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P.01282

PRIME MINISTER

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Warship building.  
E(A)(84) 23 & 24.

BACKGROUND

The Government's Election Manifesto said that it would aim at transferring a 'substantial part' of British Shipbuilders (BS) to the private sector. Given the financial and other difficulties faced by merchant shipbuilding, the most realistic way of achieving this aim is by disposing of warship building activities. The Chancellor of the Exchequer's memorandum on competition and privatisation (E(A)(84)3), which was endorsed in general terms by the Sub-Committee at their meeting on 25 January (E(A)(84)2nd Meeting) suggested that privatisation should be possible from 1985 onwards.

Privatisation

Para C. 2. In his memorandum E(A)(84)23 the Secretary of State for Trade and Industry says that there is substantial excess capacity in the five main warship building yards in Great Britain. Annex B to his memorandum implies that during the next eight years naval orders would not require more than 75 per cent of capacity; in some years they would require significantly less. He believes that complete closure of one yard (and apparently significant reductions in capacity at least one other) is needed: his merchant bank advisers, Schroder Wagg, have said that sale of the yards (other than Vickers, which has an assured future building Trident submarines) could take place only once a decision on the reduction of excess capacity had been taken. Although he does not explicitly say so, it is clear that Mr Tebbit believes that the yard to close should be Cammell Laird on Merseyside. It is a relatively inefficient yard; and its order book runs out in December 1984.

  
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3. Mr Tebbit recommends that all remaining warship yards should be transferred to the private sector, preferably individually or in small groups in order to preserve competition. However, in case this should go too slowly, or realise inadequate sale proceeds, and to strengthen the Government's hand in negotiation with potential buyers, he recommends that there should be simultaneous work towards a public flotation. BS should take the lead in negotiations with potential buyers, with a deadline of March, 1985 (end-1985 for a public flotation).

Cammell Laird and orders for Type 22 frigates

4. The Ministry of Defence wants to order two Type 22 frigates. Three yards (Vosper Thornycraft in Southampton, Swan Hunter on Tyneside, and Cammell Laird) were invited to tender. Cammell's submitted what was, though only marginally, the lowest tender; but it was prepared on assumptions, particularly concerning overheads, which BS were not willing to endorse; BS therefore instructed Cammell's to withdraw the tender, and the tenders from other yards have already expired. In his memorandum E(A)(84)24 the Secretary of State for Defence argues that it would be wrong to go to a further round of tenders. In his view, the social and other consequences of allowing Cammells to close would be prohibitive. He proposes that an order for at least one Type 22 should be directed to Cammells, subject to detailed negotiations; if Cammells demonstrated in the following six months that it could perform satisfactorily, it would receive the order for the second Type 22.

MAIN ISSUES

5. The main issues before the Sub-Committee are as follows.

- (i) Do they agree with the analysis of warship building capacity and orders in E(A)(84)23, and that in consequence it is necessary to close at least one yard?

(ii) In the light of the answer to (i) above, what should be done about the order for Type 22 frigates?

(iii) In the light of the answers to questions (i) and (ii), what should be the Government's approach to privatisation of warship building? In particular -

(a) Should any yards in Great Britain be retained in the public sector?

(b) Should the Government require overt competition to be maintained by selling different yards, or groups of yards, to different owners; or is a sale to one buyer acceptable?

(c) If a sale to one buyer is acceptable, is flotation an acceptable method? Is it perhaps preferable to a negotiated sale to a corporate buyer?

(d) Who should take the lead in negotiating any sales?

(e) Should the negotiator have a deadline and/or a pre-condition regarding sale proceeds?

Capacity and orders

6. The figures in Annex B to E(A)(84)23 suggest that on present prospects there will be over-capacity in warship building for years to come. If that is a correct assessment, then maintaining existing capacity will carry a large cost. It may also be a bar to privatisation, since it will not be easy to privatise the industry on the basis of continuing Government subsidy of excess capacity; and excess capacity often leads to directed orders, which prevent

genuine competition. Even if privatisation were possible, the sale proceeds would probably be reduced by excess capacity in the industry.

7. On the other hand, the Sub-Committee will wish to consider the following.

(a) E(A)(84)23 implies strongly that Cammell Laird should close; paragraph 6 of Annex C also suggests that Vospers steel warship building capacity should close. That would leave Vickers as the only yard with a proven capacity for building modern submarines; Vospers as virtual monopolists of glass-reinforced plastic (GRP) work; and only Yarrow and Swan Hunter competing for frigates and auxiliary oiler replacements (AORs). Is this enough competition?

