COMMERCIAL IN CONFIDENCE B

Prime Minister

Await Treasury comments

HARLAND AND WOLFF LTD (H&W)

1. I should like to seek your and colleagues' agreement to authorise H&W to take two orders, one from British Petroleum (BP) and one from the British Steel Corporation (BSC). In shipyard work terms the orders are inter-dependent and I believe we should consider them as a single package. It is a package which would provide the company with a stable production base through to 1986/87 and offer us the clear prospect of a reducing level of public funding over the same period.

BP

2. BP has sought international tenders for an entirely new design of vessel called SWOPS (Single Well Oil Production System). SWOPS is a 54,000 dwt vessel which will be used to exploit marginal seabed oil deposits by, in effect, sucking up the oil through an adjustable nozzle lowered from the surface to connect with the well-head. In the initial round we insisted for the sake of fair competition that H&W's bid was based on the same aid terms as Cammell Laird's but in the event BP shortlisted only H&W, and a Japanese and French yard.

3. The terms proposed for the order, for which H&W and BP have signed a letter of intent, are in my view well within acceptable subsidy limits and, in particular, safeguard H&W against severe penalties for deficient construction or late delivery. The subsidy involved would amount to 36.0% of selling price (as compared with about 48% for Blue Star ships); the only unusual elements are an extra 5% Intervention Fund aid, the substitution of incentive payments for penalties and interest-free loans with a subsidy value of 4.3%. Details are set out in Annex A.

4. The terms negotiated by Mr Parker also provide for the establish-

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ment of a joint management team in which BP experts in offshore construction would be closely involved with H&W in supervising building work; H&W have also retained specialist companies to handle the highly specialised offshore and dynamic positioning elements. More importantly, however, H&W has persuaded BP to accept risk of design, procurement and commissioning of the specialist offshore equipment of the ship and its risk will, therefore, be confined to the hull, propulsion unit and dynamic positioning equipment. These arrangements should undoubtedly help H&W to execute the order efficiently, and at relatively low risk considering the new technology involved.

5. H&W is now the sole UK bidder for this advanced technology order from a British company. I would be most unhappy to see the order, over £40m worth of sub-contracts for other UK companies, and the associated new technology go abroad, probably to France. It is in the national as well as the local interest that this order should go to H&W.

<u>BSC</u>

6. H&W's current order book is mainly for four Blue Star ships for delivery in 1985 (steelwork preparation already mostly completed) and the conversion of a container ship to an aviation training ship for the Ministry of Defence (predominantly outfitting work). The SWOPS order would not provide production work at H&W until mid/late 1985, and this would result in unacceptable gaps in the workload, particularly in steelwork, throughout 1985, peaking at some 800 (out of 1100) steelworkers and costing about £11m. In addition there would be further unquantified costs arising from loss of productivity etc. If therefore the workforce is to be held together in preparation for the SWOPS order, it is essential that the company win an intermediate order, and preferably one on which steelwork can commence immediately.

7. The only order in prospect for the immediate term is from BSC

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for a 173,000 dwt bulk carrier - a repeat of one ordered in 1982. The terms for this ship which will be leased from Lloyds Leasing are set out in Annex B and entail a subsidy level of 48.9% - allowing for changes in interest rates, about the same as for Blue Star. I recognise that this is a higher requirement than we have been aiming for. Taking the two orders together, however, the total subsidy is under 40% and the block of work which they represent would provide the company with a stable production base through to 1986/87, giving management the opportunity to continue the introduction of improvements promised in the Corporate Plan.

8. The BSC and SWOPS orders are inter-dependent: without BSC the yard would scarcely be able to gear itself up for the SWOPS contract and in the meantime the additional costs referred to in paragraph 6 above would be incurred. I therefore believe that we should authorise both orders as a single package which will make a major contribution to the regional economy and thus to our political stance in the Province. The alternative, in the absence of any other orders, is an accelerating run down, beginning immediately and leading towards closure. We have considered this course before and rejected it because of the unacceptable effects on the regional economy.

