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Secretary of State for Trade and Industry

14 September 1983

(4)

SECRET

The Rt Hon George Younger MP
Secretary of State for Scotland
Scottish Office
Dover House
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LONDON
SW1A 2AU

Prime Minister

A summary of the likely pattern of events at Scott Lithgow and Govan is at para 18. MCS 15/9

Dear George,

When we discussed British Shipbuilders at E(NI) on 28 July I warned that closure of Scott Lithgow (SL) was inevitable. At that time we saw closure as most likely to occur some time in 1985/86 as the workload ran out. Recent developments mean that the crunch will come in the next few weeks.

2 There are two rigs under construction at SL, one for BP and one for Britoil. The BP rig is being built in two halves, and the 'mating' process should be completed during the next few weeks, all being well. The Britoil rig is at a much earlier stage. It is very late, and already substantial losses have been provided for (£43.8m in 1982/83, against a contract value of £88.6m). The contractual delivery date is April 1984, but a realistic assessment suggests that completion may take until 1986 or beyond.

3 In these circumstances Britoil have invited BS to re-negotiate the contract. This would however involve BS in substantial further losses. A minimum estimate of these losses is about £45m, in additon to those that are already inevitable. But the Chairman of BS believes that the actual outcome will be much higher than this, because of the unlikelihood that SL could make satisfactory progress on the rig henceforth.

4 BS would gain nothing by completion since no further business can be expected for SL. BS's preferred option is therefore to engineer cancellation of the Britoil rig. BS also need to gain a short breathing space in which to complete the 'mating' of the BP rig before the crisis breaks. On present expectations Britoil are likely to issue the contractually

/prescribed ...

prescribed 30 day notice later this month, and the news is likely to break, and work stop on the Britoil rig, in early or mid-October.

5 Thus the almost total closure of SL is likely to occur much earlier than we had thought. ('Almost total', because BS may wish to retain some technical staff at the yard, as part of the 'core' offshore capability). 2,150 jobs have already been declared to be 'at risk' at SL during 1983/84, of which some 700 have already become firm redundancies. The cancellation of the Britoil rig could lead to a further 2,000 redundancies or thereabouts over the next few months. Thus in total around 4,000 have lost, or will lose, their jobs.

6 The cash consequences of Britoil cancelling its rig would be that £44.3m of stage payment due in December 1983 would be foregone and some £10m would need to be paid in redundancy costs. In addition BS would have to pay back previous stage payments, totalling £45.3m (including interest) plus £7m damages. The estimated costs of cancelling the Britoil contract and of re-negotiating it, are set out at Annex A.

7 I well appreciate the immense impact that cancellation of the Britoil rig will have at SL and on Clydeside more generally. Nevertheless I strongly take the view that we should not intervene to challenge the commercial judgement of BS's new Chairman, Mr Graham Day, on this issue, strong though the pressures may be. We have collectively already recognised that SL will need to close; there is little to be gained, and perhaps a good deal to be lost, by paying for a two or three year postponement of sentence. Nigel Lawson, with whom I have discussed this issue, agrees with this line.

8 Unfortunately, the problem does not stop there, and there is a real risk that Clydeside could soon be facing not only the closure of SL but also the loss of most of its merchant ship-building capacity, as work runs out at Govan, Ferguson and Kincaid.

9 Govan is, in Mr Day's view, BS' best merchant yard. Its closure (it runs out of work in March 1984) would not only mean the loss of one of the very few potentially 'core' yards at BS; it would also have industrial relations and other consequences which would be extremely grave, and would be likely to extend beyond Clydeside and spill over into the whole of BS.

10 Mr Graham Day put to us a proposal to secure a contract for a Canadian order which would provide work not only for Govan but also for Kincaid, Ferguson and Sunderland (Wearside). The details of this proposal are set out at Annex B. Graham Day was clearly unhappy about putting forward a request for subsidy levels of this order (58% to 67%), but could see no satisfactory alternative possibilities for Govan.

/11 After...

SECRET

11 After careful consideration, I have decided that the level of subsidy needed to have any hope of gaining this contract is unacceptable. Nigel Lawson agrees.

