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To be aware.

JU611

PRIME MINISTER

SWAN HUNTER

I have seen the 16 June letter to you from Swan Hunter Ship-builders Ltd.

Swan Hunter must have their frigate - no other have to be done - 20/6. JKS

2 I am sure that George Younger will welcome Swans' revised tender of £57.8 million for the second Type 23 frigate. I understand that this latest price makes their tender fully comparable with the best alternative. Of course, there are always additional costs to MOD of placing an order with a yard that did not build the First of Class, in particular the cost of the Lead Yard's design services. This was recognised when Cabinet agreed on 31 January 1985 that the Defence budget would bear any additional cost from letting this contract to Swan Hunter on a noncompetitive tender provided that their price was fully competitive.

3 However, I understand that the additional costs in this present case include not only the cost of the lead yard services, but also MOD's liability to VAT on items to be supplied to MOD by Yarrow Shipbuilders Ltd. I do not fully understand why this should be - and it would be extremely difficult to explain in the North East. It is only reasonable for MOD to take account of

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BOARD OF TRADE
BICENTENARY



this VAT charge in comparing the cost to them of the different tenders submitted. But Swan Hunter were promised the order provided their price was competitive; and I understand that this is now the case. It seems totally unacceptable that we should go back on our promise to Swan Hunter because of a VAT technicality which has no net effect on the Exchequer. I very much hope therefore that George Younger will feel able now to award the second Type 23 frigate to Swan Hunter in line with the Cabinet decision.

We can't go back on our promise.

4 No doubt George Younger will be able to answer Swan Hunter's concern about the second AOR. Certainly if Harland and Wolff had sufficient information to cost their tender for the AOR comprehensively they should have no difficulty in providing it to Swan Hunter very quickly.

5 I am sending copies of this minute to members of E(A), George Younger and to Sir Robert Armstrong.

MR4

PP PAUL CHANNON

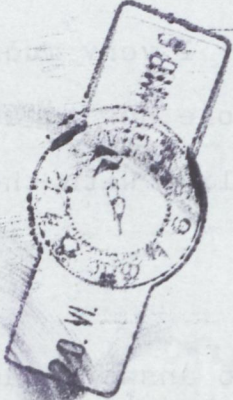
20 June 1986

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

Department of Trade & Industry

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BICENTENARY

Swan Hunter Shipbuilders Limited

WALLSEND SHIPYARD · P.O. BOX 1 · WALLSEND · TYNE & WEAR NE28 6EQ
Telephone National Tyneside (091) 262 8921 Telex 53151
International +44 91 262 8921 53556

Your Ref
Our Ref rv/dr/0630/12

30th June 1986

Rt. Hon. Mrs. M. Thatcher MP PC FRS,
Prime Minister,
10 Downing Street,
LONDON.

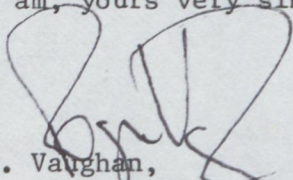
Dear Mrs. Thatcher,

We met Lord Trefgarne and John Lee last Wednesday to discuss the price for the second Type 23 frigate. We were offered a price (apparently having been artificially reduced by the cost of the Lead Yard Services contract) which would make a loss for Swan Hunter. We agreed to further consider our price for this single ship bearing in mind our wish to be competitive, despite contract terms which are unusually onerous.

We have therefore offered to match any commercial price for Type 23.03 actually offered by any other company subject to a floor price below which the contract becomes uncommercial. We believe that this totally fulfils the requirements of the Secretary of State for Defence when the order was promised to Swan Hunter. I attach a copy of our full response to Lord Trefgarne.

We have a further meeting with Lord Trefgarne on Tuesday 1st July and We urgently await a successful outcome of his deliberations.

I am, yours very sincerely,


R. Vaughan,
Joint Managing Director

Signed on behalf of the four Joint Managing Directors -
Alex Marsh, Peter Vaughan, Ken Chapman and Roger Vaughan

Swan Hunter Shipbuilders Limited

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Your Ref

Our Ref rv/dr/0630/11

30th June 1986

The Lord Trefgarne,
Minister of State for Defence Procurement,
Main Building,
Whitehall,
LONDON. SW1A 2HB

Dear Lord Trefgarne,

I am grateful to you for the time which you and your colleagues were able to spend with us last Wednesday in discussing the price for the construction of Frigate Type 23.02.

