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Prime Minister (2)

This minute provides advance warning of the difficult decisions ahead. No action is called for at present - Policy Unit not attached.

AT 2/8

PRIME MINISTER

BRITISH STEEL CORPORATION : FINANCIAL IMPLICATIONS OF THE STRATEGIC OPTIONS EXERCISE

I have already mentioned to you the industrial and political considerations which BSC's recommendations on strategic options will pose for us. I have now told Mr Haslam (the Chairman) that, because of the uncertainties created by the miners' strike, there is no sensible basis at present on which colleagues can consider the Corporation's longer-term strategy. I have asked him to review his recommendations once the dispute ends and to resubmit them to me then.

2 Meanwhile, I think you should have an indication of how BSC see the serious financial implications of the options exercise, in both profit/loss and cash terms. I must stress that these figures have not yet been scrutinised by Departments: they reflect BSC's own projections. But it is already clear that there will be a significant further cash call on Government, whichever option is pursued.

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THE STRATEGIC OPTIONS

3 BSC have assessed whether various plant configurations achieve the level of profit which they consider necessary to meet the objectives set. These are, first, to achieve break-even before interest in 1984/85 (which will almost certainly now be prevented by the effects of the miners' strike), and second, to move to enduring profitability (with the object of, initially, respecting the EC deadline for an end to state aids by December 1985 and, ultimately, allowing privatisation of the bulk steelmaking business). As the table at Annex III shows, they have interpreted these objectives as requiring a substantial level of profit - a build-up to £200 million a year and more by the end of this decade. It is against this background that the cash projections discussed below have to be seen.

4 The options are as follows:

<u>Base case</u>:	No change in the BSC core plant configuration. (NB: The core excludes Special Steels, and

peripheral businesses due for disposal this year.)

5 plant - Alpha closed: No change in the BSC core plant configuration. Alphasteel, the Newport-based private sector producer of strip products, is bought by BSC and closed. BSC's obligations in respect of an onerous investment in a Canadian iron-ore producer - Firelake - are bought out. A brief description of these two issues is at Annexes I and II.

4 plant - Alpha open: Ravenscraig is shut in 1987. Alpha remains open. Firelake is bought out.

4 plant - Alpha closed: Ravenscraig is shut in 1987. Alpha is closed and Firelake bought out.

BSC have prepared two further options (not considered here), proposing the closure of both Ravenscraig and either

Llanwern or Teeside.

5 The BSC Board have firmly recommended the 4 - plant option with Alpha closed.

THE ECONOMIC BASIS OF BSC's ANALYSIS

6 BSC have deliberately based their assessment of the options on stringent economic assumptions, particularly about steel demand, exchange rates, prices and costs. This is a sensible starting-point, but at our request BSC have also evaluated the profit/loss implications, for two options, of alternative, more optimistic economic assumptions which are a closer reflection of Government forecasts: the "Upper Case".

7 The marked improvements of the Upper Case (illustrated in the table at Annex III) represent the best outcome that could be expected if all key variables go right. But there are clearly downside risks. BSC would argue, with some justification, that failure to take out strip capacity in the UK would add to the threat of recurrent market instability in Europe. And even on the best outcome, unless there is at least the closure of Alphasteel, it would be

difficult to argue that BSC are on track towards full viability and so to justify further significant investment in the Corporation's plants.

8 We also need to consider the EC dimension. The Commission have so far been understanding about the delay which the miners' strike imposes on decisions about BSC's strategy. But they will still require us to give them a Plan which is clearly viable. Failure to do so would not only lead to direct difficulties over continued funding for BSC but, more widely, might encourage other Member States to drag their own feet and so threaten the whole anti-subsidy regime.

CASH PROJECTIONS

9 These are set out in Annex IV. The following points should be noted:

(i) Like the profit/loss projections, the cash figures are based on the stringent economic assumptions in BSC's central case.

(ii) Even in the Base option, BSC's cash requirements in 1985/86 and 1986/87 are well in excess of the existing PES baseline. This is mainly because of the revised economic assumptions. But it also reflects, in 1985/86, a significant increase in working capital (which will need close scrutiny). For 1986/87 the baseline entry was notional, since BSC's last Corporate Plan did not cover that year.

(iii) Any costs involved in dealing with Alpha and Firelake (see Annexes I & II) accelerate and strengthen BSC's move into profitability. While a call for total or partial repayment on Firelake is not completely in BSC's hands, they might be able to arrange for payments to be spread (eg by short-term refinancing of loans). The sums needed are in no sense further subsidies to cover operating losses.

