Ref A04046

MT

PRIME MINISTER

Castle Peak B Power Station, Hong Kong

EX(81) 1

BACKGROUND

1. The Secretary of State for Industry seeks approval of a package of financial assistance to enable United Kingdom industry to secure the contract for the Castle Peak B power station in Hong Kong. The proposals have been agreed inter-departmentally at official level - see the detailed report annexed to EX(81) 1 - except that the Treasury are against the proposed concession on the premium charged by the ECGD for cost escalation insurance.

2. With the aid of a similar financial package approved by the last Government, GEC and Babcock won the £350 million contract for the Castle Peak A station in 1978. Work on this has gone well and, as a result, the China Light and Power Company (CLP) - who are also in the lead in the negotiations for the Guang Dong nuclear station - and Esso Eastern have given the United Kingdom the opportunity to submit proposals for Castle Peak B without going to international competitive tender. The Department of Industry have to submit the offer by 31 January.

3. The contract would be a major boost for our power plant industry and is highly attractive -

i. at £550 million it would be the largest power plant export order ever won by the United Kingdom;

ii. in addition to GEC and Babcock, a good number of sub-contractors would benefit - see the list at Annex F;

iii. there would be about 34,000 man years of work for United Kingdom firms from 1981 to 1989 with 68 per cent of this in Assisted Areas, and significant benefits for the Glasgow area and Larne in Northern Ireland - see Annex G for details;

iv. it could boost the United Kingdom's chances for further major orders in Hong Kong and the Far East - and Department of Industry officials judge that, if GEC fail to get Castle Peak B, the Chinese will rule them out of the Guang Dong project.

4. To secure this deal the Secretary of State for Industry proposes - paragraph 6 of EX (81) 1 - that the Government should finance the consultancy services for the project by up to £20 million in the period 1981-91 and that ECGD should halve their cost escalation premium from £35 million to £17.5 million. These proposals should be judged against the background of the advice from the private sector accountants on secondment to the Department of Industry's Industrial Development Unit that both GEC and Babcock are providing for under-recovery of their own overheads and are not making excessive allowances for contingencies. (Annex D.)

Subsidy of Consultancy Services

5. The CEGB will provide consultancy services to CLP. It is proposed that, as for Castle Peak A, the Government should finance these services at a cost for this contract of £12.5 million from 1981-91, and by a further £7.5 million if this should prove necessary in negotiation and provided that GEC/Babcock made a comparable price reduction. The money would be found from DOI's current public expenditure allocations, and represents a subsidy to the power plant industry and to exports and not to the CEGB (who are operating on commercial terms).

6. The subsidy would be paid under Section 7 of the 1972 Industry Act. There is no statutory barrier to this, but the payments would be outside the Government's guidelines which provide for Section 7 assistance to be used to stimulate investment rather than to preserve employment and win exports.

7. Unless this assistance was notified to, and cleared with, the European Commission it would be contrary to Community Law. It is proposed, however, that the Commission should not be informed of the assistance either now or later; and this means that Parliament will not be notified of it when the project is announced. There are obvious risks in this, but it seems a necessary procedure to ensure that Commission delay and intervention does not mean the United Kingdom losing the contract; and it is the procedure followed by the last Government for Castle Peak A. These points are set out in more detail in the section headed "Method of Support" on page 4 of the paper by officials.

ECGD Support

8. Although the amounts are very large, ECGD's support will, with the exception of the cost escalation arrangements, be on orthodox terms. They expect to negotiate adequate security for the loans. The interest rate of 8½ per cent and the credit period of 12 years from commissioning are both in line with OECD consensus arrangements.

9. A concession is, however, proposed on the premium for cost escalation cover. Under the cost escalation scheme companies exporting capital goods worth at least £2 million, and with a manufacturing period of more than two years, can pay a premium to insure against cost escalation within various bands. This Government has twice extended this scheme for one year and in April 1980 increased the premium from 1 per cent to 2 per cent. In the present case it is proposed to charge only 1 per cent, thereby reducing premia by £17.5 million spread over ten years 1981-91. Treasury officials object to this concession which means loss of premium income to ECGD and which, they fear, could make it difficult to turn down claims for similar concessions in other deals.

10. Department of Industry officials judge that it will be necessary to make such a concession to secure the deal. They point out that the premium should represent a profit; and that, in the present case, ECGD would only have to pay out if inflation was running at higher levels than currently expected. They would see it, therefore, more in terms of abating the profit than incurring a cost. It could also be argued that the arrangement should not be repercussive if it is kept secret.

HANDLING

11. After the Secretary of State for Industry has introduced the paper, you will wish to hear the views of the Chancellor of the Exchequer, with particular reference to the cost escalation premium proposals, the Foreign Secretary, and Mr Parkinson who is representing the Secretary of State for Trade who is in India. (The Secretaries of State for Employment, Scotland, Northern Ireland have seen copies of the paper and strongly welcome the project for the benefit it would bring to employment.)

