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P.M.

Qa 05753

17 December 1981

To: MR SCHOLAR

From: J R IBBS

BACO

1. I attach the paper asked for by E Committee on 15 December, on which a meeting has been arranged at 9 a.m. tomorrow.
2. Discussions with the company have shown that they had set their minds clearly on closure. It has therefore proved impossible to get them to accept any settlement more favourable from the Government's point of view than that set out in paragraph 6 of the note. The company's attitude provides further information that there is no good economic case for keeping the smelter open. Ministers will therefore have to view this option primarily in political terms.
3. The discussions with the company have re-emphasised that the company needs a decision by the end of this week. If discussions run on beyond the weekend, the Government will risk being effectively committed to continuation; the alternative being collapse of the company.
4. I am sending a copy of this minute and the attachment to the Chief Secretary, the Secretaries of State for Scotland, Wales, Industry and Energy, the Parliamentary Under Secretary of State for Industry (Mr MacGregor), and also to Sir Robert Armstrong.

JR

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BRITISH ALUMINIUM COMPANY LIMITED (BACO)

Note by Officials

1. Following E Committee's consideration of the problems of the British Aluminium Co Ltd on 15 December, the Prime Minister arranged for a group of officials, led by the Head of the Central Policy Review Staff, to explore urgently whether an acceptable and defensible basis could be found for keeping the Invergordon smelter in operation, and to report before the end of the week. This report describes the costs and repercussions of closure; it then outlines a possible basis for continued operation, and assesses its cost and repercussions compared with those of closure.

Closure of Invergordon Smelter

2. BACO is in a dangerous financial position. If no settlement on the smelter is agreed with it immediately it may choose to go into liquidation before the end of December. BACO has hitherto assumed that the Invergordon smelter must close, and put forward proposals based on this.

3. We have taken as the closure "base case", for comparison with continuation, a proposal which does not involve any net cash settlement. After closure and cancellation of outstanding liabilities, this would leave BACO with a capital gearing of 60% and interest cover of 1.4. They would be in a tight situation, in which they might decide they had to close further downstream activities especially the Falkirk rolling mills. Indeed there is a chance that the Board might still decide that, in their shareholders' interests, they should instead go into immediate liquidation.

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4. The cash costs of this option to the PSBR are estimated as (£mn.):—

| | 1981/82 Jan-March | 1982/83 | 1983/84 | 1984/85 | 1985/86 onwards |
|--|----------------------|------------|-----------|-----------|------------------------|
| (i) Loan receipts foregone | Nil | 3½ | 3½ | 3½ | 3½ |
| (ii) Proposed extra expenditure by HADB* | 1 | 5 | 5 | 5 | Nil |
| (iii) (Unemployment Pay) (Loss of tax revenue) | 1 | 3 2 | 2 1 | 1 1 | (say) Nil (say) Nil |
| (iv) Loss to NCB of coal sales displaced by Hunterston | 2 | 8 | 5 | 2 | (say) Nil |
| <u>LESS</u> | | | | | |
| (v) Lower costs of Scottish Boards | (2) | (10) | (10) | (10) | (10) |
| | <u>2</u> | <u>11½</u> | <u>6½</u> | <u>2½</u> | <u>(6½)</u> |

The cumulative cost of these items up to the end of 1984/85 is £22½m, with a net gain thereafter which reflects the fact that the Scottish Boards no longer have to supply this electricity at a non-commercial rate.

5. Closure would have significant repercussions in Scotland:—

(i) The NCB would have 10% of its market of coal displaced (¾m tonnes), as reflected in 4(iv) above, which would be particularly difficult coming on top of the 30% loss of market arising from Peterhead power station coming onstream.

(ii) The major loss of demand for electricity would increase current Scottish over-capacity, and assist the anti-nuclear opposition's case against the construction of Torness.

(iii) 900 jobs would be lost directly, and 500-600 indirectly, at Invergordon, with serious implications for the local economy.

* Assuming Ministers agree to the proposal by the Secretary of State for Scotland

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Continuation of Invergordon Smelter

6. Officials have discussed with BACO a basis for continuation of the smelter. In the light of the discussion we believe the following proposals are the least generous likely to be acceptable to BACO:-

(i) Claims both ways would be cancelled as in the closure option (the exact arrangements for achieving this remain to be resolved).

(ii) The price per unit levied on BACO would be reduced to 1.0p (as compared with about 2.5p for other large industrial users) by excluding reprocessing charges for spent fuel and decommissioning charges. The cost to the PSBR of the annual payments would be about £16m.

(iii) The price of units to BACO would increase as from 1 April 1982 in line with costs at Hunterston but with an upper limit in any year set by the rate of increase of published electricity tariffs for industrial customers in Great Britain.

(iv) BACO would not be liable for any charges arising from a major accident at Hunterston B, such as the sea-water ingress in 1977.

(v) It would be agreed that if BACO made very high profits in future years it should contribute towards the extra subsidy implicit in these provisions. A formula for profit-sharing would be agreed based on an equal sharing between BACO and NSHEB of profits before tax after such profits had exceeded an agreed ceiling representing a fair rate of return on assets employed.

7. These arrangements would be embodied in a revision of the contract. They would need to be explained to Parliament, and defended in terms of the legal and moral obligations arising from the existing arrangements between BACO, the Boards and the Government (including the letter of comfort from the Minister of State for Trade in 1968). The presentation would have to be carefully judged in order to minimise problems with the EC Commission.

