MV Glen Sannox) and 802, in 2015 and delivered the MV Catriona in 2016.
- The dual fuel ferries project has boosted commercial shipbuilding on the Clyde, securing existing jobs in the Port Glasgow and Inverclyde area, and creating additional employment opportunities, including new apprenticeships.