Smaller Yard Strategy

9. Earlier this year I agreed with the Chief Secretary to initiate a study of the costs/benefits of a radical slimming down of H&W with a view to a substantial cut in its public expenditure support requirement. It was also agreed that an analysis of the study would be considered in the context of a review of the company's 1984/85 funding.

10. The sensitivity of this study meant that it had to be confined to a very small team of senior management, all of whom have also been involved in the negotiations with BP and BSC. I have therefore

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only recently received a draft of the study. At first glance it does not appear to have adequately covered all the ground and it will be some time before officials can present us with an analysis. We cannot however hold up a decision on the BP and BSC orders on this account.

11. Having said this, I share Peter Rees' essential aim, underlying his call for a smaller yard study, of achieving savings in H&W's overall support costs. The company has achieved considerable success in reducing its support costs in the last 3 years - down by 26% in cash terms to a provisional £37.5m in the current year. I see no danger of this provisional figure being exceeded this year. Given the past performance of the yard, this is an encouraging and in some respects remarkable result. In very difficult world conditions, real improvements are being effected. There is still a long way to go, but in seeking permission for these orders I stress that the funds will be provided within the Northern Ireland block and are not additional. I propose to use the opportunity presented by the above orders to tell Mr Parker that he must find scope for further cost-cutting and a continuation of the reducing trend in the annual cash limit. In particular I intend to tell him that in drawing up his plans for 1985/86 and 1986/87 he should know that I will not be willing to recommend to my colleagues an EFL greater than £35m and £30m respectively in those two years, inclusive of grants payable from the Intervention Fund. Initial discussions with the company suggest that these limits will be tough in themselves, particularly for 1986/87. I will nonetheless be stressing to Mr Parker that these are absolute maximum figures and that he should urgently explore and report to me on the scope for further significant EFL reductions which we could consider collectively when we review Mr Parker's business plan update in due course.

EC Dimension

12. Under Community law notification of the SWOPS order to the

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SECRETARY OF STATE FOR NORTHERN IRELAND

Commission seems inescapable because of the French competition and because it would require an increase in the rate and volume of the Intervention Fund. The BSC case is more delicate. My officials are already in contact with their DTI, FCI and Treasury colleagues on this and I propose to instruct them to ensure that decisions on notification of the BSC order are in line with the handling of analogous cases for British Shipbuilders.

Recommendations

13. I recommend that we:-

(a) authorise H&W to enter into contracts with BSC and BP as described;

(b) agree to notify BP SWOPS to the Commission and instruct officials to consider the Community dimension of the BSC order in the light of our handling of BS cases;

(c) agree to instruct Mr Parker, in return for the two orders, to base his plans for 1985/86 and 1986/87 on the availability of £35m and £30m respectively at maximum in public expenditure support; and

(d) agree to decide on 1985/86 support levels in due course in the light of Mr Parker's updated business assessment and an analysis of the small yard strategy.

14. I am copying this minute to other E(NI) colleagues, Geoffrey Howe and Sir Robert Armstrong.

Graham Sandiford

JP
(approved by the Secretary of State and signed in his absence)

ER

28 August 1984

COMMERCIAL IN CONFIDENCE

SECRETARY OF STATE FOR NORTHERN IRELAND

ANNEX A

H&W: BP SWOPS

TERMS OF SUPPORT

	£m	% of Price
Construction Cost (Note 1)	93.9	
Contract Price (Note 2)	77.0	
Intervention Fund	15.4	20.0
Shipbuilders' Relief	1.54	2.0
Interest Subsidy of S.10 loans (NPV) - (Note 3)	7.50	9.74
Interest free loans (NPV) - (Note 4)	3.31	4.29
Total Aid	27.75	36.03

NOTES:-

1. The estimated construction cost of the ship is £96.4m. Offset against this, H&W expects to earn interest of £2.5m from instalment payments received from BP ahead of need.