MOD formally classified Type 23.02 to us as a non-competitive contract in their telex of 1st March 1985. You have now received "best and final" offers for Type 23.03 as a single ship contract from three other builders and I therefore believe that the formula set out below allows a "fair and reasonable" price to be achieved for Type 23.02.

I believe that we made our position on the basis of the price clear, that is that we cannot accept that the price you offer us for Type 23.02 should, in effect, be the market price for Type 23.03 reduced by the value of the lead yard service contract for that vessel. Subject to the issues which we raise in this letter and agreement on outstanding contractual points we are prepared to make the following offer.

We will build Type 23.02 at whatever is the lowest, "best and final" offer for the Type 23.03 as a single ship contract which you formally received on 2nd June 1986 from any other Company in response to the ITT NSS 51B/1039 adjusted as necessary in the usual way for changes in the base date and other normal amendments (excluding for example, any element of lead yard services costs or VAT on long lead items) which you make in comparing bids, provided that this price is not lower than £55.8 million. Below this price level the business becomes uncommercial. We believe that this totally meets the spirit and intent of the Secretary of State for Defence's statement in the House of January 1985 in which he announced the award of frigates Type 22.13/14.

30th June 1986

The Lord Trefgarne

We also put our views to you on the subject of the lead yard services contract itself and in particular the way in which for the Type 22 series it has artificially impeded follow on builders. You gave us your assurance that we would be able to set out our detailed comments on lead yard services contracts to your Officials and therefore influence the content of this contract for the Type 23 and we have taken this assurance into account in our offer.

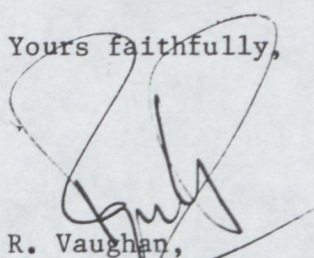
Turning to the issue of design uncertainty, it has proved impossible to properly assess the extent of this uncertainty and the Lead Yard has itself stated that it does not know the extent of the uncertainty. I must emphasise that the manner in which you require follow on builders to accept the impact of design uncertainty on their costs in turn demands that we have the opportunity to discuss areas of concern with both the Lead Yard and MOD at a time which allows us to successfully mitigate those costs. This is a precondition of this offer.

We look forward to discussing the final issues between us on the building contract for Type 23.02. The most important outstanding point relates to indemnity where we require to be indemnified at least to the extent of consequential costs arising out of any failure for any reason during tests, trials and commissioning.

We are unable at this stage to make any further comment on the price of Type 23.02 as one of a batch of orders to Swan Hunter until you are able to be firmer about the actual order package you intend placing. I would point out, however, that we have quoted Type 23.02 at £55.0 million if Type 23.02/03/04/05 are ordered from us.

I hope that the above offer for Type 23.02 as a single ship will prove satisfactory to you and enable you to announce the long promised order to Swan Hunter very quickly.

Yours faithfully,


R. Vaughan,
Joint Managing Director

Signed on behalf of the four Joint Managing Directors - Alex Marsh,
Peter Vaughan, Ken Chapman and Roger Vaughan



CCSO



Minister of State
for Defence Procurement

D/MIN/DGT/4/1

MINISTRY OF DEFENCE

WHITEHALL LONDON SW1A 2HB

Telephone 01-218 6621 (Direct Dialling)
01-218 9000 (Switchboard)

26 June 1986

Dear David,
more problems
Prime Minister 2
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26/6.
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SWAN HUNTER

In John Howe's absence abroad with Mr Younger I am replying to your letter of 23rd June about Swan Hunter.

We are planning that Mr Younger will circulate a paper for the E(A) meeting on shipbuilding on 3rd July. This will cover both the detailed position with Swan Hunter on the second Type 23 and the outcome of the competition for later ships.

Unfortunately we did not receive a copy of Mr Channon's letter of 20th June until after you had written. There has, I am afraid, been some misunderstanding. The latest bid from Swan Hunter is, in fact, higher than the best alternative.

As suggested in your letter to Mr Vaughan of 18th June, Lord Trefgarne and Mr Lee met the company's Board yesterday morning. They emphasised that the Ministry of Defence was ready to place the order for Type 23-02 as soon as a satisfactory price could be agreed and detailed contract conditions tidied up; and indicated a figure which would be acceptable.

