THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(80)102

12 September

COPY NO 55

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

BRITISH STEEL CORPORATION FINANCES

Memorandum by the Secretary of State for Industry

I reported to the Committee on 25 June that the then Chairman of BSC estimated they needed £400 million in 1980/81 above the EFL (of £450 million plus the agreed carryover of £121 million from 1979/80). BSC proposed to cover this by the factoring of debts and the sale and leaseback of assets.

2 We rejected this expedient. We said that BSC should continue trading normally and that the Government would ensure, in the last resort, that creditors had their claims fully met. We acknowledged that a revised cash provision would be needed for 1980/81 but refused to determine this until the new Chairman had taken stock and reported to me. The Committee recognised that the cash requirement for 1980/81 could, after the new Chairman's examination, turn out to be even larger than Sir Charles Villiers' guess (E(80)21st Item 1). I made a statement on these lines to Parliament on 26 June.

3 Mr MacGregor has now given me three preliminary reports. One sets out BSC's profit and loss and cash projections for 1980/81 and 1981/82 on the "present path", indications for 1982/83 and 1983/84 and options on future capacity. The second describes, in broad outline, some cost saving goals designed to restore BSC's competitiveness. The third paper outlines his proposed reorganisation of the Corporation into a number of discrete businesses acting as "profit centres" and incorporating both production and sales functions on a product basis. The object is to help achieve competitive cost levels, regain domestic market share and strengthen BSC's position in export markets.

4 In presenting these papers to me, Mr MacGregor has emphasised that the financial projections and consequential cash needs after 1980/81 were "mechanical extrapolations of existing conditions", ie they do not include provision for savings in raw materials and operational costs and improved sales performance that he hopes to achieve. Nor do they allow for economies and improvements resulting from the proposed new organisation. The estimates allow only for operational savings achievable through cutbacks in capacity below the

present 15 million tonnes strategy. (Such further cutbacks will involve redundancies additional to the 52,000 planned to take place in 1980: of these 40,000 have already left the Corporation.) I pressed for quantification of the further savings and benefits. Mr MacGregor explained that he could not provide this until the new "businesses" had been set up and cash targets fixed with the executives who would be responsible for achieving them; also there has been a delay in the Coopers and Lybrand report and recommendations on a new cost control system. He promised to provide quantified estimates and targets by the end of the year. This means that Mr MacGregor has not yet provided a coprorate plan setting out what he hopes to achieve at BSC over the next few years.

5 On first consideration, the economists here consider that BSC's main assumptions for 1980/81 and 1981/82 are not unreasonable, in particular, that their forecast of a continued decline in crude steel demand in the UK is not unduly pessimistic.

6 Mr MacGregor's conclusion is that BSC's additional cash requirement in 1980/81 may well approach £600 million above the present EFL. He says that the changes he proposes can make little impact in 1980/81, given the time it will inevitably take to implement them (including the statutory requirements for consultation on proposed organisational changes).

7 For 1981/82, Mr MacGregor has put forward four possible alternative capacity configurations. These are briefly described below.

- Base case. This envisages capacity continuing at the level resulting from the completion of the changes necessary to implement the 15 million tonnes of liquid steel strategy announced last December.

- Case I. Capacity reduced to 12.9 million tonnes of liquid steel to meet foreseeable future demand. This would involve mothballing Appleby Frodingham works in Scunthorpe and the Aldwarke works in Sheffield, Coupled with an increase in output at Ravenscraig. This configuration would involve job losses of about 15,000.

- Case II. A variation of Case I with capacity reduced to 12.7 million tonnes of liquid steel by mothballing Llanwern and Normanby Park, the smaller works at Scunthorpe. This configuration would involve about 15,000 job losses.

- Lower case. Cut back of capacity to 7 or 8 million tonnes of liquid steel to produce currently profitable products only. This would be achieved by closing or mothballing Ravenscraig, both Scunthorpe plants, and Port Talbot. Job losses would amount to 42,000.

8 The market background to the above alternatives is that UK demand for steel has declined below the level expected last

December when the 15 million tonne liquid steel strategy was agreed. At that time BSC forecast UK demand in 1980/81 at 14.3 million product tonnes, of which they expected to supply 56 per cent or 9.6 million product tonnes, with 3.3 million product tonnes of exports. (Note: 1.32 tonnes of liquid steel are necessary to produce 1 product tonne of steel.) The current BSC forecast is of UK demand in 1980/81 at 13.5 million product tonnes; they have lost market share as a result of the steel strike and expect to supply only 47 or 48 per cent of the UK market or 7.5 million product tonnes, with exports of about 2.5 million product tonnes. For 1981/82 the BSC estimate that UK demand will fall further, to 12.4 million product tonnes, but they expect to be able largely to recover their market share at a level of 53 per cent. Prices for most steel products are at present very weak, due to the excess capacity and poor demand not only in the UK and Europe but in other overseas markets and little improvement is expected in 1981/82, unless the level of sterling declines. Export sales at current levels of about 2.5 million product tonnes per annum are not therefore likely to be profitable.