2. The contract is unusual in its treatment of penalty payments. Instead of the normal arrangement involving payments by a builder to an owner for late delivery (subject to force majeure and contract termination after an agreed period) the two companies have agreed to a lower basic contract price plus incentive payments of £7.5m for timely construction. The contract price shown above includes these incentive payments of which £0.5m is payable on achievement of a key stage during construction, £4m at the end of one year after the due delivery date and £3m at the end of two years after the due delivery date. Late

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delivery will result in a proportional loss of the post delivery incentive payments for each year. Force majeure - including delays attributable to BP - will apply to the due delivery dates and to the contract termination point.

3. Interest subsidy based on a S.10 loan of 80% of basic contract price excluding post delivery incentive payments ie £70m, at an interest rate of 7½ repayable over 8½ years from the date of delivery. The calculation assumes commercial interest rates of 12% and a discounting rate of 13.875%, BP intends to apply for a S.10 loan on £77m; should this be approved, the support would rise by £0.75m to £28.5m, 37% of contract price.

4. H&W proposes to make interest free loans to BP of £5m and £3m. The first loan will be advanced one year after delivery and be repayable after 10 years; the second loan will be advanced two years after delivery and be repayable after 11 years. The calculation is based on interest foregone for the period of the loans at a rate of 12% per annum and a discounting rate of 13.875%.

5. The contract price does not include any amount for owner extras which have still to be defined and could increase both the construction cost and price by £2/3m. The effect would be to increase the amount of direct aid (Intervention Fund, Shipbuilders' Relief and S.10 credit) but not its ratio to contract price.

COMMERCIAL IN CONFIDENCE

ANNEX B

H&W: BSC

TERMS OF SUPPORT

	£m	% of Price
Construction Cost	37.00	
Contract Price	28.50	
Intervention Fund	7.98	28.0
Shipbuilders' Relief	0.57	2.0
Interest Subsidy on S.10 loans (NPV) (Note 1)	3.05	10.72
Soft Credit (NPV) - (Note 2)	1.79	6.28
Interest Support Agreement (NPV) - (Note 3)	0.49	1.71
Balloon Payment (NPV) - (Note 4)	0.06	0.21
	13.94	48.92

NOTES:

1. Interest subsidy based on a S.10 loan of 80% of contract price at an interest rate of 7½% repayable over 8½ years from the date of delivery. The calculation assumes commercial interest rates of 12% and a discounting rate of 13.875%.

2. Soft credit based on a commercial loan of 20% of contract price as increased by loans necessary to meet the first four instalments of the S.10 loan. The loans are repayable over 8½ years after a 2 year moratorium at a rate of 7½%. The calculation assumes commercial interest rates of 12% and a discounting rate of 13.875%.

3. The interest support agreement is a guaranteeing by H&W that cash balances in the lessor's books arising from the lease will earn interest at the rate of 13% and that the lessor will pay interest on borrowings at 13%. Any excess interest earnings or shortfall in

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interest payments will be paid to H&W. The calculation assumes commercial borrowing rates of 12% and deposit rates of 11%.

4. The balloon payment is a sum of £0.625m payable by H&W to the lessor at the end of the 16 year leasing period. Full provision is made for this payment although the allocation to H&W of 25% of the residual of the vessel (being sought by H&W) could equal a substantial part of the payment. H&W is also required to make a payment of £0.2m to the lessor on delivery of the vessel but it is expected that this sum will be equalled by interest earned on instalment payments received from the lessor ahead of need.

5. Under the terms of the lease, BSC is required to pay a sum of £1.23m to the lessor on delivery of the ship. In consideration for this payment, H&W is proposing to repay to BSC a bonus payment of £0.98m received from the lessor of BSC no 1 under the terms of the contract for that ship.

NAT IND: Shipbuilding Pt 7