Mr Channon also mentioned the second AOR. As Mr Younger indicated in his statement in the House on 24th April we shall be discussing a contract with Swan Hunter later in the Summer. While the tender information from Harland and Wolff will provide a useful basis for negotiation, construction of this

/ ship ...

David Norgrove Esq.,
10 Downing Street

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ship could not begin until the full detailed drawings have been produced by Harland and Wolff. It remains our estimate, therefore, that construction will probably begin in 1988.

I am copying this letter to the Private Secretaries to members of E(A) and Michael Stark (Cabinet Office).

Yours sincerely,

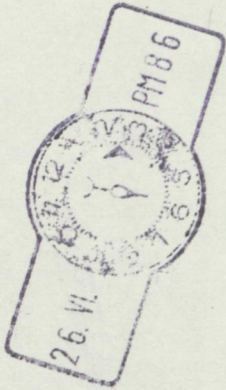
Crispin Harcourt.

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

23 June 1986

Dear John,

SWAN HUNTER

The Prime Minister saw Mr Channon's minute to her of 20 June about the revised tender put in by Swan Hunter for the second Type 23 frigate. She very much hopes that it will now be possible quickly to place the order with Swan Hunter.

I am copying this letter to the Private Secretaries to members of E(A), John Mogg (Department of Trade and Industry) and Michael Stark (Cabinet Office).

Yours,

David

David Norgrove

John Howe Esq
Ministry of Defence.

CONFIDENTIAL

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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

18 June 1986

The Prime Minister has asked me to thank you for your letter and enclosure of 16 June.

Mrs. Thatcher is, as you know, very much aware of your concern about the orders you mention. But I am afraid the pressures on her diary make it difficult for her to see you. The Prime Minister has suggested that you might find it helpful to meet instead Mr. Younger or one of his Ministers, who would be very willing to discuss this with you.

(David Norgrove)

P. Vaughan, Esq.

CAS



10 DOWNING STREET

Pompe Hunter¹

Erwan Hunter

Naval Director would
like to meet you again.

Agree that they should

see Mr Younger or me of

his Director?

Yes

no

DLW

17/6.

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CC/BG

Swan Hunter Shipbuilders Limited

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Telephone National Tyneside (091) 262 8921 Telex 53151
International +44 91 262 8921 53556

Your Ref

Our Ref/v/jgh/13601

16 June 1986

The Prime Minister
10 Downing Street
LONDON

Dear Mrs. Thatcher,

When we met on 25 April at Newcastle Airport to discuss the future work required for the survival of Swan Hunter, we accepted then, as we do now, the overriding importance of submitting tenders which are competitive on price, conditions, delivery and represent value for money. Since privatisation, we have taken a number of steps to streamline the Company, including last week's announcement of 825 redundancies, further economies in purchasing and increased labour efficiency. These improvements in our cost structure have been built into the very keenly priced tender we have now submitted for the second Type 23 Frigate on a single ship basis at a price of £57.8 million.

Evaluation of this price must in fairness be on a like for like basis. Our price assumes that we will not be required to absorb either the cost of the lead yard design or VAT on equipment purchased by GEC-Yarrow, the lead builder, who do not have to bear either cost. In the absence of this assumption, the MOD would be placing the lead builder in a monopolistic position. This defeats MOD's aim of "encouraging the maintenance of a competitive base for warship construction".

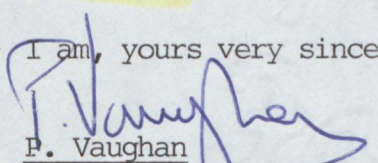
We have also submitted prices for this vessel as a part of various batch combinations for Frigates 02 to 08. As you would expect early multiple orders will result in substantial reductions in the unit price per vessel.

Of other matters raised at our meeting, we remain anxious that design work in MOD's programme should be brought forward to enable us to retain our remaining key design staff.

Naturally, we are most eager to take advantage of the opportunity you afforded us for tendering for AOR-02 at an early date. We have not yet, however, received any information to enable us to tender and would very much appreciate your help in accelerating this process.

The resolution of all these issues is material to the survival of our Company and we would very much welcome an early meeting with you to explain our situation.

