

**Cabinet Secretary Finance, Economy and Fair Work**

**UPDATE ON OPTIONS IN RELATION TO FMEL AND HULLS 801/802 FOLLOWING RECEIPT OF THE INDEPENDENT VIEW**

**Purpose**

1. To provide an update on the evaluation of the most recent Proposal offered by CBC/FMEL, to consider the recommendation to reject the proposal, and to agree next steps.

**Priority**

2. URGENT.

**Background**

**Independent view**

3. A dispute has arisen under the contract between CMAL and FMEL for the design and construction of two ferries totalling around £100 million. This has been underway for c18 months. In an attempt to break the deadlock between the two parties and inform the options for Scottish Ministers, an independent view was sought to determine whether there is any legal basis for the claim. This was received on June 14<sup>th</sup>.

[REDACTED]

5. The outcome of the independent view was shared in strict confidence with CBC and CMAL on 21 and 24 June respectively. As part of confirming the outcome we offered CBC/FMEL the opportunity to meet to discuss next steps.

**Discussion with CBC since sharing Independent View**

6. Officials met with CBC on 24 June. CBC had made it clear to Ministers in advance of this meeting that they would put forward an alternative proposal to public ownership as a way forward that would enable CBC to retain an interest in part of the business whilst financing the completion of the vessels.

7. CBC put forward a written proposal on 24 June. Following initial consideration we responded to this with two separate letters. The first response covered aspects of the written proposal and points made verbally in the CBC presentation on 24 June, elements of which CBC have now suggested are not part of their proposals. The second letter was focused on the written outline.

8. Our responses to CBC set out the significant state aid and procurement hurdles that would need to be addressed for the proposal to be considered legally compliant.

9. Following receipt of our letters, Mr McColl requested a meeting with Mr MacKay which took place in SAH on 26 June with DG Economy (and Chris Wilcock from TS). Mr McColl outlined his position again and indicated that he felt SG was not working in a solutions focused manner and was presenting obstacles that could be worked through. It was countered that SG had to operate in an legally sound manner and the state aid and procurement issues were not matters that could be dismissed – and that indeed CBC had brought its own restrictions to the table with its constitutional position that it would not invest further in the business (including the £■■■■m equity that was a conditional part of the loan agreement).

10. Mr Mackay confirmed that officials and advisors should meet with CBC to further discuss the proposals with a view to finding a solution if at all possible. A meeting took place on 27 June with CBC, TS and SG officials and lawyers from both parties. In addition, direct engagement between respective legal teams has been ongoing.

11. Separately, Mr Wheelhouse met with CMAL along with SG and TS officials on 26 June. CMAL confirmed that they will need to take a decision on whether or not to commence a process to cancel the contract and call the bonds by week commencing 8 July at the latest. They confirmed that they are acutely aware of the need to maintain confidentiality at this point, and of the sensitivities around engaging with CBC/FMEL on this matter.

## **CBC Proposal**

12. There has been considerable flux in the figures and information around the proposals across the engagements since 24 June. However an updated proposal was received on June 28<sup>th</sup> and this has formed the basis of our evaluation.

13. Key elements of the proposal can be summarised as follows:

1. FME(H) sets up a Newco (Ferguson Marine Engineering Technology Company Limited).
2. FMEL transfers all of its assets and liabilities (other than the contracts for 801 and 802) to NEWCO.
3. With the consent of CMAL, FMEL enters into a subcontract with NEWCO to complete the vessels.
4. SG converts £10m of its loan in FMEL into equity in FMEL and FMEL assigns the balance of the £5m of the existing £15m loan to FME(H). Interest would cease to accrue on the loan and warrants would be issued.
5. SG then invests a further £50m into FMEL to give it 95% of the equity in FMEL. FME(H) retains the balance.
6. The bond for 801 will cease on 31 July 2019. The 802 bond would roll off 31 December 2019. Neither bond will be extended as there is no contractual obligation to do so. Once both bonds have expired, the surety is released with the £5m currently being held in Escrow then being available for use in the group. FMEL would seek to have some of this cash collateral released on the expiry of the 801 bond. They propose that SG would take first ranking security for its £35m



[REDACTED]

[REDACTED]

[REDACTED]

### **VfM considerations**

24. Information underpinning the Value for Money considerations is set out in more detail in Annex A.

25. CBC have continued to assert that their proposal is at the least cost to complete the vessels. This includes a factor for any disruption to the business as a result of insolvency event or change of ownership that would lose key personnel and disrupt the supply chain.