9 I attach at Annex 1 a table which summarises the information on the four alternative configurations and the financial consequences of each course of action. This shows that, although the lower case option will produce a profit before interest estimated at £36 million in 1981/82, BSC anticipate that the cash requirements, under this option, due largely to high costs associated with closures and large-scale redundancies, will be £723 million to £873 million. This is not significantly below the expected cash requirements of the other 3 options.

10 Mr MacGregor has told me that he considers that a reduction in capacity to about 12¾ million liquid tonnes, as in Case I or Case II, offers the prospect of a sound and profitable Corporation in the medium term, provided he can obtain satisfactory improvements in performance in addition to the savings expected from the cutbacks in capacity. He does not consider that the lower case option would constitute a balanced, viable business. I attach at Annex 2 a table which gives an indication of what might be achieved under Case I/ Case II over the next 3 years, on the assumption that Mr MacGregor does manage to bring about a progressive improvement in performance, with associated cost reductions, over that period. These figures have not been agreed with BSC but have been calculated on information supplied by the Corporation, and I would hope that when Mr MacGregor does come forward with firm plans for the next 3 years he will be aiming at a more rapid rate of improvement and better financial performance in 1983/84 than is implied in Annex 2.

11 Before finalising his corporate plan Mr MacGregor has asked for an indication of the Government's reaction to the alternative closure options he has put forward, and he also intends to defer final decisions until the new organisation is in being and the managers of the new businesses have been consulted.

12 For the remainder of 1980/81, Mr MacGregor has told me that there is no possibility of reducing the excess requirement of £400 million above the EFL forecast in June. Indeed the Corporation's current estimates imply a further deterioration, due largely to lower sales, weaker prices, and a shortfall on disposals, pointing to an excess of £600 million above the EFL.

13 Whatever the option, the stated cash requirement of an additional £400 to £600 million for 1980/81 and the stated range of £723 million to £1,031 million (depending on the option) for 1981/82 (against the present provision of £250 million) are horrendous - even though I would expect Mr MacGregor to make some improvement next year. I have therefore given some thought to whether it would not be preferable to seek to cut our longer term losses and opt immediately for the total liquidation of the Corporation, with the disposal to the private sector of such plants as they can be induced to take and the closure of the rest. Mr MacGregor himself recognises that, if there is no recovery in the present level of demand for BSC steel, liquidation might well be appropriate. However, I consider it would be premature to do this. Liquidation would take time to implement - legislation would be needed - and would require cash outgoings of perhaps £1-£1½ billion - for redundancies, to meet foreign loans, pay creditors, etc, and to keep certain plants going until buyers could be found. If BSC were liquidated this would probably mean the end of steelmaking at Scunthorpe, Ravenscraig and in South Wales (apart from the tinplate works). Probably more than 70,000 would lose their jobs. On the other hand, we have only just appointed Mr MacGregor. I am confident that he will either make a very marked impact on BSC's financial position once he has been able to implement his proposals or he will tell me that there is no option but liquidation. I think he must be given proper opportunity to show that he is able to achieve the ultimate viability of BSC for which were recently appointed him.

14 I pressed Mr MacGregor on the possibilities of further disposals as a means of reducing the 1980/81 cash requirement. BSC are already embarked on a programme of substantial disposals estimated to yield £130 million in 1980/81. This may well turn out to be over-optimistic in practice this year. Mr MacGregor has assured me that the only other discrete unit which might be disposable in present market conditions is the stainless steel operation in Sheffield (Stanton and Staveley, who make iron pipes, are not attractive to a buyer at present because of the collapse of demand from public utilities). I have told him to try and dispose of the stainless steel operation which might bring in something over £100 million - but there is only one potential buyer in sight at present and we clearly cannot count on a sale.

15 My present conclusion is that Mr MacGregor has not yet given us sufficient in the way of identifiable targets of cost savings, improved competitiveness etc to fix BSC's EFL either for 1980/81 or for 1981/82. We need to know when he expects

to achieve enduring profitability - and how - to justify the enormous sums the taxpayer is being asked to provide in the shorter term. We also need to consider further the broader economic and indeed political implications of the options Mr MacGregor has put to me.

16 Meanwhile, BSC's cash position is fast becoming desperate. They are, of course, not alone in this: all the major European steelmakers, including those profitable last year, now appear to be suffering substantial losses on their steel operations because of the downturn in the European steel market over the past 5 months. Mr MacGregor told me some weeks ago that BSC were likely to run out of cash under the present EFL by the end of September. I replied that I could not consider even interim remedial action until we had received his initial reports. We now have these, and BSC have confirmed that they will reach their cash limit during the week beginning 22 September.

