Advisory

Project Kildonan – (previously known as Project Kingfisher) Interim update on options review

Strictly Private and Confidential

1 March 2019

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[redacted]

[redacted]

[redacted]

Dear Sirs

We provide an interim report on the options review for Ferguson Marine Engineering Limited (the "Company" or "FMEL") in accordance with our agreement dated 19 February 2019.

This report has been prepared in connection with the purpose, as stated in the agreement, to allow Transport Scotland to provide an interim update to Scottish Ministers on the progress of our work and visibility on the long list of potential options available to Scottish Ministers. All sections of the report should be read together.

This is an interim report. Our work is not complete and the comments in this interim report are therefore subject to amendment or withdrawal. Our definitive findings and conclusions will be those set out in the final report.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

Yours faithfully

[redacted]

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Understanding of costs to complete

FMEL is forecasting further cost increases on 801/2 i.e. a total cost of [redacted] including costs to complete of [redacted]

CMAL believes that the future costs may be in the order of [redacted] if FMEL completes the builds efficiently.

Both parties believe that the vessel should be completed in Port Glasgow. CMAL estimates that building a vessel elsewhere would increase costs to complete to [redacted]

PwC view

It is difficult to accurately estimate the costs to complete but FMEL has repeatedly shown that it cannot make such an estimate. We expect that the costs to complete will be in excess of [redacted] and could be in excess of [redacted]

Current status of FMEL

SG has provided £45m of commercial loan funding to FMEL and CBC has provided £3m of loan funding in January 2019 in addition to its equity investment.

Total final costs on the CMAL vessels, as estimated by FMEL, have increased from [redacted] and FMEL expects that they will increase further.

New orders totalling [redacted] have been contracted in the last 6 months but more need to be signed up as part of the steps to make the business viable.

FMEL has noted that its latest medium term cash flow shows that it will run out of cash in June 2019 unless it takes steps to mitigate cash flows. Management states it will have to mitigate cash outflow by reducing headcount and therefore production by the end of March 2019.

The precarious financial position of FMEL is well publicised in the media following the filing of the accounts and various press articles.

Costs to complete

FMEL's latest projections note costs to complete of [redacted] but management believes that these are likely to increase.

Timeline of key dates

2019

1 March 2019 - today

31 March 2019 Directors request visibility of funding or they will take action to limit FMEL's liabilities

June 2019 Management projects that FMEL will run out of cash unless mitigating steps are taken

October 2019 FMEL is now projecting that 801 will be delivered in October rather than the previous estimate of June 2019. It has refused to guarantee this date.

2020

June 2020 FMEL is now projecting that 802 will be delivered in June rather than the previous estimate of March 2020. It has refused to guarantee this date.

CMAL does not have a detailed understanding of the financial position of FMEL to be confident that it has a more accurate estimate but it believes that the cost to complete may be [redacted]

CMAL has stated that the labour element of these costs could be 50-100% greater if the vessels are not built at the yard which could increase the costs to [redacted]

As noted above, these estimates largely vary on where and by whom the work is completed rather than on the source of the funding for the work.

CPI claim

FMEL has submitted a CPI claim to CMAL and the outcome is unknown.

We understand from FMEL that the CPI claim has a value of [redacted] for work to 31 August 2018. A further claim will be lodged for costs that have arisen or will arise after that date and FMEL has stated it is unable to provide an estimate at this time. The CPI claim is not solely based on the costs to complete and so the [redacted] value should not be compared with the costs to complete.

This report considers the options available to SG should intervention be required.