(b) The forecast level of warship construction in Annex B to E(A)(84)23 is historically low; and the Annex does not provide for some classes of warship which are competing for a place in the Defence Programme over the next ten years (eg enhanced Patrol Vessels and amphibious force replacements). Export prospects may also be better than allowed.

The order for Type 22s

8. In reaching a decision on the order for Type 22 frigates, the Sub-Committee will wish to consider the following.

(a) If the view is taken that the prospect is for continuing excess capacity in warship building, and that closures are therefore necessary, then giving the Type 22 order to Cammells must mean closing another yard. DTI officials consider that the natural alternative to Cammells would be Swan Hunter. The difficulties of a closure on Tyneside might be no less

severe than those of closure on Merseyside. Moreover, apart from Vospers, the other yards have orders on hand until December 1987 or later; and they could hardly be closed before then. This could lead to a significant deferment of privatisation.

(b) Directing an order to Cammells rather than asking for new tenders would run counter to normal procurement practice. It is quite possible that the Accounting Officer in the MOD would require a Ministerial direction to protect him before the PAC. If so, the fact that Ministers had decided to direct the order to Cammells, on political grounds, could be expected to become public knowledge quite quickly. Other yards could be expected to complain.

(c) The chairman of BS, Mr Graham Day, is said to be anxious to keep Cammells open. However, he recognises that doing so would require substantial redundancies (which weakens some of the arguments in E(A)(84)24) and concessions from the workforce which may well not be forthcoming. Nor is it clear whether he has plans for reducing the capacity of the warship building industry, if Ministers consider this necessary.

(d) If the Type 22 order is not to be directed to Cammells, the natural alternative will be to ask for new tenders. Cammells could hardly be excluded from the request (after all, they did submit the cheapest bids in earlier rounds). So the future structure of the industry would be in doubt until the tender process had been completed. (However, I understand that this should take no more than a few weeks).

  
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(e) It is unlikely to be satisfactory to try to compromise by giving one order to Cammells and the other to another yard. Not only would this defer tackling the problem (if there is one) of excess capacity in the industry; it would also significantly increase the cost of the ships by preventing the yards concerned from spreading overheads.

Approach to privatisation

9. Clearly no member of the Sub-Committee is likely to suggest that privatisation of warship building is undesirable. But a number of important questions will need to be addressed in the light of the Sub-Committee's conclusions on the matters discussed above.

(a) Retention of yards in the public sector

It will not be disputed that the privatisation of all warship building yards in Great Britain is desirable. It may, however, be questioned whether it is essential, as Mr Tebbit argues. Harland and Wolff compete for naval orders and are unlikely to be either closed or privatised in the foreseeable future; it is not suggested that this is an insuperable objection to privatisation of naval yards in Great Britain.

(b) Competition

The Sub-Committee will wish to consider how important an objective competition is, and how it can be achieved. At one extreme it would be possible to argue that, as noted above, closure of yards will reduce competition; that even some sales of 'small groups' of yards would leave no effective competition (for example, if Yarrow and Swan Hunter were sold to a single buyer); and that therefore no two yards should be sold to the same buyer. At the other, it could be argued that the only effective competition is between yards in this country

  
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and yards overseas; that for strategic reasons such competition will generally not be allowed; and that sales of the yards as one entity will probably maximise the sale price and should therefore not be ruled out.

(c) Method of sale

The Sub-Committee's views on the importance of competition will have a bearing on the proposed sale method. If they decide that sale to a single buyer should be ruled out, it would be logical to decide against flotation of warship building as a single concern (though the possibility might be kept open as a negotiating tactic).

(d) Responsibility for negotiations

It is likely to be generally accepted that BS should be made responsible for conducting negotiations with potential buyers, so long as they are given their objectives.

(e) Objectives for negotiations

Again, it is likely to be agreed that the negotiators should be given a deadline. There may be more argument about whether they should be given a target for the sale proceeds. We understand that Treasury officials are likely to brief their Ministers to suggest that an objective of at least £75 million should be set. If so, other Ministers are likely to argue that there is no harm in setting such a figure as an objective, but that it should not be a pre-condition: in other words, final decisions should be taken in the light of all circumstances, of which the prospective proceeds would be one but not to the exclusion of others. Certainly it seems reasonable to suppose

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that the financial benefits of effective competition in warship building, if it could be achieved, would outweigh any difference in the sale proceeds that might be produced by one method of sale rather than another.

#### HANDLING

10. It will probably be convenient to divide the meeting into two main parts:

- i. Capacity and orders in the warship building industry; the future of Cammell Laird; and the order for Type 22 frigates.
- ii. The approach to privatisation.

