PRIME MINISTER

PHOENIX I

In my memorandum E(80)138, approved by colleagues at our meeting on 4 December (E(80)43rd), I set out the criteria to be used in establishing joint public/private ventures in areas of steelmaking where BSC overlaps with the private sector. These were:

(a) BSC not to have majority equity ownership or control;

(b) new ventures to be free-standing Companies Act companies, with no recourse to parent company guarantees or finance;

(c) companies to have good prospects of viability;

(d) working capital requirements to be channelled through BSC.

2 BSC and GKN have been negotiating for some months to rationalise their rod, bar and wire interests, an arrangement known as Phoenix I. They have now reached agreement to establish a company amalgamating in it the assets described in the Annex. This will produce a company with a turnover of some £220 million in its first year of operation. The partners are now in a position where, subject to our agreeing to BSC's participation in the new arrangements, an agreement can be announced on Friday, 20 February.

3 The financial arrangements are for GKN to provide most of the fixed assets and the majority of the stocks. BSC will provide some

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fixed assets, some stocks and cash. In exchange GKN will take half the equity and £18.3 million of preference shares. BSC will take half the equity and £23 million of preference shares. The forecast financial position over the first 3 years is:

Year end 30 June	1982 £m	1983 £m	1984 £m
Operating Profit/(loss)	(12.7)	(1.5)	7.5
Net Cash inflow/(outflow)	(28.2)	(10.9)	(3.9)
Financed by BSC as to Equity	20	-	-
Preference Shares	8.2	10.9	3.9*

*In addition there is a contingent commitment on BSC to take £14 million of preference shares in years beyond 1985, which may be needed to pay off the balance of ECSC loans used to provide some of the fixed assets taken into the new company.

4 The opening Balance Sheet at 1 July 1981 will have the following shape:

	£m		£m
Share Capital - BSC	56.6	Fixed Assets	86.2
GKN	56.6	Working Capital	
Shareholders Interest BSC*	----	Stocks	37.3
		Debtors	42.9
		Creditors	(30.9)
GKN	18.3	Terms of Employment Provision	(4.5)
ECSC Loans	19.5		
		Cash	20.0
	151.0		151.0

* BSC's preference capital (up to £23 million) will be contributed in 1982/83 and 1983/84

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The cost to the taxpayer in 1981/2 will be £34 million which I shall expect BSC to find from economies within their external financing limit. An additional £11 million and £4 million will be needed in 1982/3 and 1983/4.

5 The new company meets the criteria set out in my memorandum in the following ways:

(a) equity ownership is 50/50 and control lies outside BSC, with GKN providing the key Board management;

(b) the company will be freestanding (i.e there will be no continuing commitment after the initial funding) and it has been made clear that BSC will not be allowed to give guarantees for any commercial borrowing required;

(c) the company has a good prospect of viability, and after losses in years 1 and 2 (which will be bad years for steelmakers throughout Europe) it promises a good profit in year 3;

(d) the finance does not come direct from the Government but is channelled via BSC in a mixture of equity (£20 million) and preference shares which will be remunerated in later years.

I believe this to be the best deal possible in the circumstances.

6 If the company is not established and BSC remains in competition with GKN, I believe that there will be substantial risks and costs. BSC would lose immediately sales of 100,000 tonnes (worth £5.5 million) annually from its Scunthorpe works which it currently sells to GKN's Cardiff operation. GKN would compete as hard as possible with BSC and they can do this more effectively on the basis of a cheaper route for making steel. This could force the closure of BSC's Scunthorpe rod mill (at a cost of £21 million in asset write off plus about £5 million in redundancies) and the loss of orders from this

/rod

rod mill (500,000 tonnes) would make the whole Scunthorpe steel-making operation (now geared down to 1,700,000 tonnes annually) irrecoverably expensive. The financial and commercial cost of closing Scunthorpe would be enormous.

7 The Phoenix I arrangement has obvious political advantages. The formation of a public/private venture with a turnover of over £220 million will expand the private sector and paves the way for complete privatisation in due course. We shall also be seen to have taken a step - albeit small and not wholly adequate in the light of present difficulties - to reduce the competition which the private sector is suffering from the subsidised BSC. Agreement on Phoenix I is moreover an essential pre-requisite to an agreement on a joint public/private engineering steels company (known as Phoenix II) which, although based on GKN and BSC assets, may comprise the assets of other companies as well (for example some of the assets of Duport which I have been discussing with you separately). GKN have already proposed to amalgamate their plant at Brymbo (Wrexham) and their drop forging companies with BSC's Sheffield plants to create a second 50/50 company which would encompass 12% of BSC's total turnover. Without GKN there is no prospect of forming a joint public/private sector company in the engineering steels field which would further reduce the area where the private sector experiences subsidised competition from the BSC and would widen the scope for privatisation.

8 I do not pretend that the Phoenix I arrangements are ideal. They produce a large operating company and reduce competition (but the effective competition now comes from the continent). They involve a significant amount of public money. But they do represent an arrangement to which both GKN and Mr Ian MacGregor have agreed and there is a good prospect that the new company will succeed. In the circumstances I believe we must agree to BSC entering into the new arrangements, provided the costs are met within the EFL we shall be discussing next week. There is obvious advantage in GKN and the BSC making an announcement quickly. Unless therefore you let me know by

/midday ...

midday Thursday 19 February that you see objections, I propose to authorise BSC to enter into the arrangements. We can cover the matter when we discuss industrial affairs at Cabinet on 19 February.

9 I am copying this minute to all our Cabinet colleagues, to Michael Jopling and to Sir Robert Armstrong.

I. Ellison

K J

18 February 1981

(approved by the Secretary of State and signed in his absence)

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