Scope and process

Scope	Transport Scotland (TS) on behalf of Scottish Government (SG) has asked us to prepare an options appraisal for delivery of vessels 801 and 802 to Caledonian Maritime Assets Limited (CMAL) which are being constructed by Ferguson Marine Engineering Limited (FMEL). The criteria against which options are to be assessed are: • Delivery of contracted vessels; • Total cost to the SG of each option; and • Impact on the strategic and long term prospects for FMEL and/or broader ship building industry on the Clyde and across Scotland
Interim report due 28 February 2019	
Work undertaken for this interim report	We have undertaken a series of activities over the last two weeks to obtain a reasonable understanding of the options available. These activities include: • Kick off meeting with key stakeholders on 18 February 2019 including [redacted] and [redacted] from [redacted] from [redacted] and [redacted] from [redacted] covering scope and project timeline. • Conference call with [redacted] • Weekly calls with [redacted]. • Face to face meeting with [redacted] and [redacted] of [redacted] on 26 February 2019 exploring their forecast costs for completion of 801/2 and potential solutions they have considered. • Presentation of latest 801/2 projections from [redacted] and [redacted] of [redacted] on 26 February 2019, as well as discussions on potential solutions they have considered.
PwC specialists consulted	Consultations with [redacted], our [redacted] and our [redacted] We have also contacted our [redacted] to understand the background of the Chantier Davie Canada Inc funding.
Previous work	Our previous work to date is summarised in our report titled “Project Poseidon – options update” dated 16 November 2018
Final report due on 29 March 2019	
Expected output	The final report will include more detail on the key options selected by Scottish Government for further consideration.
Next steps	Our final report will include the outcome of the following further steps: • Meeting with [redacted] to cover issues learned from the East Coast Railway transfer to LNER • Providing examples of other UK government interventions • Considering the revised financial projections provided by FMEL on the 26 February 2019 • Considering potential insolvency structures, strategies and scenarios. • Considering potential nationalisation structures, strategies and scenarios. • Considering any other key options selected by SG.

Key options considered

The diagram opposite sets out the long list of options available to Scottish Government (SG). These are "funnelled", using SG's criteria, into propositions that could be progressed.

PwC view

If the CPI claim is not successful, and if CBC is not prepared to provide additional funding, and there are no significant new orders, then the viable commercial options available to SG are:

1. *Insolvency,*
2. *Nationalisation, or*
3. *Retender*

Contingency planning for a final report should focus on the potential scenarios associated with each of these options.

	Options	Criteria
Not considered deliverable	• Terminate contract • Terminate 802 only • Do nothing • Buy vessel elsewhere	**Vessel delivery** These options will not result in prompt delivery of 801/2.
	• SG/CMAL to provide funds • Rescue & restructuring aid • Joint venture • Contract renegotiated	**Legal*** There does not appear to be a legal route for these funding options.
	• Third party loan • CBC to fund • CPI claim • Solvent sale to third party	**Viability of FMEL** FMEL is not viable in its current form and consequently these options cannot be delivered.
Potential options	• Post Brexit competitiveness** • FMEL retender cost+ • 3rd party retender – fixed	**Significant cost to government** These options will incur greater costs to the SG than the residual options noted below.
	• Insolvency • Nationalise	The residual options will impact the shipbuilding sector in Scotland.

Note: the description of each of the options can be found on page 11.
*Whilst no apparent legal route today we do not preclude revisiting the point should there be a change in circumstances.
** Current advice is that there will be no change to state aid rules post Brexit.

Options (1 of 2)

The diagram on the preceding page shows the options that have been considered and those which we suggest should be progressed.

The commentary opposite explains the principles of why we believe certain options should not be progressed: it does not detail every option.

The table on the following page sets out the long list of options that have been identified. They have been colour coded against SG's three key criteria of: vessel delivery, cost, and impact on Scottish shipbuilding. We have also noted the execution risk i.e. the deliverability of the option.

PwC view

We do not believe that options, in isolation, based on current circumstances, other than nationalisation or insolvency, achieve SG's objectives of vessel delivery, minimising cost and protecting shipbuilding.

Scope

FMEL has a submitted a claim to CMAL for additional costs in respect of the contracts for 801/802 for the period to 31 August 2018. Commenting on the validity of this claim is outside our scope. However, if CMAL agreed to meet the full claim, (i.e. cost to date and any future cost) and settle in short order, it would significantly impact our analysis.

SG has not committed to a future pipeline of vessels. Commenting on this is also outside our scope but again such a pipeline (e.g. a £20m vessel every year for 10 years) would cause us to significantly amend our analysis if FMEL was likely to win such work.

Vessel delivery

Certain options, such as "do nothing", will not result in the vessels being delivered. Specifically doing nothing will invariably result in an insolvency. The contract could be terminated and retendered as new vessels but the tendering process and construction, assuming both run smoothly, are unlikely to result in vessel delivery in less than 3 years.

Legal

Even if SG was willing to provide funding, we have not been able to identify a mechanism for SG to provide funding to FMEL that would meet state aid and procurement law requirements. For example, given the previous negotiations on the existing loans, it would be challenging to describe another loan as commercial. Equally the contract would have to be amended materially to assist FMEL[redacted] Our view may alter if the situation changes.