I am, yours very sincerely,


P. Vaughan

Joint Managing Director

Signed on behalf of the four Joint Managing Directors -
Alex Marsh, Peter Vaughan, Ken Chapman and Roger Vaughan

Registered Number 924707 England

Registered Office: Wallsend Shipyard, Wallsend, Tyne & Wear NE28 6EQ

Swan Hunter Shipbuilders Limited

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53556

Your Ref

Our Ref ajm/dr/0613/11

13th June 1986

Mr. F.G. Dufty, ADC/SS5
Directorate of Contracts,
Procurement Executive,
Ministry of Defence,
Block F,
Foxhill,
Bath. BA1 5AB

Dear Sirs,

INVITATION TO TENDER TYPE 23.02 LIGHT FRIGATE

1. We are responding to your telex 0510152Z JUN 86 requiring us to consider agreeing a fixed price for 23.02 close to £53 million and agree other contractual terms.
2. Your telex 291130Z JAN 85 confirming the Secretary of State for Defence's announcement in relation to Type 23.02 stated your intention to negotiate an order for the second Type 23 frigate with Swan Hunter Shipbuilders as soon as this could sensibly be done and subject to satisfactory agreement on price and other terms. The price for this frigate also to reflect the economies obtainable with an order for 2 frigates rather than one and to be competitive. The Secretary of State made reference in his Parliamentary Statement to the competition for Type 23.03 which would be entered into by all builders and against which competitiveness was to be judged.
3. In the event the delays in ordering 23.02 and the fact that 23.02 is a totally different ship from the Type 22 frigate have meant that there are no economies obtainable by virtue of the fact that Type 22.14 was ordered from Swan Hunter Shipbuilders at the time of the Secretary of State's announcement.
4. With regard to competition, in our experience as a follow on builder of many different classes of warship, competition has been carried out on the basis of direct shipyard costs and due regard is taken for the necessity for any follow on shipbuilders to be provided with both lead yard service information and long lead

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

equipment items free of charge. Additionally at the time of the Secretary of State's announcement and in relation to the Type 23 Frigates, the need for set up costs also to be taken into account was clearly understood. These set up costs relate to the once off technical work required to commence construction for a class of ship in any follow on shipyard. The national need for competition dictates that these costs will of necessity be incurred.

5. Your telex referred to above and the Secretary of State's announcement on 28th January 1985 both clearly indicated that the intention was to place with Swan Hunter Shipbuilders a class of ship new to that Company with the overhead burden (noted in 4 above) of maintaining competition borne by the Ministry of Defence. You will recall that the direction of Type 23.02 to Swan Hunter was recompense for the award of Type 22.13 to Cammell Laird on non-commercial grounds. Clearly our first Type 23 Frigate in lieu of a repeat Type 22 frigate must involve additional set up costs, lead yard services etc.
6. You confirmed that your figure of £53 million is not a price quoted by any other contractor but rather is a price that ensures that we totally bear the additional costs of lead yard services, VAT on Yarrow-procured items and set up costs. That is to say that you would expect Swan Hunter Shipbuilders to absorb any costs that you would pay to the lead builder for lead yard services and also further absorb VAT which would be recoverable by the lead yard on long lead items but not by Swan Hunter Shipbuilders under current Customs and Excise rules because of the way you have organised their procurement, and of course set up costs as defined in para 4.
7. This represents a total change in the Ministry's procurement policy regarding follow on builders and must jeopardise the stated MOD policy of encouraging the maintenance of a competitive base for warship construction..

The net effect of your requirements (which amount to an additional cost burden for a follow builder of many millions of pounds and which in this context would be borne totally by Type 23.02) would be to preclude follow on builders from bidding successfully against the lead shipbuilder. This is not the spirit of the competition referred to in the Secretary of State's announcement in 1985.

8. The lead builder, in this case Messrs Yarrow, a member of the GEC group, have received the order for the first of class without any competition at all and appear now to be able, through your changed policy, to win all follow on work. This can only lead to a GEC monopoly.

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

9. In relation to the nature of this tender you have stated that Type 23.02 will be formally classified as a non-competitive risk tender and in our telex of 6th June 1986 to J.L.P Davis, Director of Contracts (Surface Ships), we pointed out that the standard conditions of Government Contracts and the spirit of agreement with the CBI state that in non-competitive risk contracts fair and reasonable prices shall be paid. Your implied change of procurement policy referred to above with regard to follow on builders does not result in a fair and reasonable price.
10. We are unable to absorb these additional costs which are rightly yours to take and yours to minimise with the lead builder. We have, however, further considered our tendered price for this ship and in view of the dire consequences for this Company and to the local community and for the prospects for genuine long-term competitiveness in the industry if we were not to receive an order for a Type 23 frigate, we are prepared to offer the following best and final price:- £57.8 million (FIFTY SEVEN MILLION EIGHT HUNDRED THOUSAND POUNDS).

