

dti

the department for Enterprise

CONFIDENTIAL

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Our ref

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Date 21 June 1988

Dear John,

BRITISH SHIPBUILDERS

BS and my officials are meeting Kvaerner tomorrow afternoon to discuss final details for their purchase of the Govan yard. This letter seeks your agreement to the terms on which I propose the negotiations should be concluded.

You will recall that earlier this year we agreed to aim for a sale on the basis of no more Intervention Fund support and a dowry of up to £90m. The £90m comprised £15m for under-recoveries and redundancy costs which Kvaerner would expect BS to face over the first 18 months and a dowry of up to £75m to be paid in cash, mainly to cover future support for new orders in place of continuing IF support but also to meet other initial costs. My officials persuaded Kvaerner to negotiate on this basis. Subsequently, however, the European Commission imposed restrictions on the dowry concept and colleagues were not persuaded that we should bring an early end to IF support. Accordingly, E(A) agreed that negotiations with Kvaerner should be pursued on the alternative basis of continuing IF support but with a much reduced dowry.

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Against the original mandate of a total cost of £90m, BS and my officials expect to be able to agree to a total package of approximately £75m. Indeed, even if one were to set aside the £15m for under-recoveries and redundancies originally contained in the £90m, the package still compares favourably with the dowry of up to £75m. This dowry was to be paid in cash up front. The present package, however, will be spread over the period to 1993. On a discounted basis, it has a value of approximately £65m.

The details of the proposed package are set out at Annex A. The negotiations have been conducted on the basis of present value calculations. The main elements of the present value total of £65m are £37m IF support and £27m to meet Kvaerner's initial costs. The principal outstanding issue is a request from Kvaerner for an additional £6m to be paid up front in cash to offset the risk through their failing to secure an order for a fifth ship which they had envisaged at the time they opened negotiations with us. If they had secured this order they would have pressed for additional IF support with a present value in excess of £11m. Without the order they have considerable doubts about their forecasts of cost recovery. It can be argued that the risk is something Kvaerner should face given they will only be bearing a small proportion of the total costs of turning Govan round. I am therefore not prepared to agree to anything like the £6m up front which Kvaerner have requested. There are, however, major risks that Kvaerner will still have to face and for which they had expected to be covered when the negotiations began. I have therefore instructed my officials, if it is absolutely necessary to conclude a deal, to be prepared to offer a final concession provided it does not exceed a present value of £1m. I have also insisted that this should only be offered in a form which is conditional and involves a clear incentive on Kvaerner to perform. This would bring the total package to £65m present value or a little over £75m in cash.

I hope you and colleagues will agree that this is a satisfactory outcome. The terms I am recommending are well within the limits agreed by colleagues. The sale will provide the first tangible justification for our decision to seek to dispose of the BS merchant yards. We will avoid any trade difficulties with China and we will secure inward investment by a major engineering company which brings with it the prospect of further investment and employment. My own strong preference would still have been to have brought IF support to a clear end. The fact that we will not have achieved this needs to be set against the favourable terms we have otherwise negotiated, but even so I believe the package is a reasonable one.

I understand BS and their financial advisers would regard a settlement on the basis I have outlined as satisfactory and would intend to seek my formal consent for disposal later this week. I also expect my Department's financial advisers to recommend that the terms are fair and reasonable. Subject to your agreement, I therefore propose to instruct my officials to try to agree final terms in the course of negotiations tomorrow. If they succeed then Kvaerner will seek the approval of their main board at a meeting on Monday 26 June. Subject to their confirmation I would then propose to announce the sale later that day.

I am copying this letter to the Prime Minister, Nigel Lawson, George Younger, Malcolm Rifkind and Tom King and to Sir Robin Butler.

A handwritten signature in black ink, appearing to be 'J. W. L.', written in a cursive style.