26. However, there is considerable uncertainty around the cost and time to complete under the CBC model. Taking aside the increases in costs that have led to the current situation, there has been considerable changes in figures even in the space of the discussions since the 24 June as outlined in the table in Annex A. This gives little confidence in the figures provided.

27. Our advisors have also undertaken an analysis of the likely cost to complete under different routes to public ownership and retendering scenarios. This also indicates that completion under public ownership or through administration is a comparable cost, however this will be subject to negotiations with HCCI.

28. Other vfm considerations include the lack of transparency over the value of any assets and liabilities currently held by FMEL and the absence of further protections for Ministers to offset any further equity injection.

### **Accountable officer considerations**

29. In parallel to the advice on the legal position for consideration by Scottish Ministers, there is also a requirement for any proposal to satisfy the Accountable Officer tests as set out in the SPFM for both the CEO of TS (in relation to the CMAL responsibilities and requirement for the vessels) and DG Economy (in relation to the overall SG investment including the existing and proposed further investment in FMEL).

30. Similarly to the legal position around this, the consideration around compliance with State Aid and EU Procurement law is also paramount, alongside the VfM tests. The AO responsibilities are addressed below:

### Propriety

- The proposed structure, splitting the business with all the assets held under private sector ownership and the contract liability held by primarily the public sector, together with the nature of the procurement risk whereby the structure could appear to be a device entirely designed to circumvent procurement rules, raise significant propriety concerns.
- FMEL have already failed to meet their obligations (to invest a further [REDACTED]m) under the existing loan agreement. In these circumstances, and considering no further protections are being offered under this proposal it is difficult to see a basis for Ministers to enter into a new, less favourable, arrangement.
- Additionally, the further injection of equity by SG could appear to reward failure by the private sector operator.

### Regularity

- The advice received indicates that any further investment in FMEL through the model proposed would not be MEOP compliant. This is further supported by the fact that CBC have stated that they, as a commercial investor, would not put further monies into the FMEL structure (including the £[REDACTED]m due through the existing loan agreement).
- There are also risks around a procurement challenge should a third party take the view that the equity injection was a means to bypass the procurement restrictions.. On this basis the regularity test would not be met for DG Economy. The TS CEO AO test would also not be met given the risks arising from a procurement challenge (in relation to the existing CMAL contract with FMEL that could be challenged).

### Value for Money

- Through the existing loan agreement, Scottish Ministers can achieve full ownership of FMEL Holdings group and the analysis from our advisors indicates that costs associated with completing the vessels under public ownership could be comparable with the proposals outlined by CBC.
- A further key element in assessing VfM is cost certainty. We currently do not have confidence in this figures offered nor do we have any certainty of delivery dates or overall cost. It should be noted that the projected overall cost has changed several times in the past few months as have the advised delivery dates. No plan was provided to substantiate these cost or delivery projections. We have also asked for further diligence around the wider liabilities of the company (that apply in all scenarios).
- On the basis of the above, the proposal from CBC would not meet the VfM test for either DG Economy or the TS CEO AO.

31. This advice has been prepared in discussion with State Aid, Finance and SGLD colleagues. [REDACTED]

## Recommendation

32. On the basis of the analysis done by our external advisers and by SG officials, we recommend that the proposal from CBC is rejected. The proposal carries unacceptable levels of risk in terms of both procurement rules and state aid considerations. Even if the very significant legal impediments were overcome, there is no compelling value for money case for the proposal. Furthermore it would not be acceptable to enter into a new agreement to benefit an organisation that has already failed to meet its obligations under the existing loan agreement.