12. The main questions seem to be -

i. Is it necessary for the Government to give assistance at all to a project which will bring major benefits to the firms concerned - the judgment that the major contractors are under-recovering their overheads is relevant here;

ii. will withholding information about financial assistance from the Commission and from Parliament lead to trouble? - It clearly could: but it seems necessary to secure the order; the French would no doubt do just the same; and most MPs would see it as fair tactics to win a major prize for the United Kingdom;

iii. Does the Chancellor of the Exchequer wish to press his officials' objections to the concession on the cost escalation premium?

The Department of Industry have to make their offer by 31 January and the Committee will therefore wish to come to firm decisions as soon as possible to avoid the risk of any delay.

CONCLUSIONS

13. In the light of the discussion you will wish to sum up with reference to the three measures listed in paragraph 6 of EX(81) 1, either approving them as a whole or noting any reservations on them.

14. If the proposals are approved, you might also wish to ask the Secretary of State for Industry to inform the Law Officers of the decision and invite them to consider, on a contingent basis, what would be the Government's defence if the Commission found out about the subsidy.

RTA

(Robert Armstrong)

20 January 1981

cc Mr Walters
Mr Ingham

PRIME MINISTER

CASTLE PEAK 'B' POWER STATION, HONG KONG

I have seen the Secretary of State for Industry's paper EX(81)1. I agree with him that to gain this large export order would help to secure the capacity of the UK power plant industry, whose strategic importance we have recognised. I therefore support the measures he suggests to assist UK industry in this case, set out in paragraph 6 of his memorandum to the Committee.

I am sending copies of this minute to the other members of EX Committee.

AH.

Secretary of State for Energy
21 January 1981

CONFIDENTIAL

PRIME MINISTER

CASTLE PEAK 'B' POWER STATION, HONG KONG

I have seen a copy of Keith Joseph's memorandum (EX(81)1) seeking approval to go beyond the normal ECGD assistance in supporting GEC/ Babcock bid for the contract to build this power station.

I am writing to express my strong support for his proposal on the grounds that the order, if secured, would preserve the 950 jobs at the GEC factory in Larne which would otherwise be lost. GEC have invested substantial sums of money in re-equipping the Larne factory which has a reputation for producing high-quality machinery for export. I consider it vital to use all reasonable means to help the company maintain this important employment in the South East Antrim area which has been so badly affected by the recession. The ICI plant at Carrickfergus is to close and there have been heavy redundancies at other firms, including today's announcement of 800 redundancies at the British Enkalon plant in Antrim town.

I am sending a copy of this minute to the other members of EX Committee and to Sir Robert Armstrong.

H.A.

H.A.
20 January 1981

CONFIDENTIAL

Qa 05225

COMMERCIAL IN CONFIDENCE

To: MR LANKESTER

From: J R IBBS

MS

EX COMMITTEE: CASTLE PEAK 'B' POWER STATION

1. The proposals put forward by the Secretary of State for Industry give rise to four main questions:

(1) How much subsidy is involved?

(2) Is this scale of subsidy essential to win the contract?

(3) Is it worth paying the subsidy?

(4) Are the particular mechanisms for providing subsidies to this contract acceptable?

How much subsidy is involved?

2. The total cost to HMG of the subsidy is £150-160 million at net present value:

	£ million
Standard Subsidy	
Net present value of the interest make-up in ECGD's loan package	122
Additional Subsidies	
Cost of reducing the ECGD premium for cost escalation cover from 2% to 1%	17½
Cost of free provision of consultancy services (not discounted)	12½ - 20
Total Subsidy	150 - 160 million (say)

3. If the UK is awarded the contract, British industry will secure around £450 million of business (see Annex C of the paper by officials).

COMMERCIAL IN CONFIDENCE

4. The ratio of total subsidy to the value of the contract is therefore 1:3. The "additional" subsidy is about 7-8% of the contract.

Is this scale of subsidy essential to win the order?

5. The evidence in the paper points strongly to the conclusion that without a subsidy on at least this scale the order will not be secured. The contract will then go to international tender, which the Japanese are thought almost certain to win with a cut-price offer that the UK could not match.

Is it worth paying the subsidy?

6. There are powerful arguments in favour of assisting British industry to win Castle Peak 'B':

- The UK must retain a healthy power plant industry to ensure a sound base for its future nuclear power programme. Until this programme is under way, the industry is dependent on export orders, which it cannot win without substantial Government subsidies, particularly with sterling at its present level. Castle Peak 'B' offers a good opportunity to secure a large part of the export business needed.
- This project is particularly deserving of support because of the need to keep the Japanese out and also because of the value of Hong Kong as a shop window for China and the Far East.

7. The CPRS agrees with these arguments and therefore, despite the large subsidy involved, supports the Department's efforts to win the order.

8. Nevertheless, it is not difficult in individual cases to argue for large subsidies which defy the normal rules of economic sense. The present proposition probably just scrapes through. It is important for EX Committee to ensure that such arguments are not used beyond the minimum number of cases

needed to maintain the desired industrial base and to cover the most important market opportunities.

Are the mechanisms for subsidising this contract acceptable?

9. Clearly some £30-40 million of subsidy has to be found in addition to the standard loan package. We appreciate the reluctance of Treasury Officials to see Section 7 money and ECGD funds used in this way, but there does not appear to be any other mechanism for providing the necessary support.

10. I am sending a copy of this minute to Sir Robert Armstrong.

JR

20 January 1981