KENNETH CLARKE

COST OF GOVAN CLOSURE AS COMPARED WITH THE LIKELY DEAL

The estimates on which we based the original negotiating mandate were as follows. The figures set aside costs and income associated with the existing China contract which are common to all cases. They did not include the costs of any remedial measures. They were in cash, but most of the costs would be incurred in 1988 and 1989, giving a present value of closure of just over £80m

	Govan Closes	Kvaerner purchases	Savings from sale
Under-recovered labour/overheads	30	10+	up to 20
Redundancies	20	5+	up to 15
Capital spend	5	-	5
Contingencies*	35	-	35
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	90	15+	up to 75

The deal I am prepared to recommend is as follows

Contribution to under-recoveries	<u>10.4</u> cash
Contribution to redundancies etc	up to <u>7.1</u> present value
Contribution to investment	up to <u>9.4</u> present value
Contribution to training	0.3
less payment for stock	0.25

	up to 27
IF for <u>4</u> ships with no further offers likely before 1992	37
Concession if needed	up to 1

Total	<u>up to 65 present value</u>

KVAERNER NEGOTIATIONS WITH BSInitial Costs

BS have offered to meet Kvaerner's initial costs up to a present value total of £27m. The details remain to be agreed but could emerge as follows:

(i) £10.4m would be paid up front towards under-recovered labour and overhead costs during the construction of the China ships.

(ii) Kvaerner are planning a major investment programme, the main element of which is civil engineering work to restructure the present three berths into two to allow them to build very large 75,000 cubic metre gas ships during the 1990's. BS have offered to pay up to a present value of £9.4m with payments conditional on stages of the programme proceeding.

(iii) £7m for redundancies. Kvaerner plan to make 500 redundant and it was a pre-condition of their taking over the yard that they obtained agreements from the Trade Unions to this programme and a wide range of changes in yard practice. These have been achieved.

(iv) £300,000 towards the training of the workforce to improved stainless steel welding conditions but BS would charge £250,000 for stock.

Kvaerner would pay only a nominal sum for the yard which would give them some cover in the event of subsequent closure.

Taken together, these figures give the present value total of £27m. Variations may be agreed within the total but the figure is on the table.

Intervention Fund

Moss Rosenberg, Kvaerner's shipbuilding subsidiary which in turn would be Govan's parent, hopes to secure final agreement with the respective Boards of Kvaerner Shipping and their partners to orders for two gas ships of 35,000 and 56,000 cubic metre capacity, together with binding options to be confirmed this year for identical sister ships. This workload would carry the yard until the second half of 1992,

assuming in the meantime the restructuring of the yard takes place. If Yarrow wins the Ministry of Defence competition for the Aviation Support Ship, and Yarrow cite Govan as sub-contractor for the hull, the programme would be pushed forward to 1993. DTI officials have told Kvaerner that they should not expect offers of support for follow-on work other than the usual period before build commences to allow for design work, etc. In short, Kvaerner recognise that no further offers are likely before 1992.

Kvaerner will confirm the build costs and prices for these ships on Wednesday but the total cost is likely to be £160m, implying Intervention Fund support at 28 per cent of some £45m with a present value of £37m.

It is of course very difficult to anticipate what the costs of any support for new orders at Govan might be during the 1990's. The EC Sixth Directive, which ends in December 1990, looks for degressive support. Whatever follows is likely to take the same approach but there are clearly many uncertainties.

Independence of Clients

Treasury have queried the independence of Govan's clients. The client for the four ships is a partnership 60 per cent owned by Kvaerner Shipping and 40 per cent by Havtor Management, which represents a number of Scandinavian concerns. Two thirds of Kvaerner Shipping is owned by Kvaerner Industrie, one third is quoted on the Norwegian Stock Exchange. There is strong non-Executive representation on the Board to ensure orders are placed competitively on a world-wide basis.

Whatever its structure, in which Kvaerner Industrie might be expected to have the dominant influence through Kvaerner Shipping and its position in the partnership, it is evident the partnership does not simply follow Kvaerner Industrie's line. And while Kvaerner Industrie plainly sees attractions in returning to shipbuilding as a basis for marketing gas ship technology world-wide, in a narrow sense they could avoid all risk of shipbuilding loss by purchasing from Japan rather than from Govan when any losses at Govan will go straight through to their accounts. DTI regards the position as reasonably safeguarded, especially the intensity of competition from Japan which Govan has evidently been facing.

