



Ref. A084/2064

PRIME MINISTER

Warshipbuilding Privatisation

FLAG A C(84) 19

BACKGROUND

The Ministerial Sub-Committee on Economic Affairs (E(A) has considered this subject on two occasions (E(A)(84) 11th and 15th Meetings). On both occasions the discussion concentrated almost exclusively on the destination of orders for two Type 22 frigates, on which there was a sharp difference of view between the Secretary of State for Defence and the Secretary of State for Trade and Industry: the Secretary of State for Defence wished to direct at least the first order to the Cammell Laird (CL) yard on Merseyside; the Secretary of State for Trade and Industry wished the order to be the subject of a further round of competitive tendering. It is largely to resolve this difference that the matter has been referred to the Cabinet.

2. But the Cabinet will also need to take decisions on the general approach to the privatisation of warshipbuilding. The Government's Election Manifesto said that it would aim at transferring a 'substantial part' of British Shipbuilders (BS) to the private sector. The privatisation programme endorsed by E(A) earlier this year (E(A)(84) 2nd Meeting) suggested that privatisation should be possible from 1985 onwards.

3. Mr Tebbit's detailed proposals on privatisation are summarised in Annex A to C(84) 19; they are very similar to those which he previously put to E(A). He recommends that all warship yards should be transferred to the private sector. He implies that it would be preferable to sell yards individually or in groups in order to preserve competition. He favours sale to industrial buyers; but in case this should go too slowly, or produce inadequate proceeds, there should be simultaneous work towards a public flotation. The Chairman of BS, Mr Day, should be given the detailed task of negotiating sales, but with unequivocal and detailed instructions on such matters as scope, method and speed. The deadline should be March 1985 (at the end of 1985 if a flotation proves necessary).



4. As background to the discussion Mr Tebbit will wish to report orally to the Cabinet the proposals for merchant shipbuilding approved by the Ministerial Sub-Committee on Economic Affairs today (E(A)(84) 19th Meeting, Item 1). It has been agreed that merchant shipbuilding capacity should be roughly halved over the period to 1987-88 but that there should be no explicit targets for capacity or manpower. It will be for BS to work within the External Financing Limit and the constraints on subsidy negotiated with the Commission; and the restructuring will be, so far as possible, by "part-closure" than by the closure of major yards.

FLAGE

MAIN ISSUES

5. The main issues before the Cabinet are as follows:

(i) Against the prospects for warshipbuilding capacity and orders described in Annexes D and E to C(84) 19, how should the Type 22 orders be dealt with?

(ii) In the light of the decisions taken under (i) above, what should be the Government's approach to privatisation of warshipbuilding? 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?

Type 22 Orders

6. In the E(A) discussions there has been a difference of view between the Secretary of State for Trade and Industry and the Secretary of State for Defence about warshipbuilding capacity. Mr Tebbit has argued that substantial over-capacity is in prospect and can be avoided only by closing at least one yard. Mr Heseltine has argued that the prospective gap could be partially filled by exports, merchant work and re-fits. Most members of E(A) considered it most unlikely that exports could be won at realistic prices on any scale likely to diminish the problem of over-capacity in the warshipbuilding industry.

7. If the Cabinet also take this view it follows that at least one warshipbuilding yard should close. If BS had a free hand, it seems clear that they would choose to close CL. However, largely for industrial relations reasons they prefer to give CL at least the chance of staying open under the 'alternative strategy' described in Annexes D and E to C(84) 19. Mr Tebbit clearly has misgivings about that strategy; but he recommends going along with it, at least to the extent of allowing CL, with other yards, to submit a further round of competitive tenders for the Type 22 orders.

8. Mr Heseltine has argued against this that CL have won two previous rounds of competitive tenders; that to require the yard to submit to a third round would be widely suspected as being a way of allowing BS to rig the tenders so as to ensure that it closed; and that the social consequences on Merseyside of allowing CL to close would be extremely serious. He therefore proposed to E(A) that the order for at least one Type 22 frigate should be directed to CL, taking their latest previous tender as a basis for negotiation; if the yard performed satisfactorily on that order they would receive the second order.



9. In reaching a view the Cabinet will wish to consider the following points:

(a) BS have always admitted that their 'alternative strategy' for keeping CL open is fragile. The events described in paragraph 7 of C(84) 19 must have made it more so.