(iv) The cash costs of all the options are understated by up to £30 million a year since they exclude cash requirements for the Special Steels business, either as part of Phoenix II if that goes ahead, or as a continuing BSC business if it does not.

(v) In 1984/85, none of the options include the costs to BSC of the miners' strike. These totalled about £38 million in April-June, and are currently running in the range of £3-£5 million a week.

CONCLUSION

10 I thought it right to warn you of what is clearly a gloomy prospect for public expenditure. I shall examine very closely the possibilities of achieving savings, both on the major issues of Alphasteel and Firelake and in the areas conventionally scrutinised by nationalised industry sponsoring Departments (capital expenditure, working capital, operational efficiency, etc). In recent years, BSC's cash costs have certainly come down substantially: even on the unrefined figures, none of the options proposed for the next five years would cost as much as the funding we had to provide the Corporation with in the one year 1980/81. But I have to say that I see no prospect of BSC's cash requirement being held to the figures in the present PES baseline for 1985/86 and 1986/87.

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11 I am sending a copy of this minute to Nigel Lawson only. I cannot stress too strongly the importance I attach to restricting the circulation of the information in this minute; I would be grateful therefore if you and Nigel could ensure that no copies are taken, and that it is only shown to those who need to see it.

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26 July 1984

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ANNEX 1

ALPHASTEEL

Background

Alphasteel, which produces strip steel products, has a nominal capacity of about 1 million tonnes a year which clearly adds to overcapacity in the strip market. The company has the potential (and has tried in the past) to disrupt the UK market by lowering prices to gain market share. Although Alpha currently has an agreement with BSC designed to avoid this, the agreement expires at the end of this year and the company has already been seeking extra quota from the EC Commission. BSC believe that the only way they can avoid being drawn into destructive competition, at an estimated annual cost of £25 million is to acquire and close the company, so preventing such losses and bringing added benefits from the acquisition of Alpha's orderbook and quota entitlement.

2 BSC have been told to explore the scope for such a deal, on the strict understanding that the Government have taken no decision on whether a buyout would be acceptable, either in principle or in detail. The estimated cash costs and benefits of a successful deal, assuming a price of £100m, are shown in Annex IV. Subject to further information, BSC consider that a price in the range £75-£125 million would be justifiable in terms of the return and might prove negotiable. There may also be scope for BSC to negotiate either further phasing or partial payment in a form other than cash (eg by taking over some of Alpha's debt; or by offering the Greek owners a share in one of BSC's businesses).

Comment

3 There are political and presentational difficulties in a nationalised industry taking over and closing a private sector company. But they should not be over-estimated. Alphasteel's very shaky commercial and financial position means that it could not be claimed that a healthy part of the UK private sector steel industry had been sacrificed to BSC's interests. Indeed the company itself seems willing to contemplate closure, providing an acceptable price can be negotiated.

4 We shall of course press BSC hard to negotiate a deal as close as possible to their lowest figure but the benefits to BSC cannot be measured against any normal acquisition criteria. In essence, the acquisition would reduce over-capacity, stabilise the UK market, improve BSC's plant loading and enhance their profit and loss and cash position. Most importantly, if a decision to close Ravenscraig or one of the other integrated plants were judged impossible, we shall not be able to persuade the EC Commission that BSC will be viable on its present plant configuration. Closure of Alpha, so improving BSC's prospects and reducing UK strip capacity, would give us a negotiating hand.

ANNEX II

FIRELAKE

1. Firelake is an iron ore mine in Canada. BSC hold 42% of the shares in a joint venture called Sidbec - Normines Inc which owns the mine and an iron ore pelletising plant. The other shareholders are Sidbec (a steel company wholly owned by the Quebec Government) with 50% and Quebec Cartier Mining Company (owned by US Steel), which also operates the joint venture, with 8%.

2. The joint venture was set up in 1975 in order to safeguard iron ore supplies in the face of a forecast world shortage. However, in practice iron ore is now plentiful and cheap, so that the prices for pellets needed by the joint venture to cover its costs are roughly double the level of world prices. The participants are required under their agreement to buy, in amounts proportional to their shareholding, the output of the joint venture at the higher price, or make good directly the losses of the joint venture. This is known as the take-or-pay agreement. In addition they have guaranteed payments of interest and repayment of principal to the holders of long-term bonds used to finance the joint venture.