The first part might be opened by the Secretaries of State for Trade and Industry and Defence speaking to their respective memoranda. The Secretary of State for the Environment will have views on the political impact of decisions on Merseyside and other parts of the country. The Chief Secretary, Treasury will have views on public procurement and public expenditure aspects.

11. The second part of the discussion might also be opened by the Secretary of State for Trade and Industry. Either the Chancellor of the Exchequer or the Chief Secretary, Treasury may have comments both on particular aspects and from the standpoint of the privatisation programme as a whole. The Secretary of State for Defence will wish to comment on the importance of effective competition among warship builders.

#### CONCLUSIONS

12. You will wish the Sub-Committee to reach conclusions on the following.

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- i. Is the view of the Secretary of State for Trade and Industry correct, that there is substantial excess capacity in warship building in prospect, and that this requires correction by one or more major closures?
- ii. In the light of the answer to question (i), should the order for Type 22 frigates -
  - a. be directed to Cammell Laird on the basis proposed in E(A)(84)24;
  - b. be the subject of re-tendering by the three yards previously asked to tender (Cammell, Vospers, and Swan Hunter);
  - c. be dealt with in some other way?
- iii. Do the Sub-Committee agree with the detailed proposals regarding privatisation in E(A)(84)23, and in particular:
  - a. that no warship building yard in Great Britain should be retained in the public sector;
  - b. that yards should be sold individually or in small groups, but that the possibility of a public flotation should be kept open;
  - c. that British Shipbuilders should take the lead in negotiation with potential buyers?
- iv. If British Shipbuilders do take the lead in negotiations, what guidelines should they be given?

*PLG*

P L GREGSON

9 May 1984



10 DOWNING STREET

Prime Minister

You may wish to make a  
start on these papers. The  
Cabinet Office brief will  
come tomorrow.

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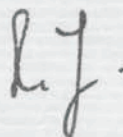
WARSHIPYARD PRIVATISATION AND TYPE 22 FRIGATE ORDERS  
E(A) ON 10 MAY

We commend Mr Tebbit's determination to reduce UK warship-building capacity, to proceed apace with warshipyard privatisation, and to consider the wider context of how best to use two Type 22 frigate orders which MOD must soon place.

In summary we recommend:

- i. the withdrawal of Cammell Laird and Swan Hunter from warshipbuilding;
- ii. placing the Type 22 frigate orders with Vosper Thornycroft;
- iii. privatising the three large, dedicated warshipyards - Vickers, Vosper and Yarrow - as separate entities;
- iv. placing the detailed negotiations in the hands of Graham Day, with a deadline for disposal of December 1985.

Our Annex sets out the supporting logic and suggests the sequence in which E(A) should tackle overlapping issues.



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WARSHIP BUILDING PRIVATISATION

1. WHAT ISSUES ARE AT STAKE?

There are four key issues which E(A) will have to address. We suggest the following sequence as most logical:

- i. Given the available market for UK warship building, is capacity reasonably in line with demand?
- ii. In the light of i. what best use should be made of the Navy's urgent requirement to place orders for two Type 22 frigates?
- iii. In the light of i. and ii. how much warshipyard capacity can we hope to privatise?
- iv. How should disposal take place?

2. THE MARKET, AND THE CAPACITY OF THE WARSHIPYARDS

Since the late 1960s, UK yards have won no major overseas warship orders. So, for all practical purposes, the current market for UK built warships - and certainly the only one which will determine the behaviour of investors - is the requirement of the Royal Navy.

For this finite market there will be a continuing surplus of capacity for the two main fighting surface ship types - frigates, and glass reinforced plastic (GRP) ships, ie Minehunters and Mines Countermeasures vessels. Using MOD's Long Term Costing of 1983, Schroder Wagg estimate the surplus capacity on frigates at about 50% to 1986, falling to around 20% from 1987 on. For GRP vessels, the surplus is put at 70 to 80% well into the mid-1990s. Worse, the surplus of capacity will grow if:

- a. labour productivity starts to improve, as it should under the new pay deal and/or
- b. Harland and Wolff start to compete more actively on naval work with GB yards.

Demand and capacity are approximately in balance for submarines and for auxiliary oil replenishment vessels (AORs).

But the over capacity problem, where it exists, is a serious one. It cannot simply be transferred to private owners.

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Where Government can afford to be cavalier about asset write-off (because it is a non-cash item) the private sector cannot. And there is a problem over redundancy pay. While shipyard workers remain in the State sector they are covered by the rather generous Shipyard Redundancy Payments Scheme, which private sector owners almost certainly cannot afford. Yet shipyard workers will not give up such rights without a fight on transfer to the private sector.