(b) There is a difference of opinion as to whether CL can really be said to have 'won' the second round of tendering. It is clear that they submitted what was, if marginally, the lowest price. It also seems clear that the assumptions they made about overheads were falsified by the loss of an expected order, though BS national management did not require them to withdraw the tender on that account; and it has been argued that a private sector concern in a similar position might well have chosen to maintain its quotation and seek extra work to absorb overheads. But it now seems (paragraph 8 of C(84) 19) that CL expects to lose £7.4 million on the Type 22 order if it gets it. It seems hard to deny that whether to allow this sort of loss to be made is a matter for BS's national management (and ultimately the Government as owner and financier of BS). If so, CL's previous tender cannot simply be taken as a basis for negotiation without more ado.

(c) The social consequences of closing CL would indeed be severe. But if the Cabinet consider that warship-building capacity must be reduced, one or more yards will have to be closed. If CL is spared, others will suffer. The Cabinet will need to decide whether the social consequences of this would be less severe.

(d) Whatever happens to warshipbuilding, there will, as E(A) has agreed, be a substantial contraction of merchant shipbuilding with severe employment consequences in the North East in particular. Sparing CL will aggravate this latter problem.



(e) Directing a Type 22 order to CL would not be easy to reconcile with the policy on merchant shipbuilding under which it will be left to BS to decide how best to contract the industry within the financial limits which have been set.

Carrying the Costs

10. It was pointed out in the discussion in E(A) that the costs of over-capacity cannot be avoided. All that can be done is to choose whether they appear as excessive contracts prices or as losses on contracts. If the Cabinet should favour directing a Type 22 order to CL and so to prolong excess capacity, it will therefore be necessary to decide where the cost should fall.

Mr Tebbit argues:

(i) that the cost should come out in a higher tender price and so fall on the Defence Budget; and

(ii) that any cost overruns should also fall on the Defence Budget.

11. The Cabinet may well feel that the first of these arguments is fair. The second is less clear cut:

(a) If CL were demonstrably less efficient than other yards and so more likely to suffer cost overruns, there would be logic in making the budget of the Minister who wishes to direct the order to CL bear the financial consequences.

(b) Otherwise, there is no reason to treat an order from CL differently from an order from another yard, with cost overruns, unless otherwise provided by contract, falling on the supplier. To lay it down in advance that they would fall on the customer would give no incentive to efficiency.



Privatisation

12. No member of the Cabinet is likely to suggest that privatisation of warshipbuilding is undesirable. But the specific proposals in C(84) 19 raise a number of issues:

(a) Retention of yards in the public sector

It is unlikely to be disputed that the privatisation of all warshipbuilding 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 Cabinet 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 closure of yards will reduce competition; and that even some sales of small groups of yards would leave no effective competition; 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 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 Cabinet'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 warshipbuilding as a single concern.

(d) Responsibility for Negotiations

It is likely to be generally accepted that the Chairman of BS should be made responsible for conducting negotiations with potential buyers, so long as he is given clear objectives.

(e) Objectives for Negotiations

Again, it is likely to be agreed that the negotiator should be given a deadline (Mr Tebbit suggests March 1985, or the end of 1985, if a flotation proves necessary). There may be more argument about whether they should be given a target for the sale proceeds. Treasury Ministers may be briefed to suggest this. If so, other Ministers may argue that there is no harm in setting 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 the only one. Certainly it seems reasonable to suppose that the financial benefits of effective competition in warshipbuilding, 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

13. It will probably be convenient to divide the discussion into two main parts:

(i) how the order for Type 22 frigates should be dealt with, in the light of the Cabinet's views about prospective capacity and orders in the warshipbuilding industry; and

(ii) privatisation.

The first part might be opened by the Secretary of State for Trade and Industry; you will then wish to invite the Secretary of State for Defence to reply. 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.

14. 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 warshipbuilders.

CONCLUSIONS

15. You will wish the Cabinet to reach conclusions on the following:

(i) In the light of prospects for warshipbuilding orders and capacity, should the order for Type 22 frigates:

(a) be directed to Cammell Laird; or

(b) be the subject of re-tendering by the three yards previously asked to tender, as proposed in C(84) 19?

(ii) If the order is directed to Cammell Laird, where should any resulting excess costs fall?

(iii) Do the Cabinet agree with the detailed proposals regarding privatisation in C(84) 19, and in particular:

(a) that no warshipbuilding 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 the Chairman of British Shipbuilders should take the lead in negotiation with potential buyers?



(iv) If the Chairman of British Shipbuilders does take the lead in negotiations, what guidelines should he be given?

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Approved by
ROBERT ARMSTRONG
and signed in his absence.

18 July 1984

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