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CABINET

MINISTERIAL COMMITEE ON ECONOMIC STRATEGY

The British Steel Corporation and Private Sector Steel Companies

Memorandum by the Secretary of State for Industry

On 17 September I told the Committee that falling demand for steel was affecting not only BSC but also the private sector steel companies and there was now a serious risk that some private sector plants in competition with a subsidised BSC might have to close. I proposed and the Committee agreed that I should discuss with the Chairman of BSC the possibility of changes in the frontiers between the Corporation and the private sector. I have concluded that collaborative ventures are likely to provide the only way of ensuring both that the private steel industry maintains about its present share of the market, and that a means of eventually transferring substantial parts of BSC's operations to private ownership is created at the same time. This note indicates the general principles which, in my view, should continue to guide negotiations to this end and reports progress so far.

2 In present circumstances, when the European steel industry is in such disarray that mandatory production quotas have had to be introduced by the Commission, where output of the UK steel industry has been reduced by between a third and a half, with consequent disastrous effects on cash flow, there is no obvious or easy way of tackling the problem of private companies in the area of overlap. I have considered various options, all of which have disadvantages:

(a) Do nothing. Several private sector steel companies would cease to trade, resulting in a smaller private sector and a steel industry dominated even more than at present by BSC.

(b) Permit BSC to take over the assets of those companies whose operations overlap with theirs. Three companies have proposed this course, Duport, Hadfields (a subsidiary of Lonrho) and TI to relieve them of continuing losses, to provide some cash for closure and redundancy costs and thereby to improve their balance sheets. This would of course expand the public sector, and probably make greater demands on the Exchequer. I have indicated that this option should be ruled out on those grounds.

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(c) Encourage private sector companies to take over those BSC operations which overlap with theirs. There are few strong private sector companies capable of taking on even a part of those operations. The most powerful, GKN, has taken a policy decision not to expand its interests in steel, and preferably to reduce them. The other companies are equally reluctant to be involved, and in addition have fewer financial resources.

(d) Foster arrangements whereby BSC and the private sector companies pooled (or possibly exchanged) assets, and created thereby one or more free-standing Companies Act companies. Given the financial difficulties of the private sector and the reluctance even of the best of them to remain involved, it may be difficult to create such companies without a financial injection from the Government. This need not set a precedent for similar action outside the steel industry since this case is limited to the overlap between a subsidised nationalised industry and the private sector; but it would best be done as discreetly as possible.

3 Officials here have been exploring these options both with BSC and with private steelmakers. This has been done on the basis that the Government is in no way committed to accept any particular outcome, and that proposals will be attractive to the Government to the extent that they limit demands on the Exchequer, prevent the destruction of private sector companies in the area of overlap and that they increase private sector participation in activities currently undertaken by BSC, but without jeopardising the ultimate viability of BSC.

4 While a shift of emphasis from public sector to private sector ownership of the steel industry is in line with our long term objectives, progress is bound to be slow, both because of the unhelpful economic climate and the current pressures on the managerial resources of BSC and of the other companies. Attention has, therefore, been concentrated on the billet, bar and rod businesses in which there is both substantial private and public sector involvement and where at least in the case of GKN and BSC a good deal of preparatory work has already been done. Details of the area in which the overlap is greatest are set out in the Annex. Proposals are now being tabled by GKN, Hadfields, Duport, TI and BSC; but a great deal of negotiation remains to be done in order to achieve an acceptable consensus between the participants and a sensible arrangement from the point of view of commercial viability. While detailed negotiations must necessarily be conducted directly between the parties, the Department will be ready to help the process of discussion as necessary. Sir Robert Clark, the Chairman of Hill Samuel (who are acting as my advisers) has accepted an invitation to act as an independent Chairman, where the preference of the parties concerned is for such an arrangement.

5 There is the important question of the extent to which the Exchequer, directly or indirectly, would have to provide financial assistance to get any new companies off the ground. Principles will have to be determined and techniques devised to meet several different types of problem:-

(a) Payments for assets of companies which will then go out of business. It is very important that the valuation of such assets should be related to the contribution they are expected to make to the profitability of the new business and not to their historic cost. These costs are in fact a considerable burden on the companies concerned because of high interest rates, and it may not be possible in all cases to offer an amount for the assets sufficient to maintain the current viability of the company or of the group of which it is a member. We should be prepared to defend any such instance on strict commercial criteria.