17 We therefore need to take an immediate decision on BSC's EFL for 1980/81, so that the Corporation can continue to operate while the options for the future are being developed by Mr MacGregor. We also need to discuss with BSC the capital reconstruction which needs to come into effect in the first half of 1981 and for which legislation is already planned. We shall then need to look carefully at the quantified targets of financial improvements in later years that Mr MacGregor has agreed to supply by the end of 1980. All of this will take us into the early part of 1981.

18 There are two ways in which we can deal with the need for BSC to have an increased EFL. One is to set a revised limit now intended to cover the likely cash needs of the Corporation until 31 March 1981. This would have to be £600 million if we were to have any confidence that it would not be breached. Such a high figure, which we would have to announce before we had received Mr MacGregor's corporate plan, might weaken both the Government's and Mr MacGregor's position in drawing up and agreeing BSC's future strategy. As an alternative we could agree to provide an interim increase in BSC's EFL for 1980/81, with the ultimate figure to be established before the end of January. Any increase will of course damage the credibility of the EFL system as a discipline on nationalised industries; but the open-ended alternative of giving BSC enough money to carry on the business month by month until we are in a position to set a new definitive limit would be worse still.

19 I do not consider we have sufficient information to determine as of now our future policy on BSC. But we need to take a first look at the problems created by this delay for certain financial decisions which cannot be postponed. I have in mind our impending decisions, first, on the investment and financing review (IFR) for nationalised industries, as part of the 1980 Public Expenditure Survey; and, next month, on external financing limits (EFL's) for all nationalised industries.

20 The Chief Secretary is, I understand, circulating a paper proposing a settlement on the IFR figures. It will give

tentative figures for BSC since we must make some preliminary assumptions about these, based on the very limited information we have, as a basis for wider decisions on the IFR and, ultimately, the 1980 Survey. I must stress that these figures have no more significance than that, and they do not in any way prejudice decisions we shall eventually take on the MacGregor strategy when we have it, and which will be embodies in the next Public Expenditure White Paper. There is no question of these interim figures being shown to BSC.

21 The EFL problem is, in some ways, more difficult. Our intention in publishing EFL's as early as November is that they should exert a downward influence on pay settlements in the coming winter. If we made an exception of steel, and set its EFL, say, in January, when we have decisions on MacGregor, we not only forfeit that restraint on pay, but we risk forfeiting the co-operation in this exercise of other industries already critical of our accelerated EFL timetable. I have considered therefore whether to set a provisional EFL for steel in November, but conclude that we have so little to base it on - a fact which is bound to become know, given the publicity which surrounds any EFL set for steel nowadays - that that course carries the greater risk of undermining both the credibility of the EFL system, and our relations with BSC. I believe the only sensible thing to do is to treat steel as an exceptional case and set its EFL in January 1981, relying on the good sense of the new BSC management to reach an acceptable pay settlement meanwhile.

22 I therefore ask the Committee to agree:

i to defer the determination of an EFL for BSC for 1981/82 until we have had the opportunity of considering the corporate plan promised by Mr MacGregor before the end of December;

ii to agree to increase the EFL for BSC for 1980/81 either by £600 million or, on an interim basis, by £400 million which will probably need revision before the end of January.

K J

Department of Industry
12 September 1980

ANNEX I

SUMMARY OF BSC PROJECTIONS FOR 1981/82

		Base Case	Case I	Case II	Lower Case
Capacity (m tonnes liquid steel)		15.0	12.9	12.7	7.8
Production, (in tonnes liquid steel)		13.3	11.7	11.8	7.0
Deliveries: (million product tonnes)	Home	7.3	7.2	7.3	4.3
	Export	2.7	1.5	1.5	1.0
Profit/(Loss) after depreciation but before long term interest (£m)		(450)	(299)	(302)	36
Cash requirements (£m) (including contingencies)		879/1,029	858/1,008	881/1,031	723/873

Within the total cash requirements for each option, the main components are as follows:

£ Million

	Base Case	Case I	Case II	Lower Case
Capital expenditure	200/250	200/250	200/250	100/150
Closure costs	20	150	170	450
Contingencies	100/200	100/200	100/200	100/200

Note: the above projections are preliminary only and do not take account of any potential savings from improved performance.

Possible future financial position of BSC under Case I/Case II option

	1981/82	1982/83	1983/84
Production, liquid steel (million tonnes)	11¾	12.8	12.8
Deliveries: (million product tonnes) Home	7¼	8.2	8.2
Export	1½	1.4	1.4
Profit/(Loss) after Depreciation but before interest (£M)	(240)	(65)	50
Cash requirement (£M) (including contingencies of £100 million)	700	400	285

Note The figures for 1982/83 and 1983/84 are based on very preliminary indications by BSC, with adjustments to reflect possible savings through:-

a reduction in long term interest after capital reconstruction in 1981.

b reduced cash requirement due to £80m improvement in stock position.

c progressive achievement of £180m of cost reductions on non-production labour and on energy conservation.