12 However, there is an alternative. The CEGB is proposing to order 2 (certainly) or 3 (probably) colliers early in the New Year. Govan has already indicated a desire to tender for these ships. CEGB will be going out to tender, and there will be competition from the Far East. But the price-cost gap that might need to be bridged by a combination of existing support measures (acceptable to the EC) and additional support is likely to be much lower than on the alternative Govan contract. The subsidy involved is likely to be substantial and we shall need to negotiate hard with BS, and the CEGB. Details are at Annex C.

13 Norman Lamont has spoken to Giles Shaw about whether the timing of the order could be brought forward, so as to reduce the gap between the end of Govan's existing workload and the start of work on the CEGB ships. Officials of the DTI have also spoken to CEGB officials.

14 I understand that the CEGB are prepared to consider placing the order with BS, providing we are prepared to go most of the way towards bridging the price-cost gap. This would probably cost in the region of £3.5 million to £4.4 million per ship.

15 I understand that the CEGB are also prepared to accelerate the tendering process and the placing of the order, so that work on the ships could be brought forward to start in about June/July 1984. This would mean that Govan had a spell with little or no work in the yard, when labour and overheads would have to be carried - at a cost we estimate to be around £7 million.

16 This is not an ideal solution to the problem of Govan. It is expensive, although not as expensive as the alternative Canadian contract; and the yard would have an "idle" spell in the spring of next year. Nonetheless, I believe that it offers the best way forward both in terms of the strategy for BS that we have asked Mr Day to develop; and in terms of securing an outcome that recognises the consequences for Clydeside of what I now believe to be the inevitable and early closure of Scott Lithgow.

17 The basis on which we hope to secure this order for Govan will have some presentational difficultes, notably with the European Commission. But support is - and we should be able to present it as - an essential element in the slimming down and efficient restructuring of BS that we have instructed Mr Day to tackle.

18 In summary: events at Scott Lithgow are now moving towards an early closure, probably in early 1984. I have considered whether we should agree that BS should be allowed to bid for a contract for Govan that would involve subsidies of 58% to 67%, but have decided that we should not make subsidy at such a rate available. We will have to consider what support we should make available for the CEGB to place an order at Govan later this year. I thought you should be aware of all these developments.

19 I am copying this letter to the Prime Minister, Geoffrey Howe, Nigel Lawson, Peter Walker and Sir Robert Armstrong. A copy also goes to Michael Heseltine as an MOD SOV vessel is now being completed at SL, but I understand that BS would see no difficulty in completing the SOV in another yeard if it became necessary.

20 Finally I should stress that apart from the obvious political sensitivities it is essential that the commercial confidentiality of BS's proposed tactics with Britoil should be carefully protected. I should be grateful therefore if this matter could be handled by you and copy recipients strictly on a "need to know" basis.

Yours Ever,

Cecil.

COMMERCIAL IN CONFIDENCE
CONFIDENTIAL

Britoil contract at Scott Lithgow

1 Cash costs of cancellation

	£m
Foregone instalment payment (due December 1983)	44
Repayment of monies already received and interest	45
Damages	7
Extra redundancy costs	10
	106

The repayment of monies already received and damages (£52 million in total) could possibly be made to fall in 1984/85.

2 Cash costs to renegotiate

The costs set out below are the costs that BS would incur if they re-negotiated the contract on the lines that Britoil is likely to request. They include:

i hire of rig: $22 million per year (say £15 million). This would be for two years, if Britoil's delivery date expectations are right (March 1986); 1 year if SL's are (January 1985);

ii extra supervision costs (ODECO): £1½ million per year: either 1 or 2 years, as above;

iii BS to meet Britoil's extra financing costs duee to late delivery: £7-8 million for the first year, and £4 million thereafter;

These costs add up as follows:

1984/5	£m	1985/6
15		15
$1\frac{1}{2}$		$1\frac{1}{2}$
8		4
$24\frac{1}{2}$		$20\frac{1}{2}$

on Britoil's (more realistic) delivery scenario

3 In addition SL would have to accept that stage payments should be related to actual progress. At present, SL have received 2 payments: £4.431 million in December 1981 and £35.448 million in December 1982. The contract value is £88.622 million, so SL have had about half. They have built only about one quarter of the rig. On a pro-rata basis, they would therefore receive:

0	in 1983/84)	
say £10m	in 1984/5)	on Britoil's
and £38m	in 1985/6)	delivery scenario

OR

0	in 1983/4)	
	)	on SL's delivery scenario
£48m	in 1984/5)	

This is a re-phasing of cash, which would not have an impact on the loss position of the contract.