So we agree with Mr Tebbit and Schroder Wagg that reducing over capacity is for BS to pay for, and therefore to identify. This is an indispensable prior condition of privatisation.

3. THE TWO TYPE 22 FRIGATES

Each ship represents about 2 years of work. The orders could be placed in a way which:

- i. fulfils a largely social objective by sustaining employment in difficult areas; or
- ii. aids privatisation by providing a solid 'launch' order book; or
- iii. quite simply awards the orders to the lowest bidder.

These three options do not converge.

In theory, the frigates can be built at any one of four yards - Vosper Thornycroft (Southampton) or Yarrow (Glasgow), which are both dedicated warshipyards; or Cammell Laird (Merseyside) or Swan Hunter (Tyneside) which are mixed activity yards.

On employment grounds Yarrow does not have a priority claim to the T22s since it is busy until the end of 1987. Much the same is true of Swan Hunter: although the yard is short of merchant work, it has warship work into early 1988. The effective choice is between Cammell Laird and Vosper, both are desperate for work.

As to pricing, we note that no tenders are currently live. But the difference per ship between the lowest and next highest bid up to the end of March was £600,000 in a shipyard value of £70 million and a full ship cost of £140 million. We should be chary of low bids from mixed yards. It is not hard for them to juggle some warship overhead into non-warship work.

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As to privatisation, we have grave reservations about the saleability of the mixed activity yards, even with the T22 orders. Investors will correctly perceive that these two yards live on MOD handouts in order to fill in the lulls between merchant orders (Swan Hunter) and offshore orders (Cammell Laird). Neither yard shines in its mainstream activity.

Since warship building capacity has to be cut, we urge the withdrawal of Cammell Laird and Swan Hunter from warship building and the placing of both T22 orders with Vosper Thornycroft. The effect is likely to be the immediate closure of Cammell Laird (or possibly its rescue, Scott Lithgow fashion) and a steady run down at Swan Hunter. But this solution provides a good package of warshipyards for privatisation, with orders and capacity broadly in line at each yard. In short, we have a broadly viable industry of the sort we would dearly like for merchant shipbuilding.

There will be vigorous counter-arguments to this proposal. Michael Heseltine has shown himself very anxious to protect employment on Merseyside. But the creation of a viable warship industry is a real and worthwhile prize. Cammell Laird is going to have to shed 1,800 jobs, nearly half its workforce, even under Graham Day's rescue plan. And, although Government's relationships with Liverpool could deteriorate if Birkenhead does not get the orders, it is not clear through this hazy logic that Government would get any credit if Cammell Laird were allowed to win. If Merseyside deserves a favour, who does not? Where does the special pleading stop.

4. THE PACKAGE OF YARDS

We envisage the following package of yards as available for disposal:

Vickers	Barrow	Submarines
Yarrow	Glasgow	Frigates and GRP vessels
Vosper Thornycroft	Southampton	Frigates and GRP vessels
Hall Russell	Aberdeen	Small craft
Brooke Marine	Lowestoft	Small craft

For every vessel type except submarines MOD will have competition available, without breaking its traditional practice of not inviting tenders from overseas.

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The future behaviour of MOD will be crucial to privatisation because the stultifying relationship between monopoly customer and monopoly purchaser is so well entrenched that to disrupt it now will frustrate sale of the yards. So, for several years, although not permanently, we believe that MOD will need:

- a. to continue to place orders in the UK;
- b. to refrain from placing them with subsidised state-owned yards, including Harland and Wolff and
- c. to continue its present funding practices. This last point is vital in the short-term. MOD finances virtually all the yards' working capital, and without it they will all collapse from shortage of cash. We do not see the need for a permanent guarantee of MOD's future behaviour. But we judge that it will have to endure for at least the remainder of this decade.

Splitting BS' warship activity into much more genuinely competitive units is a good stride forward. These conditions are an inevitable price.

5. METHODS OF DISPOSAL

Provided capacity cuts are made, grouping any or all of the large yards should be ruled out. A grouping of Yarrow and Vosper would destroy UK competition in two important ship sectors. A grouping of Vickers with either or both the others would create competitive imbalance.

We should welcome, and deal openhandedly with, competitive bidding for the yards. Prima facie, we have four sources of bid - previous owners, current management, new bidders, and public flotation.

Beyond that, we agree that the detailed negotiations should be left to Graham Day, without MOD at his elbow.

We also agree that the end of 1985 is a proper deadline.

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