
From: Transport Scotland Secretariat
Sent: 11 May 2017 18:35
To: Cabinet Secretary for Finance, Economy and Fair Work
Subject: Submission on FMEL 11 may 2017

[Redacted] / Cabinet Secretary for Finance and the Constitution

Please find attached urgent submission from Roy Brannen

Annex A Submission of 29 April

Annex B Payment Schedule Spreadsheet

Many thanks,

[Redacted] PS/Transport Scotland| Chief Executive's Office|Transport Scotland [Redacted]

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From: Roy Brannen
Chief Executive
Transport Scotland
11 May 2017

Cabinet Secretary for Finance and the Constitution

**FERGUSON MARINE ENGINEERING LTD (FMEL)
CASH FUNDING SITUATION - OPTIONS**

Purpose

1. To update you on proposals for re-profiling stage payments in respect of the two 100m vessels, and to invite you to agree that CMAL should bring forward up to £14.55m payments from 2018/19 to this financial year, making payments in May and June 2017 against equipment and materials purchases and attributable staff costs.

2. This advice has been cleared by DG Economy, DG Finance, SGLD and with input from colleagues across Scottish Government and Transport Scotland.

Priority

Urgent

Background

3. You accepted the advice in my submission of 29 April (attached at Annex A). You have also asked officials to consider any further options of support or investment, outwith the contract that would enable the yard to manage the cash profiling issues it is facing. Separate advice will be provided on this.

Update

4. As reported in Mary McAllan's note of 5 May, CMAL/TS and FMEL met on 4 May to discuss re-profiling, and "in principle" agreement was reached on a way forward. The key elements are as follows:

- The surety bond remains in place and is unchanged.
- the existing contracted milestone payments remain in place. The only adjustments are to the final delivery payment. £14.55m of this will be available to be paid against new equipment and materials milestones in the months of May and June 2017. This includes payment for major equipment purchases in April. More detail on this is below under "Milestone payments".
- The original final delivery payments were 25% (£24.25m) of the Contract Value and will effectively be reduced to 10% (£9.7m), the difference being the £14.55m.

[Redacted]

Milestone payments

5. Existing and proposed milestone payments are set out in the attached payment schedule (Annex B). This shows that existing milestone payments become due at particular points during the construction process – e.g. at certain stages of fabrication, hull inspection, launch etc. [Redacted]

6. What is now proposed is that up to £14.55m (shown by the yellow highlighted lines in the spreadsheet) is brought forward to May/June 2017 from the delivery payments due in May and July 2018. This has the effect of reducing the delivery payments to £4.85m for each vessel as shown in the spreadsheet.

7. [Redacted]

In addition, CMAL have sight of more detailed breakdowns of a large number of smaller items, and will continue to closely monitor this with FMEL. Once the items are purchased by FMEL, CMAL acquires title to them so that, in the event of the yard failing, CMAL have access to the components in order to continue with the vessel construction.

8. The process of allowing monies to flow from CMAL to FMEL will involve CMAL being provided with a list of items that are to be purchased by FMEL, which CMAL will then check to ensure that they are attributable to either 801 or 802. CMAL will only allow advancement of funds to be used for the construction and development of the vessels. CMAL will then cross reference the payments with FMEL's bank statement to identify amounts and to whom they have been paid, in order to ensure that the funds are flowing to suppliers. It is CMAL's expectation that the costs of the necessary equipment, materials and wages will total £14.55m, but this will be monitored closely, including by weekly meetings with FMEL.

9. CMAL's assessment is that if the £14.55m was not made available to FMEL in May/June 2017, the yard would be unable to purchase the necessary equipment and materials and there would be a high risk that construction of the vessels would stop

Legal and procurement advice

10. [Redacted]

State aid

11. [Redacted]

Financial advice

12. Should the request to advance milestone payments be agreed, the financial impact for Scottish Ministers would be to advance payments of £14.55m from 2018-19 to 2017-18. SG Finance has confirmed that, given the scale of the overall capital programme that this pressure can be managed corporately within SG and is therefore affordable. This additional funding would first be sought from any underspends that emerge in other transport projects with any balance being managed outside of the transport budget.

Accountable Officer consideration

13. I previously advised that a re-profiling of payments of up to £14.55 million could be possible, subject to detailed consideration of the proposal and its effect on the economic balance of the contract. Given the subsequent advice received, our need to maintain appropriate milestones for the completion of the vessels and the appropriate management of risk I am satisfied that Ministers could agree to the additional milestones to accelerate payment of the £14.55m as outlined above. This recommendation is made on the basis that the economic balance of the contract is not altered to the extent that the risk of challenge is heightened.

