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Secretary of State for Trade and Industry

21 March 1985

NB PM

The Rt Hon Michael Heseltine MP
Secretary of State for Defence
Ministry of Defence
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D Michael,

PRIVATISATION OF THE WARSHIP YARDS: THE SUBMARINE FACILITIES PROJECT AT VICKERS SHIPBUILDING AND ENGINEERING LTD

When we decided last Summer to proceed with the privatisation of the warship yards, we recognised that further consideration might need to be given to the treatment of the Submarine Facilities Project (SFP) at Vickers Shipbuilding and Engineering Ltd (VSEL). Our officials have been in touch over the matter since, in the light of revised profits forecast from VSEL and a valuation of the yard by Lazards who are advising British Shipbuilders (BS) on the disposal of the yards. The background is set out in the attached note.

2 The problem arises because by 31 March 1986, the Government will have invested some £97m in the SFP by way of unremunerated PDC, while the purchaser would be taking on interest-bearing loans totalling some £49m and would also have to meet the cost of completing the SFP (a further £77m). The purchasers will thus be taking on a commitment to spending or repaying some £126m on top of whatever price they are prepared to pay for VSEL. Lazards latest estimate for the net sales proceeds of VSEL on this basis is £50-£55m. This is some £45m short of the Government's £97m PDC investment in the SFP by that date, even allowing nothing for the value of the remaining assets at VSEL. Even though this valuation may be conservative and other developments may improve VSEL's profits' forecast there is clearly a strong probability that the sale price we can achieve for VSEL will be below our recent investment. On the other hand, VSEL expect to pay dividends to BS totalling some £34m for the last 3 years. It could be argued that the Government's investment in the SFP might have been £34m less if these dividends had not been paid. But we still risk being accused of selling state assets below their worth if we privatise VSEL without taking special action in respect of the SFP. Our best defence against this would be to point out that the reason for the

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low price is that Government always recognised that the benefits of the SFP would not show up solely in the financial return to VSEL; that the nation as a whole benefits from having a modern submarine construction facility; and that the benefits of the SFP include the increased certainty that the requirements of MOD's submarine construction programme (including Trident) will be met and the lower price which MOD will pay for submarines as a result of the increased efficiency at VSEL. These are benefits which accrue directly to the Government and not to VSEL.

3 Even with such a defence, there will be strong criticism that we are selling a valuable national asset for considerably less than its cost price. We must therefore consider alternatives. It would not help presentationally if we were to offer either to continue funding the SFP after privatisation or to convert the loans into PDC: the underlying shortfall between our investment and the purchase price would remain.

4 The main alternative, therefore, would be to acknowledge that the SFP is a national asset for building submarines principally for the Royal Navy (and possibly also for export) and that since it is not expected to generate an economic return to VSEL, it is better in the national interest for MOD to own the SFP and lease it to VSEL. There would be extra public expenditure costs in the early years since the Government would need to fund the completion of the SFP (there is no PES provision beyond 1985/6) but this would be compensated over time by receipts of rent and/or a reduction in the price paid for submarines. This is quite closely akin to your preferred path of contractorisation for the dockyards. On the assumption that the lease is an operating lease, Lazards estimate that VSEL would fetch some £30-£35m net on this basis.

5 I would be grateful for your comments. I would like to keep this question separate from our consideration of BS's revised privatisation strategy, but you should be aware that BS are proposing that Cammell Laird should be merged with VSEL and that the two should be disposed of together. This is obviously something which you and I will want to consider very carefully and at this stage I have formed no view on the matter. However, if we were to agree to it, it would take BS some months to work out how best to deal with the SFP.

6 I am copying this letter to the Prime Minister, the Chancellor of the Exchequer and other members of E(A) and to Sir Robert Armstrong.

Yours
Norman

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PRIVATISATION OF THE WARSHIP YARDS: THE SUBMARINE FACILITIES PROJECT AT VICKERS SHIPBUILDING AND ENGINEERING LTD

1 The Government decided in 1982 to allow British Shipbuilders to proceed with the modernisation of VSEL through the SFP. The full amount of Government funding eventually agreed was £190M in 1982 prices, funded 2/3rds by unremunerated Public Dividend Capital (PDC) and 1/3rd by loans at NLF rates (£25M of this loan is being put up by MOD). The latest estimate we have of the full cost of the SFP at out-turn prices is £223M which is in line with the original budget. When BS originally put forward the SFP they distinguished between a basic strategy (strategy 1) which they regarded as essential for the submarine construction programme to be completed within the timescales required and strategy 2 which they regarded as desirable but not essential. Strategy 1 accounted for some 2/3 of the total cost.