## Bond position/HCCI view

33. PWC and TS/SG had spoken to the Bond holders HCCI who confirmed they would be willing to extend the bonds for 1 month mainly predicated on availability of its key staff over the coming weeks without a fee. **CBC have confirmed that the Surety has signed the extension of the bonds.** This would extend the bonds to 31 August. The original paperwork has still to be received and signed by FMEL and CMAL

34. It should be noted that there is a (reduced) risk FMEL may not elect to finalise the extension of the bonds. This is entirely within their gift and they cannot be compelled to do so – although it is positive that they have acted so quickly on this. In this event, it is likely that CMAL will wish to commence a process to terminate the contract by July 8<sup>th</sup>. CMAL require sufficient time to give notice to terminate the contract and allow FMEL to repay any payment to date (which they cannot do) and then move to notify the bond holder to call the bonds. Their advisors have indicated that sufficient time must be allowed to accommodate any delays in the process without the bonds expiring. In addition, in this scenario, we would need to accelerate our discussions with HCCI (as creditor) – likely seeking a meeting with them later this week.

35. Should the bonds be extended, CMALs agreement would be required to delay this process for a further month, in the absence of any other options emerging in the meantime.

## Next Steps

36. Over the coming days we propose to undertake the following actions:
- Meet with CBC – presenting the benefits of extending the bonds and continuing to work with SG to deliver the most advantageous solution for the yard going forward. This could include references to the benefits of CBC's involvement to date.
  - Write to CBC confirming that this proposal is being rejected. Hard copies of this letter will be provided to CBC during the meeting referenced above. Confirm position on Bonds with FMEL
  - Confirm timing of meeting with HCCI.
  - Meet with CMAL to advise them of our next actions.

The information from these meetings will assist us in determining the optimum vfm proposal over the coming weeks. Further advice will be prepared over the course of the next few days to provide feedback on the outcome of the above meetings.

## Handling

37. It will be important for us to work in partnership with CBC and FMEL on the next steps to minimise uncertainty to the workforce and delays to the delivery of the vessels.

[REDACTED]  
[REDACTED]  
[REDACTED] We will also continue to work with CMAL on the actions required of them.

38. SG will not seek to proactively put any information around this into the public domain until further steps have been considered (advice to follow).

39. However, CBC/FMEL may take the decision to make public comment on this, criticising the SG for not agreeing to its solution. We will prepare updated press lines to address this (including that we have given the CBC proposal detailed consideration).

40. Depending on CBC/FMEL reaction to Scottish Ministers response to their proposal, we may want to keep the option of further interim engagement with the unions under review (in advance of a formal decision on public ownership).

41. As previously discussed with Ministers, updates to Parliament will be provided once a final decision on the future of the yard has been taken.

## Recommendation

42. Ministers are asked to;

- **Note the detailed advice in this submission and its Annexes**
- **Agree the recommendation to reject the CBC proposal**
- **Confirm they are content for officials to meet with CBC on Thursday , July 4th to confirm the analysis and rejection of the proposals**
- **Confirm that a letter from Ministers will be issued to CBC during that meeting with officials , formally rejecting their proposal.**
- **Confirm that they are content with the handling plan.**
- **Note that further advice will be issued on the next steps later this week (including the option of public ownership).**

**Michelle Rennie, Transport Scotland**  
**Liz Ditchburn, DG Economy**

| Copy List:                                      | For Action | For Comments | For Information    |                  |                   |
|---|------------|--------------|--------------------|------------------|-------------------|
|   |            |              | Portfolio Interest | Constit Interest | General Awareness |
| First Minister                                  |            |              |                    |                  | X                 |
| Deputy First Minister                           |            |              |                    |                  | X                 |
| Cab Sec Finance, Economy and Fair Work          | X          |              |                    |                  |                   |
| Cab Sec Transport and Connectivity              |            |              | X                  |                  |                   |
| Minister for Energy, Connectivity and Islands   |            |              | X                  |                  |                   |
| Minister for Public Finance and Digital Economy |            |              |                    |                  | X                 |
| Lord Advocate                                   |            |              |                    |                  | X                 |

**Officials and SPADS as per cover email.**



**ANNEX A – PWC/MacRoberts summary (separate email attachment).**