14. In reaching that conclusion, I have also taken into consideration that the continuation of the surety bond and the reduced delivery payment provide sufficient financial protection and incentive until the end of the contract to complete the vessels and therefore maintain adequate leverage over FMEL to point of delivery.

15. From a value for money perspective, the overall payments due under the contract remain unchanged and I am satisfied that such an arrangement, offset against the risks identified with the failure to deliver the two vessels and the potential wider failure of the yard represent value for money for the taxpayer.

16. With respect to the contract for the two vessels, the assessment is that this is the maximum flexibility that can be recommended to ministers at this time

Recommendation

17. Against this background, and having considered advice from CMAL and SGLD, I am satisfied that the changes proposed are compatible with procurement regulations and state aid requirements and that any risk of challenge is minimised. I therefore invite you to:

- Note the update on developments set out above, and the key terms of the proposed arrangements between CMAL and FMEL
- Agree that SG should make available to CMAL an additional £14.55m in this financial year brought forward from 2018-19 so that CMAL may accelerate milestone payments to FMEL which will now be made in May and June 2017
- Note that the proposed changes will be subject to a contract variation laying out what additional oversight CMAL will have to ensure that there is adequate protection to the workforce, sub-contractors and suppliers to ensure they are paid and paid timeously.
- We will review the detailed contract variation between CMAL and FMEL to check that there are no procurement or state aid issues.

Roy Brannen
 Chief Executive
 Transport Scotland
 11 May 2017

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constituent Interest	General Awareness
First Minister Deputy First Minister and Cabinet Secretary for Education and Skills					x

Cabinet Secretary for Economy, Jobs and Fair Work Cabinet Secretary for the Rural Economy and Connectivity Lord Advocate Minister for Transport and the Islands					
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Permanent Secretary DG Economy DG Finance [Redacted] PS/Transport Scotland; Director of Financial Management Transport Scotland Directors [Redacted] Rollison R (Richard) McAllan M (Mary) [Redacted] Lloyd E (Elizabeth) McFarlane J (John) Higgins K (Kate) Maxwell S (Stewart) (Special Adviser) McAllister C (Colin)

ANNEX A – SUBMISSION OF 29 APRIL 2017:

Cabinet Secretary for Finance and the Constitution

From Roy Brannen
Chief Executive
Transport Scotland

FERGUSON MARINE ENGINEERING LTD (FMEL) CASH FUNDING SITUATION - OPTIONS

Introduction

1. Further to the advice previously provided on 13 April 2017 and 24 March 2017 from Graham Laidlaw we undertook to seek further advice from CMAL regarding the legal, technical, procurement and financial issues arising from the request from FMEL in respect of the potential removal of the Surety Bond and the bringing forward of stage payments to a different milestone schedule than that set out in the contract.
2. Further advice is set out below. This has been cleared by DG Economy, DG Finance, SGLD and with input from colleagues across Scottish Government and Transport Scotland.

Legal and Procurement Advice

3. Redacted]
4. [Redacted]
5. [Redacted]

Technical Advice

6. Vessel 801 steel work has reached 79% and vessel 802 has achieved 57% steel fabrication. During March 2017 there were severe concerns raised by CMAL about the progress of both vessels 801 and 802. At that time both Hulls were some 3.5 months behind schedule and there were no credible plans being offered to CMAL in regard to achieving the delivery dates.
7. Clyde Blowers appointed a Project Management Team in order to look at every aspect of the new build project to date and also put into place credible plans to achieve delivery dates that were in line with the contracts. A revised strategy has been adopted by the FMEL team in order to address the delays and improve performance. In essence the performance and output of the shipyard is monitored daily and the FMEL and CMAL Team are able to see the progress against the plan.
8. The revised strategy is based on the principle of completing vessel 801 at FMEL in its entirety with a launch date set at 24th August 2017 allowing some 9 months to complete the vessel and achieve delivery. The revised strategy for vessel 802 is to launch the vessel (date set at 17th November 2017), it will then be towed to Inch Green, Greenock for completion. The plan is also to commence the aluminium topside of the vessel (passenger and crew accommodation plus bridge etc) at Inch Green in advance

of the Hull being towed to the location post launch – this is due to commence in May 2017.

9. There is now an identifiable plan for each vessel but it will demand a “Herculean” effort to get the projects back on track. It is also reliant on excellent Project Management skills and there cannot be any form of delay in regard to the “on time delivery” of major component parts. Whilst CMAL still have concerns about the contractual delivery dates, there are positive signs that the overall management of the shipyard has improved by the application of additional senior resources.

10. Clearly any subsequent agreement with regard to a revision of milestones will only assist if FMEL can deliver against the agreed programme.

Financial Advice

11. Analysis provided by CMAL suggests potentially that FMEL will incur losses in respect of the contract for the two ferries and, given the investment made in yard infrastructure by FMEL since taking over the business, confirms that there are difficulties to be managed by the business and risks associated with the completion of the two vessels.