2 Because Strategy 1 was accepted as being essential, the investment appraisal carried out by the Industrial Development Unit (IDU) concentrated on the extra returns to be expected from Strategy 2 over Strategy 1. It was agreed that the extra benefits from Strategy 2 justified the extra investment, even though there was a strong risk that the investment as a whole would not exceed the required rate of return of 5%. Subsequently, MOD took the view that Strategy 2 was essential to the long-term viability of VSEL, one of our key defence contractors, and accordingly agreed to make the £25M loan toward the SFP.

3 The situation on the SFP now is that by 31 March 1986 when privatisation is due to be completed, we expect that the Government contribution to the SFP will have been:

Unremunerated PDC	£104M
NLF Loan	£ 27M
MOD Loan	£ 25M
	£156M

The unremunerated PDC would be treated as equity capital and would only be repaid to the extent of the net sales proceeds for VSEL. The NLF and MOD loans (total £52M) are at quasi-commercial interest rates repayable over 15 years and, in the absence of arrangements to the contrary, the new owners would take them over from BS and be responsible for their servicing and repayment. They would also have to meet the cost of completing the SFP (on BS's estimates there will still be some £67M left to spend), so they will be taking on a commitment to spending or repaying some £120M on top of whatever price they are prepared to pay for VSEL.

4 Lazards latest estimate for the net sales proceeds of VSEL on this basis is £50-£55M ie some £50-£55M short of the Government's PDC investment in the SFP by that date, and allows nothing for the value of the remaining assets at VSEL. Even though this valuation may be conservative and we can expect other developments* to improve VSEL's profits' forecast which will in turn marginally improve the sale price for VSEL there is clearly a strong probability that the sale price we can achieve for VSEL will be below our recent investment in it and could be substantially below. VSEL have of course paid dividends to BS in recent years (£12.3M in respect of 1982/3, £13.0M in 1983/4) and could pay some £9M for 1984/5 if BS maintain their current policy of taking dividends of 75% of VSEL's profits.

5 Even so, the Government risks being accused of selling state assets below their true worth if it goes down this course without taking special action. The main alternatives are:

(a) to acknowledge that the SFP is a national asset for building submarines principally for the Royal Navy (and possibly also for export) and that since it is not expected to generate an economic return to VSEL, it is better in the national interest for the Government to retain ownership of it and to lease it to VSEL. The financial benefits of this arrangement would obviously accrue to MOD in lower prices for submarines, so it would be for MOD to take over the SFP and lease it to VSEL (MOD have in the past adopted unusual procedures for other assets of this sort (eg the Glass Reinforced Plastic facilities at Vosper Thornycroft and Yarrow Shipbuilders). There would be extra public expenditure costs in the early years since the Government would need to fund the completion of the SFP (there is no PES provisions beyond 1985/6) but this would be compensated over time by the reduction in the price paid for submarines. Depending on the assumption made about the rent to be paid for the SFP, the effect of such a course would be to reduce the price paid for VSEL. On the assumption that the lease would be an operating lease and not a financing lease, Lazards estimate that VSEL would fetch some £30-£35M net.

*eg. an acceptance by the Government of an increased target rate of return on non-competitive contracts following the current review of the Review Board for Government contracts, and, possibly, an acceptance by MOD in the context of the negotiation with VSEL over the contract for SSN19 of the need to take special action to compensate for the exceptionally capital intensive nature of the facilities at VSEL.

(b) for MOD to offer some kind of guarantee about the planned level of use of the SFP. In reaching their estimate of the price purchasers would be prepared to pay for VSEL with the SFP, Lazards have heavily discounted VSEL's future profit forecasts and have assumed a conservative P/E ratio because although there must be a high expectation that MOD's submarine purchasing programme (including Trident) will continue in line with VSEL's own forecasts, a potential purchaser will inevitably discount this to some extent in calculating the price he is prepared to pay. Such discounting would be severely reduced if MOD were to give guarantees on the MOD's planned level of use of the SFP in the next few years.

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DTI

6 March 1985

Econ PQ: Privatisation

Pt II