You should note that this price includes a reduction in the previously quoted schedule 14 costs quoted in our tender of 1st June 1986 of £860,000. For your information this reduction is made up of £375,000 for dry docking, £200,000 for ELI attendance of representatives and £285,000 for Yarrow Shipbuilders commercially supplied information. We would wish these items to remain on Schedule 14 list with their new values. We are however, prepared to reflect these savings in the proposed ceiling price for Schedule 14 which we should now be £300,000 above the resultant schedule 14 price. We will send you new schedules tomorrow.

You should be aware that in our view Yarrow Shipbuilders are charging an extortionate amount for information provided under commercial contract. Their quotation for commercially supplied information is in excess of £700,000 per ship and reflects a 900% increase for comparable information compared with that provided for Type 22.14. Our proposed schedule 14 cost is the amount which we believe is necessary to provide if we were to carry out this work ourselves.

We believe that this price on the terms of the competitive procurement policy for follow on ships that existed hitherto is both fair and reasonable.

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

11. As you are well aware, we have already offered substantial savings for a number of combinations of multiple ship orders and we are prepared to reflect this in our offered prices for 23.02 as follows:

Type 23.02 ordered as first of a pair with 03 or 04 or 05 £56.9 million (FIFTY SIX MILLION NINE HUNDRED THOUSAND POUNDS).

For your information the Schedule 14 reductions are for the same items as noted above but is now a total reduction of £717,500 from the previous Schedule 14 value. The same provisions with respect to a ceiling price will apply as above vis £300,000 above the resultant Schedule 14 price after taking above reduction.

Type 23.02 ordered as first of three with 03 and 04 or 03 and 05 or 04 and 05 £56.2 million (FIFTY SIX MILLION TWO HUNDRED THOUSAND POUNDS). The schedule 14 reductions in this case amount £670,000 comments as above apply.

Type 23.02 ordered as first of four with 03,04 and 05 £55 million (FIFTY FIVE MILLION). Schedule 14 reductions are £646,250, comments as above.

12. With respect to multiple ordering we would again draw your attention to the substantial savings included in our tender for Type 23.03 et seq. For multiple orders of two or more follow on frigates our unit price changes from £54.7 million for two to £50 million for 03 to 08 inclusive.
13. With respect to the various contractual conditions with which you would look for compliance listed in paragraphs 4 and 8 in your telex, we would comment as follows:-
- i Design uncertainty - We have already confirmed that we are bearing the costs associated with our response to ITT paragraph 11, within the tender price. It is confirmed that this also applies to the above offered price.
 - ii Clause 29a Force Majeure - Your objection to our proposal appears to be our requirement for force majeure for nominated and de facto monopoly suppliers. As explained to you earlier this week, because the Ministry are involved in the specification of nominated sub-contractors and because certain items, again due to specification, result in a de facto monopoly supply it is impossible to carry out competitive tenders with these groups of sub-contractors. They therefore have an overwhelming bargaining strength.

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

Force majeure purely relates to the payment of liquidated damages for contract delay. We are prepared to undertake responsibility for the performance of all those suppliers and sub-contracts, selected by us, preferably after competition. We feel however that the achievement of satisfactory contractual terms with your nominated and de facto monopoly suppliers is extremely difficult and therefore we consider it fair and reasonable for you to carry the responsibility in terms of force majeure and potential liquidated damages for delay caused by these suppliers. We would point out that in the event of a default of nominated or de facto monopoly suppliers, we are already prepared to carry the consequential costs in relation to programme delay, dislocation or disruption. This in our view is a totally adequate incentive for us to put whatever pressure we can bear on these sub-contractors.

If you continue to nominate suppliers of your choice or specify unique equipment, then you too must carry some of the burden of control. Our proposed clause 29a therefore stands subject to any modification to incorporate the above intent.

iii Clause 25 - Payment - You have stated that it is the Ministry's intention to use contract cash flow as a significant lever. You have proposed that the Ministry operate a cash regulator so that the contractor at any time is not paid more than £1.5 million in excess of the contractor's total expenditure including contract profit. This we accept.

