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SECRET

PRIME MINISTER 31 July 1984

BRITISH STEEL

1. The Recent Past

Since the first full year of your first administration, BSC has had nearly £3 billion:

£1119 million in 1980/81

£766 million in 1981/82

£568 million in 1982/83

£321 million in 1983/84

£2774 million

The EFL for 1984/85 is £275 million, but an overshoot seems certain.

Mr Lamont has recently gained approval to raise BSC's borrowing ceiling from £3 billion to £3.5 billion. In fact, BSC's borrowings would be closer to £7 billion but for capital write-offs of over £3.5 billion provided by the Iron and Steel Act 1982.

Yet the billions have bought neither a flourishing BSC nor secure employment. Since its formation in 1967, BSC has cut back its workforce from over a quarter of a million to below 80,000. In the late 1960s it was producing around 25 million tonnes of liquid steel annually; last year it produced under 12 million. Down the years, when demand was strong, BSC hung on to high cost capacity. When demand was weak, it shed too little.

Capital investment was either misapplied or failed to bring adequate productivity or other cost gains. Ian MacGregor in 1980 inherited a lower output of crude steel per man year than was the case in 1970. So, despite steady retrenchment, BSC:

i. is still saddled with too much capacity;

ii. sustains its 50% share of the UK market on the back of a European cartel which is due to be phased out.

Apart from the fact that it is sheer nonsense for the state to be engaged in steelmaking anyway, there is no case - strategic, economic or social - for preserving a British steel industry bigger than the market requires. Most pressing of all, Government's instruction to BSC is to break even before interest in 1984/85; and the EC's directive to all European steelmakers is to abandon state aids by 31 December 1985. BSC seems light years away from all this.

2. <u>What are BSC proposing?</u>

The Corporation is taking a cautious view of the market (ie principally the UK market) - a more or less static demand, with BSC holding a static share but with exports rising steadily throughout the decade. BSC forecast that sales of finished products will rise from 9 million tonnes last year to 9.7 million tonnes in 1990. They are also assuming (prudently in our view) that the ending of Article 58 Quotas in 1985 will make the European market more volatile and that European steelmaking capacity will still exceed demand by 1990.

BSC concentrate therefore on further capacity reduction. Their plan takes the five main steel making plants - Ravenscraig, Llanwern and Port Talbot in the Strip Products Group, and Redcar and Scunthorpe in the General Steels Group - as a proxy for total capacity; and evaluates in profit and cash terms the effects of keeping all five open, then of going from five to four and from four to three.

There are two nasty twists to the evaluation. One is BSC's desire to buy up a private sector steel maker, Alphasteel in Newport, to take on its EC quota, and then close it. On the face of it, this looks indefensible - at a cost of £100 million, too. The second is BSC's intent to buy out its share of a Canadian iron ore mining and pelletizing operation (Firelake) for £140 million.

Compared with the PES provision of £483 million cash over 3 years, the BSC projections over 5 years are startling:

£ million 1984/5 to 1988/9	Profit (loss) after Interest	Cash Outflow
1. As now	(193)	1052
2. As now but close Alphasteel	198	930
3. Close Ravenscraig, close Alphasteel	435	795
4. Close Ravenscraig, but Alphasteel open	195	905
5. Close Ravenscraig, and one other BSC plant, but Alphasteel open	230/290	820/850

Nor is that the whole of the story. You need to add £150 million for the disposal or restructuring of Special Steels, and well over £50 million on their figures for the effects of the miners' strike.

The BSC Board under Bob Haslam are unanimous in their view that BSC must proceed quickly to four plants, and not obstruct the possibility of going to three thereafter. They also insist that Ravenscraig must be the first of any plants to close. The second plant closure is for debate: either Llanwern or one of the General Steels plants.

3. What is Mr Tebbit proposing?

While the miners' strike is on, he is seeking neither discussion nor decision. We fully recognise the damage which could result from a leak. On the other hand, if Ministers are not aware of BSC's intentions while the NUM is still on strike, they might accidentally underwrite the future of steel plants which should close.

Secondly, delays on decisions about BSC are in themselves very costly.

Thirdly, Mr Tebbit is warning of heavy cash calls rather than trying to head them off. We think that, even at this stage, he could challenge more of the figures.

Fourthly, it appears that he is content to approve BSC's purchase and closure of Alphasteel. On present evidence, we dissent.

All in all, we see a need for more than merely taking note and deferring further work. Having had sight of the complete plan, we set out below some observations in the form of questions which you could ask Mr Tebbit to work on.

4. Policy Unit Observations

i. Profit and Cash

All the options except 'do nothing' put BSC back into profit after interest. Yet the cash calls are appalling, mainly because fixed capital expenditure runs way above profit generation. And despite nearly static sales, BSC are proposing to add nearly £200 million to their working capital.

What justification can BSC provide for their capital investments?

ii. General Steels vs Strip Products

BSC's profit and loss and cash flow statements make it clear that Strip Products drain far more cash than General Steels yet contribute lower profits.

Why do BSC want to stay in Strip Products, let alone invest heavily in them?

iii. Alphasteel

Alphasteel has been making losses for at least four years, and is thought to have an accumulated deficit of nearly £60 million, coupled with negative net worth. BSC do not know why the Greek owners keep it going. In these circumstances, we fail to see why BSC should pay £100 million of money they do not have to buy Alphasteel and close it down. Financially and presentationally, this looks terrible.

Why cannot BSC concentrate on closing its own excess capacity and leave Alphasteel to the mercies of its owners?

iv. How Many Plants?

BSC face up to the prospect of closing two major plants rather than one, but Mr Tebbit's note drives on without stopping at this point. Why?

v. Privatisation

BSC are proposing (and DTI appear to be supporting) the long haul route to privatisation - a gradual return to profitability bought by high cost investment, with plant closures and redundancies at the taxpayer's expense. Why don't we contemplate inviting private sector bids for all or parts of BSC, with a dowry lower than the costs forecast by BSC?

The key task is to remove the burden of BSC upon the wider economy. Ministers and others may protest that that kind of objective is financially sound but 'politically unwise'. Not so. This Government's political aims are to reduce public expenditure, to make public sector corporations behave commercially, and to obtain value for the money that the taxpayer has to contribute. In this case, political and financial aims are identical.

R.Y.

ROBERT YOUNG