

From: Michael Grylls, M.P.

ccIG



HOUSE OF COMMONS
LONDON SW1A 0AA

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
The Prime Minister,
10 Downing Street,
LONDON SW1

29th July 1980

R30

Dear Prime Minister,

I understand there is a possibility that the Cabinet will consider on Thursday the two issues of compensation (under the Aircraft and Shipbuilding Industries Act 1977) and the related question of the de-nationalisation of the warship builders.

May I say first of all that I do have a personal interest in that I am a Consultant for Bryan Balls & Partners who, in turn, act for the Vosper Group, whose Chairman is Sir John Rix.

You may remember having seen a copy of a document I sent in May 'A Path to Fairness', which gave a number of ways in which the unfairness of the compensation terms could be resolved. Shortly after that I had a further document prepared by John Redwood, which outlines the various methods by which the pledge of de-nationalisation could be honoured. I did not send this on to you at the time as I did not wish to burden you with masses of papers.

However, it seems to me that on both issues there is a possibility that the Government's action will fall short of what it said in opposition. In this respect, I have had several discussions with Keith Joseph, but I am doubtful whether I have convinced him!

With the greatest respect, I think our failure to amend the terms of compensation are doing the Government's image great damage in financial circles and, knowing Yarrows and Vickers, as well as Vospers, I know they are bitterly disappointed at the Government's refusal to put right the injustice of Labour's compensation terms.

As far as de-nationalisation /

- 2 -

The Rt. Hon. Mrs. Margaret Thatcher, M.P.

As far as de-nationalisation is concerned, I am quite sure you are well aware of the arguments, but I thought you might like to glance briefly at the enclosed Report, as the matter seems to be coming to a head. In particular I would draw your attention to the summary and paragraph three, which sets out the disadvantages of warship building remaining in British Shipbuilders.

Maurice Macmillan is a non-executive Director of Yarrows and both he and I would, of course, be happy to talk with you at any time if you feel it would be helpful.

Yours ever,

Michael Grylls

Michael Grylls

Enc:

THE WARSHIP BUILDERS

HONOURING THE PLEDGE TO DENATIONALISE

John Redwood
April 1980

SUMMARY

- Paragraph I Sets out the timetable of nationalisation and the evolution of Conservative policy in favour of disposal of assets in British Shipbuilders up to the May 1979 election. It highlights the apparent reversal of policy since May 1979.
- Paragraph II Sets out the 4 options of (a) leaving all the companies within British Shipbuilders (b) offering the three warship builders back to their original owners (c) returning the three businesses to the market individually (d) formation of British Warshipbuilders as a united business with sale of shares to public, employees and industrial buyers.
- Paragraph III Sets out the disadvantages of remaining within British Shipbuilders. (a) lack of export growth in naval orders (b) management overstretched (c) businesses starved of cash owing to losses in rest of British Shipbuilders (d) PSBR - adverse effects.
- Paragraph IV Sets out the balance of advantage in returning the businesses to their original owners or selling the three separately.
- Paragraph V Examines the possibility of setting up a new company, British Warshipbuilders and selling shares in it.
- Paragraph VI Employee Participation. Recommends offers of shares to employees in any offer for sale of shares under options 2-4 above. ||
- Paragraph VII The Secretary of State's powers.

SUMMARY (cont'd)

Paragraph VIII Examines the opportunities for a private sector industry in improving the business.

Paragraph IX Concludes in favour of the sale of shares in a new company, British Warshipbuilders.

Appendix I Model for formation of 1948 Companies Act Company (Transport Bill 1980).

Appendix II PSBR effects of nationalised/privatised businesses.

WARSHIP BUILDERS

I

Timetable of Nationalisation and evolution of Conservative Policy

- 31st July 1974 Wedgwood Benn announced his intention to nationalise companies.
- 1st July 1977 Vesting Day for the transfer to British Shipbuilders.
- September 1973
to February 1974 The reference period for compensation purposes. In the case of a quoted company the base is the average share value during the period, for an unquoted company the equated share price.
- 1976 The Right Approach p.33
"The Government must set clear boundaries to the Corporations' spheres of action, without which there will remain the serious risk of unfair competition with the private sector. In some cases it may also be appropriate to sell back to private enterprise assets of activities where willing buyers can be found."
- October 1977 The Right Approach to the Economy p.47
"The long-term aim must be to reduce the preponderance of state ownership and to widen the base of ownership in our community. Ownership by the state is not the same as ownership by the people."
- April 1979 Conservative manifesto states intention to denationalise the warship builders businesses.
"We will offer to sell back to private ownership the recently nationalised aerospace and shipbuilding concerns, giving their employees the opportunity to purchase shares." Manifesto p.15.