12. Should the request to advance milestone payments be agreed (subject to legal and procurement considerations above regarding acceptable economic balance) the financial impact for Scottish Ministers would be to advance payments **up to £14.55 million** from 2018-19 to 2017-18. SG Finance has confirmed that, given the scale of the overall capital programme that this pressure can be managed corporately within SG and is therefore affordable.

13. Taking into account the advice received, the challenge therefore is to explore what support would be appropriate to FMEL to ensure the business remains stable to allow the continued progression towards completion of the two contracted ferries on CMAL’s behalf whilst maintaining a prudent and legally compliant position and demonstrating value for money for the taxpayer in avoiding any potential failure.

Accountable Officer Consideration

14. In providing advice as Accountable Officer I am required to consider the propriety, regularity and value for money of any proposed course of action. In order to form a view in this regard my advice reflects advice and input from Transport Scotland, SGLD and SG Finance.

15. My advice has considered the propriety and regularity issues with regard to the significant risks of challenge of any substantive changes to the Surety Bond arrangements requested. Given the legal advice received I cannot recommend any such relaxation. In addition, given the significant risks and potential liabilities to which

Ministers would be exposed I cannot recommend a course of action whereby SG surety over the yard would be an acceptable proposal.

16. Notwithstanding the legal advice received I have also had to consider the precedent this would set given an on-going vessel replacement programme, industry norms and the need to protect interests moving forward. In addition, any such arrangement would represent a contingent liability and under the terms of the Scottish Public Finance Manual would be subject to notification to the Scottish Parliament.

17. With regard to the request for the re-profiling of milestone payments, given the advice received and our need to maintain appropriate milestones for the completion of the vessels and the appropriate management of risk I would be content to recommend that CMAL work with FMEL on a revised list of additional milestones to accelerate payment while ensuring that the economic balance of the contract is not altered to the extent that the risk of challenge is heightened. If such an agreement can be satisfactorily reached, a key component will be retaining sufficient financial incentive until the end of the contract to complete the vessels and therefore maintaining adequate leverage over FMEL to point of delivery. The retained position with regard to the surety bond ensures significant safeguards in this regard. The timing and quantum of payments to FMEL to have input from SGLD, Procurement and State aid colleagues to minimise the risk of challenge and to maintain an appropriate level of security over on-going construction of the vessels

18. From a value for money perspective, the overall payments due under the contract remain unchanged and I am content that such an arrangement, offset against the risks identified with the failure to deliver the two vessels and the potential wider failure of the yard represent value for money for the taxpayer.

19. I would highlight however that in recommending such a course of action, I believe that there remains a risk that such additional flexibility offered (on top of that already given) may not be sufficient to alleviate all of the cash flow risk to which FMEL is exposed. However in respect of the contract for the two vessels, my assessment is that this is the maximum flexibility that I can recommend to ministers.

Recommendations

20. Consequently, and drawing on the advice from CMAL and SGLD, it is suggested that the viable options available or the recommended course of action for Ministers are;

- not to accede to FMEL requests for a change to the Surety Bond
- not to accede to FMEL suggestion of Scottish Ministers being provided surety over the yard in the event of failure of FMEL.
- CMAL work with FMEL on a revised list of additional milestones to re-profile payment (up to £14.55m) while ensuring that this does not unduly alter the economic balance of the contract, and that there is still appropriate commercial

leverage over FMEL by retaining sufficient financial incentive at the end of the contract to complete the vessels.

- The timing and quantum of payments to FMEL to have input from SGLD, Procurement and State aid colleagues to ensure compliance with procurement regulations, state aid requirements and thereby minimise any risk of challenge and to be signed off at AO level across SG.
- Subject to successful negotiation of the above point, that the Scottish Government to provide additional budget allocation to CMAL in 2017/18 to make the earlier payments to FMEL.
- That any variation is subject to a contractual addendum laying out what additional oversight CMAL should have if there are any changes to the contract to ensure that there is adequate protection to the workforce, sub-contractors and suppliers to ensure they are paid and paid timeously.

21. Any such agreement should be on the proviso that no further financial support for the delivery of the vessels beyond that agreed in the contract will be considered.

Next Steps

22. Given the urgency attached to this by Mr McColl I would welcome your early views.

ROY BRANNEN
CHIEF EXECUTIVE
TRANSPORT SCOTLAND

Ext [Redacted]

Copy to

First Minister
Deputy First Minister and Cabinet Secretary for Education and Skills
Cabinet Secretary for Economy, Jobs and Fair Work
Cabinet Secretary for the Rural Economy and Connectivity
Minister for Transport and the Islands

Permanent Secretary
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DG Finance
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