4 Britoil would also seek to renegotiate a realistic delivery and drop dead date, with increased damages payment.

5 The estimated costs of rengotiation, as set out above, arise only from changes in the Britoil contract. They do not take into account further losses due to poor performance on the contract, or due to slippage arising because of the "last ship" syndrome. Given SL's track record, there is a high probability that substantial further losses would be incurred for this sort of reason - it should be noted that with only one quarter of the rig constructed, losses of £44 million have already had to be provided for.

6 The BS Chairman, Mr Day, takes the view that, while he has reasonable confidence in the estimated costs of cancellation, he has no confidence whatsoever in those for renegotiation. The auditors have for many years been unable to confirm the estimates of the costs of completing contracts at SL and have expressed particular reservations about the 1982/3 accounts. There is therefore, in his view, no reason to suppose that the present estimates of the cost of completing this contract are any more realistic. The Chairman also sees a high risk arising from the "last ship" problem. He therefore takes the view that the costs associated with renegotiating the contract and trying to complete it may therefore be substantially in excess of the figure quoted above.

Deepartment of Trade and Industry

14 September 1983

GOVAN - CANADIAN TRANSPORT CONTRACT

1. British Shipbuilders (BS) are seeking Government assistance above standard levels to help them win an order for three open bulk carriers. The deal involves the purchase of the ships by a finance company, as yet unspecified, which would lease them (without UK tax allowances) to two Norwegian ship operators, Lorentzen and Jahre (L and J). They, in turn, would charter them for eight years to a Canadian company, Canadian Transport (CT), for service in the forest products trade between Vancouver and the UK/Continent. The ships are to a new design, prepared particularly for this trade and specified by CT to shipowners and shipbuilders world-wide for this contract. There are some known prospects for further orders to the same design but the market is specialised and limited.

2. 38 tenders were received by CT. These have been reduced to a short list including, in addition to L and J, two other Norwegian owners, one US, one Japanese and two Hong Kong (one London-based). Another tender by two UK shipowners is now understood not to be acceptable to CT. The competing tenders are based on construction, all to the same new design, in Korean, Japanese or Yugoslav yards. L and J have, however, indicated to BS their willingness to build at Govan if the Japanese bid to them can be matched. There is no EEC shipowning or shipbuilding competition left in the running.

3. The Board of CT is to take a final decision on Friday 16 September. There appears to be no flexibility in this timing and a decision on the assistance availableto BS is therefore extremely urgent.

Support Required

4. The CT charter will be in US dollars and BS' quotation also has to be in US dollars. The vessels would be built at Govan, with significant sub-contracting to Ferguson and Sunderland. The engines would be built at Kincaid. Delivery would be in May, September and December 1985.

5. The construction cost is estimated at $33 million per ship. To match the price offered by the Japanese, which L and J have revealed to BS, BS believe that the highest price acceptable to L and J would be $22 million per ship, including the cost of pre-delivery finance with an NPV of approximately $1.3 million. Excluding exchange risks and premia on selling forward, therefore, a direct subsidy of $12.3 million per ship (55% of contract price) would be required, as against the current rate of Intervention Fund (IF) plus Shipbuilder's Relief (SR) of 17%. The total cost

to Government of this deal is set out as Alternative A in the attached Table.