July 1979

Conservative government vetoes the idea of returning warship builders companies to their original owners and concludes it is inappropriate at that juncture to introduce private finance into the shipbuilding industry.

August 1979

Naval Shipbuilders announce intentions to pursue their compensation claims more actively in the light of the Government's attitude.

The companies are still in a position of having lost a material portion of their assets but having no idea of the time or amount of the final settlement of compensation money. This has made corporate planning almost impossible and has meant that the businesses have been unable to pursue the policy of rebuilding their interests as they do not know how much cash will be available in order to do this.

In the case of Vickers the company has had to announce the sale of Roneo Vickers, an important office equipment subsidiary, owing to cash pressures on the group. This indicates the urgency of a need for a solution.

II

The options open to the Secretary of State

The Secretary of State for Industry has four principal options open in his approach to warship builders.

(a) The three companies could remain wholly owned subsidiaries of British Shipbuilders as they are at present. The compensation payments would have to be made to the three original owner companies following settlement.

(b) The three companies could be offered back to the original owners following agreement on, and payment of compensation.

(c) The three companies could be offered separately on a commercial basis to the highest bidders.

(d) A new company, say called British Warshipbuilders Ltd, could be formed to hold all of the warship building yards and related assets. Shareholdings in this company could then be sold to the public, employees and industrial shareholders in whatever proportions were deemed appropriate.

III

Option 1

The option to remain with British Shipbuilders seems undesirable for the following reasons;

(a) British Shipbuilders' management is overstretched in its efforts to deal with the varied problems throughout the group.

(b) In particular the sales effort going into warships is now insufficient to maintain the necessary momentum for this fiercely competitive international business. The export performance since nationalisation has been most disappointing.

(c) British Shipbuilders has financially overstretched itself and it is more likely that cash limits and financial targets in the financial year 1980/1981 will not be met. A government policy is not well disposed towards increasing subsidies towards businesses that fail to hit their targets one of the few remaining options is to sell assets. The warship building business represents in conjunction with selected ship repair yards obvious candidates for sale to deal with this problem.

The arguments that will be advanced in favour of maintaining British Shipbuilders control of the warship business are that;

i) They are profit making and contribute to the group
and

ii) Sale of part of British Shipbuilders' business will be disruptive.

These arguments have little force when it is remembered that the sale of such assets simplifies management's task rather than complicating it whilst the fact that the subsidiaries are profitable enables them to be sold for a reasonable sum of money.

The recent statements from British Shipbuilders have demonstrated that the tight cash limit regime coupled with the persistent losses of the merchant marine business are penalising the success of the warship business.

"Shortage of cash and the need to increase borrowing has entailed very stringent controls over capital expenditure. No major schemes were authorised during the year (1978-9) although £23m was spent on normal replacements and completion of schemes in progress when nationalised" (Chief Executive's review of operations Annual Report and Accounts).

The Chief Executive has therefore acknowledged that the warship business has not benefited from any major new capital spending scheme since 1977 as a result of its incorporation in the nationalised business. Coupled to this is the disconcerting lack of buoyancy in the order book for naval vessels where the year to March 1979 showed only 41 vessels ordered, the same level as the preceeding three years, and sharply down on 65 orders in the year to March 1975.

Completions have faired even worse with only 14 in 1978 compared with 24 in 1977. This decline in completions and declining orders is taking place against the background of a major rearmament programme for NATO and other non-communist countries.

Naval Completions and Order Books in number of Vessels

Naval Completions

<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u> <u>1st Q</u>
33	14	24	14	3

Naval Order book (total)

65	53	46	43	41
----	----	----	----	----

of which specialist Naval Yards order books

36	29	29	28	29
----	----	----	----	----

Within the general pattern of decline the specialist naval yards have performed relatively well in the naval sector.

(d) Finally, this option entails the heaviest public sector expenditure as there will be no capital receipts from sale of assets, and any increase in capital spending on naval shipbuilding (which is much needed in order to remain competitive) will be an additional burden on the PSBR.

IV

Option 2

To expedite the return of the companies to their original owners. Their record under private sector management was good and there is every reason to believe that the return to their original owners would i) simplify the corporate planning of those companies and ii) strengthen the British industrial position with regard to international competition in world wide markets and could aid improved efficiency in the supply of warships to the Royal Navy.

