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NORTHERN IRELAND OFFICE
GREAT GEORGE STREET,
LONDON SW1P 3AJ

SECRETARY OF STATE
FOR
NORTHERN IRELAND

The Rt Hon Leon Brittan QC
Chief Secretary to the Treasury
Great George Street
LONDON
SW1

23 May 1983

Prime Minister:

Content with these arrangements?

Yes

23/5

Dear Chief Secretary

HARLAND AND WOLFF : 1983/84 FUNDING AND THE BLUE STAR ORDER

I am writing to seek your approval, and the consent of colleagues, to the proposals which you and I discussed on 12 May for the funding this year of Harland and Wolff and the terms of the Blue Star order.

We agreed that in present circumstances we should not seek to decide now on the funding for Harland and Wolff for the whole of 1983/84, and I am seeking agreement only to further interim funding to last until the end of July. The terms of the Blue Star order were considered by E(NI) last September (E(NI)82/8th meeting) when we decided to authorise the shipyard to take the order for four ships from the Blue Star line.

I am sorry to have to seek a further decision at this time but it is important that we consider now the revised terms for the order as Harland and Wolff will run out of money at the end of this month, and is fast running out of work. Further funding, even of the interm nature that we discussed, cannot be decided without reference to making a start on the only new work available. This means considering now the terms of the Blue Star line order. Moreover, the labour force have heard of the order, and expect it to be secured; delay, leading as it would to redundancies, will be read as Government preparing to close the Yard after the election, and unrest may result.

Blue Star Order

This order, for 4 refrigerated cargo vessels (10,000 dwt) for leasing by banking interests to the Blue Star Line, is the only possibility for Harland and Wolff in the short term. Substantial progress has been made towards the stiff conditions which colleagues attached to

CONFIDENTIAL

their/....

their approval last September. Employment fell by 425 (6%) between mid-1980 and March 1982, since when some 775 redundancies have taken place. A further 750, already announced, will occur by end-July 1983 - taken together a shrinkage of 22.5% in sixteen months. Both management and unions have agreed in writing that the 1983-84 pay claim should be "tough and low", although clearly the outcome at British Shipbuilders will have a major bearing on attitudes at Harland and Wolff. The company retained consultants to advise on cutting costs: as a result a net saving of over £6m should be possible in 1983-84. Harland and Wolff's performance on the BP tankers has been much superior to that of the 2 BS yards building the sister ships.

Finalisation of the terms of the Blue Star order has proved difficult, not on account of Harland and Wolff but because of Blue Star's problems in satisfying both the banks and the Ship Mortgage Finance Company as to its credit-worthiness. A basis has now been identified for the financing structure for all 4 ships.

Revised Terms of Blue Star Order

The terms of the order have been revised. As explained in the Note by Officials (Annex A), the changes in direct aid and credit subsidies reflect mainly the restructuring of the deal sought by colleagues to eliminate what would otherwise have been a loss and also the inclusion of an interest indemnity mechanism which colleagues agreed to in principle last September. However, it has also proved necessary for Harland and Wolff and the Government to assume certain contingent liabilities in order to meet the requirement of the lessors that their position be secured vis-a-vis Blue Star.

In the view of Hambros who are financing 2 of the vessels, the value of Blue Star and its parent company's assets does not adequately cover their exposure and they seek assurance that Harland and Wolff will cover part of their risk, to a maximum of £10.4m gross. (As this sum may be subject to Corporation Tax at 52%, £5.4m, would on this basis return to the Exchequer). Advice from my professional advisers, Slaughter and May, is that in view of the scarcity of investors willing to participate in transactions of this sort and the other, usually more attractive, leasing opportunities on offer, Hambros' request that Harland and Wolff carry this risk is unsurprising. The likelihood of this risk materialising appears minimal; as explained in Appendix C of Annex A, it would require an improbable coincidence of events to generate a call. Even if called, the sum involved would be offset by savings on the credit arrangements (see Annex A, Appendix D). I accept that this should be a contingent liability on the Northern Ireland Public Expenditure block.

A decision not to approve any order is tantamount to closure. An order for 2 ships only would entail diseconomies of scale of about £2.5m and trigger a further 850 unacceptable redundancies. Faced with these unpalatable alternatives, I regard acceptance of the revised terms for the 4 ships as the best way forward, and I so recommend.

EC Dimensions

We decided last September that the aid, while legally notifiable, should not in practice be notified to the European Commission largely on the grounds that exposure of the use of soft credit on this and earlier orders for both Harland and Wolff and BS would be unwelcome. Despite the risks I see no reason why that decision should be changed now.

Funding 1983/84

In our discussion on 12 May we agreed that we should not at this stage authorise full external funding for Harland and Wolff in 1983/84 (estimated at £42.2m). Accordingly I propose to provide drip-feed funding from the Government to end of July amounting to £16.1m, including £9.4m which we had already agreed for 1 April - 31 May. I shall bring forward full 1983/84 funding proposals for discussion in the course of July, accompanied by the officials' report sought by colleagues last September on the appropriate future development of the business of Harland and Wolff.