Business viability of FMEL

Options that will allow delivery, but require third parties to be comfortable as to the viability of the business are inherently uncertain as we do not know third parties' attitude and the viability of the business is reliant on work not won, a pipeline not yet in place and resolution of 801/2 which is not yet agreed.

We believe that the execution risk associated with these options is too high: specifically we do not believe that a third party would provide any form of funding (debt or equity).

There does not appear to be an imminent agreement on the CPI claim. Even if the interim CPI claim was agreed at [redacted] these funds would be utilised in full meeting interest costs, contingent costs, and loan repayments leaving no significant funds for FMEL. However, as noted above, an agreement that covers all future costs (which are unknown) would change the analysis.

For example, a combination of options may be possible but this is likely to require the agreement of the full, unquantified CPI claim. One scenario could be where the CPI claim is substantially successful, and there is a meaningful order pipeline, then the commercial proposition for external debt to support the business is much stronger.

Options (2 of 2)

PwC view

The residual options will have a significant cost to SG and will have an impact on Scottish shipbuilding.

The various scenarios that could happen in each of these residual options should be outlined in more detail in our final report.

Cost to SG and impact on shipbuilding

Both FMEL and CMAL have noted that they do not believe that retendering the work to complete 801/2 is commercially viable as the costs are likely to be greater (50-100% greater per CMAL) than other options, and the tender process would take several months which would further delay 801/2. However SG may consider that the financial cost and delay to 801/2 may be less detrimental than the other residual options.

Conversely the residual options which we believe should be explored in detail are nationalisation and insolvency. Both have significant costs and uncertainties and both will have impact on Scottish shipbuilding.

Either could include combinations of other scenarios such as:

- Terminate 802; build out 801; then sell the yard to a private investor; or
- Build out 801/2; SG approves ferry pipeline; sale to a private investor; refinance.

Options matrix

	Option	Delivery	Cost	Ship-building	Execution risk
1	CBC to fund	G	G	G	R
2	CPI claim	G	R	G	R
2	Contract renegotiated	G	R	G	R
2	FMEL - retender cost+	A	R	G	A
2	Joint venture	G	R	G	R
2	Rescue & re-structuring aid	G	R	A	R
2	Post Brexit competitiveness	R	A	G	R
2	SG/CMAL to provide funds	G	R	G	R
3	Third party loan	G	G	G	R

Notes:
1. Option where CBC supports shipyard and funds delivery of 801/2 vessel
2. Options where SG supports FMEL
3. Option where third party supports FMEL
4. Options where a third party is used to deliver vessel
5. Options where SG takes control of the shipyard to deliver vessel(s)
6. Options where vessel(s) are not delivered

The description of options can be found on page 11.

	Option	Delivery	Cost	Ship-building	Execution risk
4	Solvent sale to third party	G	G	G	R
4	3rd party retender - fixed	A	A	R	A
4	Buy vessel elsewhere	A	R	R	G
5	Insolvency	A	A	R	G
5	Nationalise	G	A	A	A
6	Terminate 802 only	A	A	G	R
6	Terminate contract	R	A	R	R
6	Do nothing	R	R	R	R

KEY	Delivery	Cost	Ship-building	Execution risk
G	Likely delivery of 801/2	Low (estimated at [redacted]	Positive impact on future	Low – should be deliverable
A	Uncertain delivery of 801 and /or 802	Medium (estimated at [redacted]	Unknown impact on future prospects	Medium – risks to delivering option
R	Unlikely delivery of 801 and/ or 802	High (estimated at [redacted]	Negative impact on future prospects	High -likelihood of not being deliverable

801/2 cost

FMEL management provided the latest projections on 26 February 2019, including the 801 / 802 cost as shown opposite.

These have been produced on the basis that 801/2 will be delivered in October 2019 and July 2020 respectively, which has slipped further from original estimates.

There are no assumptions for a cost price increase.

FMEL management forecasts that cash will run out within the next three months.

These projections have not been reviewed.