The financial arrangements would be complicated and require detailed negotiation in the light of i) the amount of money invested by British Shipbuilders in the business following vesting day and ii) the progress or lack of progress made by

the new management in handling these businesses since vesting day. The aim should be to come to an amicable decision quickly to minimise the damage being done to these businesses by continued management from British Shipbuilders headquarters.

The fairest solution would be to take account of the low level of capital investment and the static order volume in such a way that the original undervaluation of the three companies could be reflected in the cash price for resale.

The main objection which will be argued to this case is that the warship builders are worth rather more than the figures suggested in preliminary discussions by the original owners, and that therefore it would be inappropriate for the government to sell them on this basis.

Assuming this objection could be overcome, this solution has the following added advantages: it is the easiest to accomplish, it restores the element of competition, it enables the original world renown names to continue to be effective from a marketing point of view and it would be the least disruptive to good industrial relations.

IV

Option 3

To return the three business to the market individually. This would necessitate the sale by the Department of Industry of each warship builder to the highest bidder. This could be done by allowing a period for bids to be made to the department for these businesses or by seeking an independent city institution to fix a value for independent offers for sale. In such a sales programme it would be up to the original owners to bid for the business like anyone else but they would of course have to make a decision as to the wisdom of such investment in the same way that

they would contemplate any other new project. It would be most unfair on them as they could easily end up paying - if they were interested - a substantial premium over the value of the business calculated for compensation purposes and in certain cases would not be able to afford the business as their cash flow has been adversely affected by the loss of their warship building subsidiaries and the delay in compensation payments.

The disadvantage of this scheme is that it would require 3 separate management and marketing teams representing companies that would not be large in relation to their most important overseas competitors.

V

Option 4

A most interesting option is to form an entirely new business out of all the existing warship building yards. To facilitate discussion we will call it British Warship Builders. This company should be a 1948 Companies Act Company and should have control of all of the assets of the warship building section of British Shipbuilders passed to it on a suitable vesting day as soon as possible. It would not need any share of British Shipbuilders headquarters staff, leaving them free for their mainstream business.

Once such a company has been formed the options are then several;

1. A management contract could be negotiated with one of the three original owners. It is known for example, that Vosper have both the capability and the interest in such an arrangement. To vest management in a reputable group such as Vosper would facilitate pursuing the other options reviewed beneath by enhancing the standing of the company in the eyes of the financial community. It would also negate any British

Shipbuilders claim that denationalisation of a portion of their business would dilute management.

2. Whole or part of the business could be sold to the public leaving the business either completely de-nationalised or arranged on BP lines or with a government majority and a public minority shareholding.

Of these the one that seems less desirable is the one where private shareholdings remain in the minority as it is unlikely to produce as firm a discipline as de-nationalisation can encourage, whilst raising less cash to assist in government financing.

3. In 2-3 years British Warshipbuilders could be fully returned to private industry.

4. Selling shares in this new company could allow employee participation in the business.

5. The shares sold or given to the original owners in compensation should be geared to the success of the venture. This could be achieved by having different rules for their dividend payments such that the dividend on these shares automatically rose or fell by say 125% of the percentage increase or decrease in profits. The attractions of such gearing to encourage management are obvious; employee shares could also be geared in this way.

6. Shares in the new company could be allocated to cancel the necessary compensation payments that had to be made to the original owners.

7. Warship building would then be freed from British Shipbuilders' cash limits and could raise cash like any other private company.

VI

Employee Participation

It is recommended that if any of the options involving share sales to the public are adopted an element of employee shareholding should be encouraged because:

a) it makes re-nationalisation much more difficult particularly without compensation as it increases the number of voters who would suffer from such action.

b) Labour negotiations cannot be harmed by people in the business having a stake in its success and it is quite possible that they will be improved.

c) Government policy favours such participation and should be furthered in the interests of extending ownership generally outside the housing market.

"We will expand and build on existing schemes for encouraging employee share ownership and our tax policies generally will provide incentive to save and build up capital" Manifesto p.14

"We will offer to sell back to private ownership the recently nationalised aerospace and shipbuilding concerns, giving their employees an opportunity to purchase shares" Manifesto p.15

"... recently published draft proposals suggesting tax reliefs to encourage employee share ownership schemes, based on profit sharing or added value sharing. In particular, we see the attraction in giving incentives to deferred share schemes which give a fuller benefit of ownership to employees the longer they hold on to the shares in question"

Right Approach to Economy p.34

VII

The Secretary of State's powers

The Secretary of State has the necessary powers to order British Shipbuilders to divest itself of portions of its business or to instruct it to form a new company or companies out of its existing assets.