6. Presentationally, it would be a little easier to defend in the EEC (although it would still be objectionable) a deal under which the overt breach of IF rules involved in Alternative A was avoided. This would be possible by adopting a price of $28.2 million per ship and allowing BS to offer an interest free loan to L and J or their lessor, in which Government would not be directly involved. BS have calculated that a loan of approximately 50% of contract price for eight yers from contract signature would have equivalent effect to Alternative A. This arrangement is set out as Alternative B in the attached Table, whcih shows a higher total cost but with a smaller amount in exceptional form, both absolutely and as a proportion of contract price.

TABLE

Cost to Government

US $

Alternative A

Construction Cost	99,000,000		
Less: Normal Aids		IF@15%	9,900,000
		SR*@ 2%	1,320,000
Exceptional Aid		Additional Subsidy	21,780,000
Total Direct Aids	33,000,000		33,000,000
Selling Price	66,000,000		
Additional Aids		Normal Home Credit (11.14% NPV)	7,352,400
		Exceptional Pre-Delivery Interest (5.9% NPV)	3,894,000
Total Aids		Normal (28.14%)	18,572,400
		Exceptional (38.9%)	25,674,000
			44,246,400
			= 67.04%

* Shipbuilders Relief

$

Alternative B

Construction Cost	99,000,000		
Less: Normal Aids		IF @ 15%	12,692,308
		SR* @ 2%	1,692,308
Total Direct Aids	14,384,616		14,384,616
Selling Price	84,615,384		
Additional Aids		Normal Home Credit (11.14% NPV)	9,426,154
		Exceptional Interest Free Loan (30.0% NPV)	25,373,936
Total Aids		Normal (28.14%)	23,810,770
		Exceptional (30.0%)	25,373,936
			49,184,706
			= 58.1%

* Shipbuilders Relief

ANNEX C

CONFIDENTIAL & COMMERCIAL IN CONFIDENCE

CEGB order for 3x20,000 dwt colliers

1. On the CEGB's present plans, tenders would be invited in early November for submission at the end of December, leading to the placing of a contract in January. This would not allow construction to commence before July/August 1984, about four months after current orders at Govan are completed.

2. The CEGB has agreed to discuss with its consultants the possibility of shortening this timetable both by issuing the invitation to tender sooner and by allowing a shorter period for their submission. The scope is limited because this is already a tight programme but it seems that there might be some chance of cutting out up to a month. On this basis, it is just possible that the CEGB might be in a position to place the contract before Christmas, which might enable Govan to start construction in June, leaving no more than three months hiatus.

3. CEGB will, of course, be looking for the best deal available. In particular, they will be considering either chartering the vessels from an operator or owning them themselves and engaging an operator to manage them. They are likely to invite charter tenders from about six operators. This means that the range of shipyards tendering to construct the ships could be wide, although the CEGB do intend to ensure that, within the UK, it is BS centrally (and Harland and Wolff) which is invited to tender, rather than individual BS yards. It will, therefore, be within the control of BS to concentrate their tender onto Govan. It is, however, clear that it will be necessary to support the Govan tender to the level of Far Eastern competition.

4. The CEGB has already obtained indicative prices from both BS and Japan. BS's quotation, allowing for Intervention Fund at 13 per cent and Shipbuilders' Relief at 2 per cent, was £10.6 million. (This compares with BS' indications to us, on the same basis, of £10 million with a medium-speed engine, which would not be built by BS, and £10.75 million with a BS slow-speed engine.) The Japanese quotation was £9 million. Subject to any lower prices which might be offered from the Far East, therefore, an additional subsidy of £1-2 million would be likely to be needed to make the Govan price competitive. This would mean total assistance per ship as follows:

		Medium speed	Slow speed
Construction cost	£	11,500,000	12,362,500
Contract price		9,000,000	9,000,000
Intervention Fund (13%)		1,170,000	1,170,000
Shipbuilders' Relief (2%)		180,000	180,000
Normal Home Credit (11.14%)		1,002,600	1,002,600
Additional subsidy		1,150,000 (12.8%)	2,012,500 (22.4%)

5. In addition to these support costs, the gap of some 3 months between the end of Govan's current order-book and the start of construction on the CEGB order would cost of the order of £7 million in unrecovered labour and overheads involved in keeping the yard operational with no work.

Department of Trade and Industry

13 September 1983

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