You are also requiring us to accept that this cash regulator clause no longer works in the opposite direction, i.e. you will not fund any excess of contract cost over receipts, which has been the practice hitherto. As we explained to you earlier this week, the following observations are relevant:

- a) We have already accepted your intention to withhold any instalment payment on the basis of any default of our contractual obligations subject only to being given two month's notice in writing. Effectively, this means you already have the ultimate lever through cash flow for ensuring contract performance.
- b) The operation of the regulator to maintain a near neutral cash flow both for the contractors' and the Ministry's benefit is to smooth the inevitable peaks and troughs in cash flow which are the result of an instalment scheme based on cardinal date programmes which are, in this industry, a relatively imprecise document. These programmes are themselves subject to change due to shifting critical paths, MOD modifications

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

and other practical factors concerned with the construction of large complex projects over a number of years.

- c) We cannot believe it is in the Ministry's interests to have their contractors concerned about instalment patterns to the exclusions of issues of efficiency, performance and customer satisfaction which the threat of insolvency would imply - only companies such as GEC-Yarrow can afford to take a relaxed view of this issue.
 - d) You have further requested and we have accepted that contract instalment patterns are confirmed at contract award which due to the early stage of contract definition further exacerbates the position.
 - e) Our offer is therefore based on the acceptance of our proposed revisions to Clause 25 contained in our last tender.
- iv Clause 27 Liquidated damages - Your required change to the liquidate damages clause is acceptable.
- v Price Variation Clause 21 on labour costs - We have already agreed the tender index date and table in the manner normally practiced. This was confirmed at clarification, reference CMQ524/7 and 524/8. Our offer is on the basis of the clause 21 provision contained in our last tender in accordance with CMQ 524/7 and CMQ 524/8.
- vi Clause 59 Guarantee - Your proposed guarantee clause requires us to guarantee the total ship including those components designed by the lead shipbuilder and including those components already procured by the lead shipbuilder for which we have no contractual relationship with the supplier. Your clause also does not exclude consequential costs which is contrary to all normal commercial practice and contrary to your agreement to accept a guarantee provision and not rely on common law. We are unable to get insurance on the commercial market for either the liability for consequentials or for lead builder's design and procurement errors and therefore we believe it unreasonable for you to require this guarantee from us. In relation to design we assume that by the time 23.02 is in its guarantee period, all design uncertainty will have been resolved and therefore our proposed Clause 59 is reasonable for the guarantee period and as such forms the basis of our tender.
- vii Your requirement for a change in delivery date to CAD 15 November 1990 is accepted without additional cost.

13th June 1986

Mr. F.G. Dufty,
Directorate of Contracts

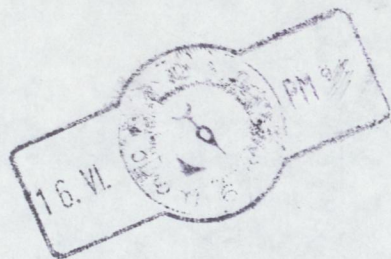
14. We understand that the above items form the substance of all outstanding major issues leaving minor issues for clarification, along with issue of financing which will be discussed at a later stage.

Yours faithfully,

Alex. J. Marsh.

A.J. Marsh
Managing Director - Operations

Copies to: Rear Admiral Hugh Thompson,
J.L.P. Davis, Director of Contracts
Vice Admiral Sir Derek Reffell, Controller of the Navy



PRIME MINISTER

FRIGATE ORDERS

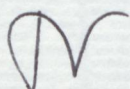
Mr. Nick Brown MP telephoned to ask to see you about the two Type 23 frigate orders which are likely to be decided early next month. He maintains that the Ministry of Defence do not understand the wider implications of the importance of these orders to the North East.

Tim and I suggest that you should not see him. There are four yards in the running for the orders and if you see Mr. Brown you will be under great pressure to see a number of other MPs. (The four yards are represented by a dozen or more MPs.)

Your normal practice is to see MPs about closures in their constituencies. This case falls on the margin, because the MPs are bound to fear substantial redundancies in the yards which do not get the orders. But as the line slips the number of MPs you could see grows very substantially. The lobbying you experienced over the AOR orders should really be the exception rather than the rule.

I should like, if you agree, to tell Mr. Brown you fully understand his concerns. But you hope that he would agree to see Mr. Younger if his concerns are directed specifically at the Type 23s or Mr. Channon if he would like to discuss shipbuilding more generally. If of course he wanted to set out his concerns in writing you would make sure they were given full consideration. I would also say that a decision is unlikely to be taken for several weeks. *-and point out-*

the fact in para 2. I can't see an M.P. and refuse to see 11 others.




pp (David Norgrove)
9 June 1986