The powers are conferred by the Aircraft and Shipbuilding Industries Act 1977 Chapter 3. Under Section 3: 1a) and b) the Secretary of State has to give permission and could therefore withdraw permission to carry on particular types of activities. Clause 3: 3b) required the Secretary of State's approval to dispose of companies whilst section 4: 2 and 3 entitles the Secretary of State to issue general directions and 7: 1f) gives the Secretary of State power to specify items for inclusion in the annual corporate plan.

Thus the Secretary of State can issue a general directive to divest certain companies at the same time granting the necessary permission under clause 3: 3b) and he could withhold his permission to carry on particular activities following the issue of such a directive. The powers should be watertight.

The response to such a directive might be to argue that it would impose financial difficulties on the corporation. It could be argued that a financial duty is to be settled under clause 10: 1 and that under 10: 5 such a financial target must not imply an "inadequate return on capital employed". However it is difficult to see what the force of this clause in the Act is as the financial duties laid down for the corporation since vesting day have been in clear conflict with this particular clause in the legislation as the targets set have implied that the corporation should lose money on its turnover. It is difficult to see how this could on any construction be deemed an adequate return on capital employed.

In conclusion the powers are adequate without involving legislation but the disposal of the warship builders would mean

that clause 10: 5 was ignored to a slightly greater extent than it has been to date. This would not seem to be any cause for concern. It if were thought to be a cause for concern, it would still be up to the Secretary of State to set a target which was not in conflict with clause 10: 5 and the fact that the corporation was unable to meet it would be the Corporation's problem rather than the Secretary of State's. To date no-one has challenged the position under this clause whilst the sale of the warship businesses make no difference to the lack of return on the main assets employed in merchant shipbuilding and little difference to the overall losses on total capital employed.

VIII

The opportunities for a revitalised British Warshipbuilding industry

As soon as agreement is reached on restructuring the new management would;

1. Carry out an extensive world market survey to analyse potential demand.
2. Revitalise the sales force to ensure British Warship builders products were well known and understood world wide.
3. As a matter of urgency allocate more resources to strengthen the design teams to implement the findings in 1. above to ensure British Warship builders had the right products.
4. Tighten financial controls on stocks and working capital.
5. Negotiate improved productivity on the back of a rising order book - which enables maintenance of employment.
6. Reduce overheads, currently high owing to the high costs of British Shipbuilder headquarters operation.

IX

Conclusion

It is recommended that the Government consider options in the following order:-

1. The formation of a 1948 Companies Act company thereby removing all of the financial requirement for warship building from the public sector borrowing requirement and facilitating the sale of equity.

2. Sale of shares to the public to leave only a minority share holding with the government. In such an offer for sale there should be three reserved categories of allocation; i) free shares allocated to the original owners to cancel the compensation debt owing to them. ii) Employee shares which can be both free deferred shares and shares offered at a discount according to the number of individuals wishing to acquire and iii) Discount shares available to the original owners, the level of the discount to be subject to negotiation in relation to the compensation negotiations. These shares could have a gearing element as part of the management contract remuneration.

Appendix I

There are now precedents for drafting a suitable denationalisation bill. The Civil Aviation Bill before the House of Commons illustrates the method for British Aerospace whilst the Transport Bill contains provision for enabling the sale of shares in National Freight Corporation.

National Freight

Immediately before the appointed day, the commencing capital debt and outstanding loans to the Corporation from the Minister shall be extinguished. The successor company shall issue to the Minister or to his nominees fully paid up shares of such nominal value as the Minister, with the consent of the Treasury, may direct. Shares in the successor company can be disposed of with the consent of the Treasury. All dividends, and receipts from sales of shares shall be paid into the Consolidated Fund. Stamp duty shall not be chargeable in respect of any increase in the share capital of the successor company which is certified by the Treasury as having been effected for the purposes of the transaction.

Appendix II

When a company is controlled by the State as is British Shipbuilders all of its capital expenditure becomes part of the Public Sector Borrowing Requirement. In addition the compensation payments have to be financed.

The loss of the annual profits would be more than offset by these savings for several years, whilst the risk of major losses from commercial errors would also be eliminated for the government by sale of the companies. There would be no PSBR effects from capital spending if a 1948 Companies Act Company were formed and a majority shareholding sold unless the government wanted to take up rights issue shares.