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8. In order to avoid an open-ended commitment, officials put to BACO a proposal for a review after three years. However, BACO made it clear that no "break clause" would be acceptable because it could again put them in a position where the smelter ceased to be viable. It would raise the following difficulties:-

- there would be insufficient basis to authorise the considerable investment now required to improve the smelter's energy usage;
- BACO would be unable to make definite provision for raw material to secure its downstream businesses;
- depreciation of the smelter would have to be accelerated, with adverse effects on BACO's Profit and Loss Account;
- BACO's effective borrowing power would be seriously damaged.

9. The transactions in paragraph 6, although helpful to immediate confidence in BACO, would leave BACO with a capital gearing of 50% and, at least during 1982, its income cover for its interest payments would be 1.2 - even less than under the closure option. Its weaker activities would remain at risk of closure.

The cash cost of this continuation option to the PSBR is about £16m. a year. The cumulative cost up to the end of 1984/85 is £52m if the smelter runs at full output. In practice it is likely to run at a lower level in 1982, resulting in a somewhat lesser payment.

10. The Government's liability for providing a subsidy of £16m a year would continue until the end of the contract in the year 2000. This would rise further if actual costs relating to Hunterston in any year increased faster than electricity prices generally, for example if -

- (i) Hunterston B's availability did not reach the projected 62% in 1982/83 and later years (previous highest level 53%);
- (ii) Hunterston B operating costs rose excessively;
- (iii) Hunterston B faced major new capital charges, whether due to unforeseen operating problems or new requirements of the nuclear inspectorate;

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(iv) the costs of reprocessing fuel escalated faster than now provided for by the Scottish Boards.

On the other hand, the subsidy payments would be less if either availability or costs (including reprocessing costs) moved more favourably than expected.

11. The continuation proposal could also have further repercussions for public expenditure:-

(i) The Kaiser/RTZ smelter at Anglesey has a similar contract with CEGB and will become liable to higher fuel charges as soon as Dungeness B comes on stream (now forecast for 1982). This smelter employs 1,146 people directly, and closure might be expected to raise the area's current unemployment rate from 21.5% to 30% or so. The owners are likely to press for a subsidy that puts them in a position similar to that of BACO.

(ii) The Alcan smelter at Lynemouth, Northumberland, has contracts with NCB with break clauses at 1 January 1984 and 1 January 1987. Although this smelter was built at the same time as the two other smelters its contractual arrangements are sufficiently different from them as to weaken its case for parallel assistance. None the less Alcan is a major competitor of BACO, and if Alcan established a case to be put on a par with Invergordon it could cost, in additional subsidy to the NCB, about £3-£4m pa from January 1984 and £6-£8m pa from January 1987.

(iii) The announcement of the proposal might intensify pressure from other energy-intensive industries such as steel, chemicals, cement, etc, for special treatment.

Discussion

12. The first question Ministers will have to decide is whether the continuation proposals ^{are} likely to be acceptable to the Government. The cash cost is put at £16m a year, rising with electricity prices until the year 2000; the cost

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would be higher if costs rose disproportionately at Hunterston. The gain would be preservation at Invergordon of 900 jobs directly and some 500-600 indirectly. The deal would involve writing off past liabilities of £59m. Care would be needed to avoid difficulties with the EEC. It would be difficult to resist a similar claim from the Anglesey smelter, and a request for some assistance in respect of Lynemouth. Pressures from other major industrial energy users will be intensified.

13. The PSBR costs of continuation and closure are approximately as follows:-

| | 1981/82 June-March | 1982/83 | 1983/84 | 1984/85 | 1985/86 Onwards |
|-----------------|-----------------------|---------|---------|---------|--------------------|
| A. Continuation | 4 | 16 | 16 | 16 | 16 |
| B. Closure | 2 | 11½ | 6½ | 2½ | (6½) |

14. Either continuation or closure would leave BACO in a weak financial position. Unless aluminium demand improved, BACO might still decide to go into liquidation before long. Under either option, Ministers might therefore wish to take further steps to strengthen the company's financial situation:-

(i) One means, which would avoid EEC problems, would be to allow £5m of outstanding claims to be settled in the company's favour as part of the overall settlement;

(ii) Under the closure option, some Ministers have proposed a net payment of up to £30m, though this would be likely to cause further problems with the Commission. Even then continuation of all BACO's activities could not be guaranteed, although the chance would obviously be better the larger the assistance provided. An alternative to (i) and (ii), if the company needed further help next year, would be to judge this separately on its merits as a rescue case under Section 8 of the Industry Act.

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Conclusions

15. Ministers are invited to decide:-

(a) whether a settlement on the terms in paragraph 6 should be offered to BACO in order to avoid closure of the Invergordon smelter;

(b) if (a), whether the settlement should include the additional £5m of outstanding claims in the company's favour (paragraph 14);

(c) if not (a), whether a settlement involving closure of the smelter, on the lines considered by E(EA) as in the minute of 10 December by the Secretary of State for Industry, should be offered;

(d) if (c), whether a closure settlement should be on a no cash basis, or should include a payment to the company of up to £30m.

MR. SCHOLAR

cc Mr. Whitmore

I have set up the meeting for Friday at
9 a.m. to discuss British Aluminium. The
following will be present:

Secretary of State for Scotland

Secretary of State for Wales

Chief Secretary

Secretary of State for Industry

Secretary of State for Energy

Robin Ibbs

es.

16 December 1981