FMEL 801 / 802 gross margin outturn forecast

[redacted]

These were filed in December 2018

Source: Management presentation as provided on 26 February 2019

Delivery of vessels 801/2	• In the September 2018 updated forecast, the delivery dates of 801 and 802 were expected to be June 2019 and March 2020 respectively. • The latest FMEL management projection on February 2019 has revised the delivery dates of 801 and 802 to October 2019 and July 2020 respectively. • Management notes that due to the ongoing claim dispute, these dates are likely to be revised again.
Updated contract cost as provided on 26 February 2019	• Comparing the 2019 budget with the 2018 updated forecast, the contract cost is expected to increase from [redacted] • This is driven by three factors: a [redacted] increase in direct labour costs and consumables; [redacted] increase in material cost and [redacted] increase in production overhead. As per the above table, projected hours booked have increased to [redacted]
Cash flow forecast	• FMEL management forecasts cash with run out in June 2019 unless corrective actions are taken. Management has confirmed that it would take steps earlier if funding is not secured by the end of March. We are still awaiting a 13 week short term cash flow.

Appendices

Description of key options

Option	Description
Terminate contract	CMAL terminates the contracts and no further action is taken by SG. The directors would likely have to mothball the yard and potentially appoint administrators.
Terminate 802 only	CMAL terminates 802 contract. They would withhold any further funding, which if provided would consequentially be used to settle the creditors of FMEL.
Do nothing	No action is taken. Again the directors would likely have to mothball the yard and potentially appoint administrators.
Buy vessel elsewhere	The current vessels 801/2 are discontinued and SG procures a contract to build new ships.
SG / CMAL to provide funds	Funding is provided, most likely through a commercial loan.
Rescue & restructuring aid	SG provides FMEL with state aid for rescuing and restructuring non financial undertakings in difficulty
Joint venture	SG, CBC and a third party enter into a joint venture to operate the yard with the third party providing some funding
Contract renegotiated	CMAL agrees to amend the 801/2 contract to allow greater value for FMEL e.g. open book costs are paid.
Third party loan	An alternative funder is identified.
CBC to fund	CBC agrees to provide FMEL with new funding which ranks behind SG.
CPI claim	CMAL agrees to pay FMEL the full [redacted] interim claim.
Solvent sale to third party	CBC sells the business to a third party which is prepared to fund the business.
Post Brexit competitiveness	The UK leaves the EU on 29 March 2019 without a deal and the UK Government agrees a series of measures to become more competitive such as removing the minimum wage.
FMEL retender cost+	CMAL retenders the work to complete 801/2 and FMEL is successful in winning a cost plus contract
3rd party retender fixed	CMAL retenders the work to complete both vessels and a third party agrees to do this at a remote site for a fixed price.
Insolvency	The directors appoint administrators who look to market the business for sale, continue work on 801/2 (funded by CMAL) and try to identify alternative ways of completing 801/2.
Nationalise	SG buys the business for [redacted] and funds completion of 801/2 under supervision of CMAL. SG investigates a sale back to the private sector and explores provision of a ferry pipeline.

Description of key options no longer considered

The following options have been considered previously and are no longer considered applicable as set out below:

Option	Description
Accelerating contract milestones	Further accelerating the milestones would require a contract amendment (with the related procurement law challenges) and, whilst it would allow FMEL to continue to trade for several more months, it would only buy time for a wider a solution to the funding shortfall
Debt for equity	SG's existing loans already provide for the conversion of debt to equity and this mechanism does not deliver 801/2 or address the funding shortfall
Diversify	This is what FMEL is trying to do but it does not deliver 801/2 or address the funding shortfall
Divest part of the business/ asset base	There are no other viable businesses within FMEL to sell
Financial transactions for new vessels	Whilst this would be positive for FMEL it does not deliver 801/2 or address the funding shortfall
Mackellar	This part of the business has now been closed
Mothball	This does not deliver 801/2 or address the funding shortfall
Purchase dry dock	Whilst this would be positive for FMEL it does not deliver 801/2 or address the funding shortfall
Replace or Amend HCC	Further amending the bonds would require a contract amendment and, whilst it would allow FMEL to continue to trade for several more months, it would only delay the requirement for a solution that dealt with the funding shortfall
SG asset purchase	The only asset that may have value is the yard. HCC would be required to release its security which would be unlikely. SG is already the second ranking creditor. Without a tenant, valuing the yard is challenging. If FMEL remained the tenant it would require funding to pay the rent
Tenants	Whilst this would be positive for FMEL it does not deliver 801/2, significantly address the funding shortfall and it is not believed that there are ready tenants
Turnaround	This is what FMEL is trying to do but it does not appear achievable nor does it deliver 801/2 or address the funding shortfall

Glossary

Our report includes a number of terms and short descriptions, which we define alongside

Term	Definition
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]