3. The excess costs of this arrangement to BSC are currently about £35 million a year. The commitment will not expire until 1999.

4. The participants have been discussing possible ways of reducing their losses. The proposal which has received most attention is that the mine should close but that the pelletising plant should continue, using ore from another deposit owned by US Steel. The Quebec Government would cover the operating losses of the pelletising plant and the participants would buy pellets at world prices. This would eliminate the cost penalty borne by BSC.

5. An arrangement of this sort would require the agreement of all the participants. If it were implemented, BSC would be expected to meet their share of the mine closure costs. More significantly, the long-term bonds would become repayable at the discretion of the bondholders. It is thought likely that the holders would demand repayment since the interest earned on the bonds

is not high by current standards. BSC's share of closure costs and bond repayments amounts to the equivalent of £140 million. This is assumed in BSC's planning projections to be paid in a lump sum in 1984/85, although in practice BSC might be able to spread the impact of the bond repayments over two or three years by raising the cash from new overseas borrowing.

6. The buying out of the onerous element of the Firelake commitment, on the lines suggested above, appears to be an attractive option provided that the initial finance can be found. However, this option cannot be exercised by BSC alone but requires the agreement of the other parties. BSC are currently awaiting proposals from the other participants.

BRITISH STEEL CORPORATION STRATEGY

PROFIT/(LOSS) AFTER INTEREST BUT BEFORE EXCEPTIONAL COSTS (£ MILLIONS)

1983/84	Options	84/85	85/86	86/87	87/88	88/89	Trend Year 1990	BSC's definition of profit required in trend year
	CENTRAL CASE (1)							
(174)	Base	(88)	(22)	(53)	(26)	(4)	64	268
	5 plant - Alpha closed	(64)	52	36	71	102	159	270
	4 plant - Alpha open	(89)	16	32	107	128	198	240
	4 plant - Alpha closed	(65)	55	84	169	193	270	239
	UPPER CASE (2)							
	Base	(74)	17	21	68	94	182	268
	5 plant - Alpha closed	(50)	95	117	173	203	283	270

Notes: 1. The Central Case projections have been produced by BSC on the basis of only slight growth in UK steel demand to 1990; and price increases 2½% below UK inflation until 1986/87 and thereafter moving in line with inflation.

2. The Upper Case projections have been produced at our request by BSC assuming:

(a) advantage is taken of a projected decline in the value of the £, to DM2.90 by 1990, which would permit selling price increases broadly in line with UK inflation; and

(b) by 1990 UK steel demand is 7% higher than the Central Case.

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ANNEX III

BRITISH STEEL CORPORATION STRATEGY

EXTERNAL FINANCING REQUIREMENT (£ MILLIONS)

Options	84/85	85/86	86/87	87/88	88/89	Total
Present EFL/PE baseline	(273)	(135)	(75)	-	-	- (483)
Base case	(266)	(300)	(165)	(169)	(152)	(1052) Spec Steels (50)
Five plant with Alpha closed (1) and Firelake bought out (2)	(461)	(285)	(122)	(50)	(13)	(931)
Four plant with Alpha open and Firelake bought out (2)	(428)	(284)	(139)	(29)	(26)	(906)
Four plant with Alpha closed (1) and Firelake bought out (2)	(470)	(315)	(96)	52	34	(795)

Notes:

	84/85	85/86	86/87	87/88	88/89
1. Alphasteel (figures included as appropriate)					
Assumed purchase price	(60)	(40)	-	-	-
Benefit with 5 plants	6	20	12	85	100
Benefit with 4 plants	17	9	45	82	61
(The difference in the phasing and total of the benefits results from a difference in the timing of investment in continuous-casting in South Wales as between the 4 and 5 plant options).					
2. Firelake (figures included as appropriate)					
Cost of buy-out	(140)	-	-	-	-
Benefits	-	36	34	38	40
3. Phoenix II					
BSC's share of the estimated profits (included in all options), which would be foregone if the venture did not take place.	7	14	12	12	22
Rough estimate of additional BSC funding to establish the venture (excluded from all options)	(24)	(30)	(10)	(11)	-
Rough estimate of BSC costs if the venture did not go ahead (excluded from all options)	(103)				-

4. Disposals The figures in this table do not include any receipts or payments arising from disposals of, or investments outside, BSC's core businesses.