(b) Valuation of assets of companies (including assets of BSC) which will be incorporated into new businesses. Publicly financed investment by BSC during the last decade means that their plant is generally good, and better than many of the analagous private sector companies. It will not be easy so to arrange the financial structure of the new companies as to avoid a majority equity ownership by BSC.

(c) Provision of working capital. Steelmaking requires large amounts of working capital, and the equity of the new companies should preferably be capable of supporting the necessary borrowing without the use of parent guarantees.

(d) New capital investment. Although in general the plant available is of good quality, there are one or two notable omissions, particularly continuous casting. Without such facilities, any new company is unlikely to be viable in the medium term; finance for substantial new fixed investment in this area (projects costing upwards of £25m) would have to be provided.

6 The Department has retained Hill Samuel to advise on the principles which should apply in these cases, and on appropriate financial techniques. Their advice is that the present and prospective state of the steel market, and the poor track record in recent years of virtually all UK companies, both publicly and privately owned, makes it unlikely that any investors not presently in the steel business would participate at all, or only at a premium for risk which would seem indefensibly high. Thus the companies' equity will inevitably be held by companies or parent groups currently involved in steelmaking.

7 Hill Samuel also advise, and I accept their view, that any new company must be viable commercially from the beginning. A good practical test will be whether it will be able to borrow adequate amounts of working capital from the banks in its own right, and without recourse to parent guarantees. Furthermore if such guarantees are given by BSC to a subsidiary in which it has a minority shareholding then the PSBR is in no way relieved of the burden and control has been lost. A more elaborate and less effective method of financing public sector activities will have replaced a simpler and more overt one.

8 To achieve viability in the sense defined, any company will from the beginning need to restrict its gearing to one-third, and its interest cover should be in the range of 2½ - 3 times as a minimum and in all circumstances. It is evident that such a company must be relieved of obligations incurred prior to its foundation, for example employees' pensions, and must avoid as far as possible cash outlay for assets acquired. These are onerous, but perhaps necessary conditions for the new company to have any chance of success. Negotiations have not yet gone far enough between any of the parties to say whether arrangements can be devised which meet these criteria in any given case in a manner acceptable to the participants, but feasible alternative company structures have been suggested by the Department's advisers to demonstrate how the principles mentioned above could in practice be applied.

9 The hope is that very considerable help towards the future viability of the enterprise can be provided by permitting BSC to transfer the assets which they will be putting into the business at a low valuation and which can be dealt with as part of the capital reconstruction already announced. But it will be unrealistic to suppose that no new cash will be required, over and above that which can be raised by the enterprise itself on its own account. Thus some new money will be needed from Government, though here again it will be the objective to feed that money into the company via BSC, to avoid too obvious an appearance of direct Government aid to the private sector. The amounts to be so provided should be very significantly less than would be required to finance BSC's business if it remained within the public sector, since the working capital at least should be raised from the market as in the case of any normal private sector company. Any such cash provision would therefore be justified on the grounds that a public sector alternative would be more expensive.

10 Mr MacGregor has undertaken to include in his Corporate Plan specific proposals for the progressive shift of activities in overlapping areas from BSC to the private sector. In January I shall be seeking the agreement of colleagues to the Government's response to that Plan as a whole, and to the privatisation proposals within it. Meanwhile, however, a great deal of work has to be done in order to reach the stage of practical and viable proposals and of bringing urgent relief to the private sector companies being damaged by subsidised BSC competition. To the extent that the Department is involved in this work, I intend that officials should be guided by the principles set out in this paper and I invite my colleagues to agree that this is the way we should proceed.

Department of Industry
2 December 1980

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ANNEX

SPECIAL STEELS: UK PRODUCERS

PLANT	OWNER	LOCATION	NOMINAL CAPACITY '000 billet tonnes	NOS EMPLOYED
Tinsley Park	BSC	Sheffield	435	about 8000
Stocksbridge	BSC	Sheffield	435	
Templeborough	BSC	Rotherham	870	about 8000
Aldwarke	BSC	Rotherham	870	
Roundoak	BSC/TI 50/50	Brierley Hill (near Birmingham)	560	2100
Brymbo	GKN	Wrexham N.Wales	360	2250
E.Hecla Leeds Road	Hadfields (Lonrho subsidiary)	Sheffield	325	2662
Llanelli	Duport Steels (subsidiary of Duport Engineering Ltd)	S.Wales	500	1200