The longer term outlook

Mr Parker, appointed in February as Chairman and Chief Executive, has made a vigorous start and I have asked him to bring forward, as soon as possible a strategy for the longer-term future of the Yard which I would hope to put before colleagues for consideration.

Conclusion

The immediate necessity is to secure the Blue Star order and, with it, an approval of total interim funding of £16.1m until 31 July. I have already emphasised to colleagues on other occasions the importance of Harland and Wolff to Belfast and to Northern Ireland. Its importance has in no way lessened. I have got to be able to keep the Yard going, albeit at a considerably reduced level, in order to give the new managing director a chance both to assess the future prospects of the Yard and to put the company on a more stable footing.

I would be grateful for agreement that we should:-

(1) Authorise Harland and Wolff to accept an order for 4 ships for Blue Star on the terms set out in Annex, without notification to the European Commission;

Provide/...

(2) Provide total interim funding of £16.1m until 31 July 1983.

I am copying this letter to the Prime Minister, other E(NI) colleagues, Douglas Hurd, and to Mr Sparrow and Sir Robert Armstrong.

Yours sincerely

Derek Hill

JAMES PRIOR
(Signed on behalf of the Secretary of State in his absence)

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NOTE BY OFFICIALS

HARLAND AND WOLFF LIMITED : BLUE STAR LINE ORDER

Introduction

1. The only possibility of an order for H&W in the short term is for 4 refrigerated cargo vessels (10,000 dwt) for leasing to the Blue Star Line. Ministers approved the terms originally proposed for these ships last September (E(NI)(82) 8th meeting) subject to restructuring of the deal to eliminate the forecast loss.

2. Finalisation of this order has proved difficult, largely on account of Blue Star's problems in satisfying both the banks (which will be funding the leasing arrangement) and the Ship Mortgage Finance Co (which advises the Department of Industry on ship financing terms) as to its credit-worthiness. Outline agreement has now been reached, however, on a financing structure for all 4 ships, embodying restructuring of the deal designed to eliminate its previous loss-making basis.

Revised terms

3. There follows a comparison of the terms now proposed for the 4 ships in total with those agreed last September:-

		Terms originally submitted to Ministers		Revised Terms	
		£M	% of Price	£M	% of Price
(a)	Intervention Fund	10.70	17.2	11.43	17.2
(b)	Shipbuilders' Relief	1.25	2.0	1.33	2.0
(c)	Interest Subsidy on SIO loans (NPV)	5.86	9.4	6.26	9.4
(d)	Soft credit (NPV)	3.29	5.3	3.40	5.1
(e)	Interest Indemnity (NPV)	-	-	4.43	6.7
(f)	Loss	4.45	7.2	-	-
(g)	Interest free loans	-	-	3.68	5.6
		25.55	41.1	30.53	46.0

*The possibility of this indemnity which represents most of the increase in the terms, was referred to in last September's submission.

CONFIDENTIAL

E.R.

4. The changes in the direct aid ((a)-(g)) proposed for the order arise for the following reasons:-

(a) Intervention Fund payments are as before at the rate of 18% on ships 1-3 and 15% on ship 4, ie maximum rates available under the relevant tranches of the Fund. The increase in payments is attributable to contract price increases (from £62.13 million to £66.4 million) made possible by the provision of interest free loans to the leasing companies by H&W (see (g) below) in accordance with Ministers' instructions following their discussions last September;

(b) Shipbuilders Relief (2%). The increase in payments is due to the increase in price referred to at (a);

(c) Home Credit (under SIO of the Industry Act, 1972). The interest subsidy shown as being included in terms originally submitted to Ministers has been updated to take account of current interest rates. The increase in cost of the revised terms is due to the higher Section 10 finance associated with higher prices referred to at (a). The credit is based on loans to the lessors totalling £53.1 million;

(d) Soft Credit. The original subsidy has increased to take account of higher prevailing interest rates and also other changes stemming largely from the increase in the contract price for all 4 ships. The credit is based on loans to the lessors totalling £11.3 million;

(e) Interest Indemnity. The lessors of the ships have calculated the leasing charges needed to give them their required rates of return on the basis that any cash surpluses held by the lessors during the transaction will earn interest at the rate of 14% per annum. As foreshadowed in the papers discussed by Ministers last September H&W have agreed to guarantee the lessors that

E.R.

this rate will be earned and the cost shown at (e) is an estimate of the likely payment should deposit interest rates remain at their current levels. Should deposit interest rates rise above 14%, any excess interest will be paid by the lessors to H&W;

(f) Loss. Because of the loans being provided by H&W it has been possible to increase prices and thus elminate the loss;

(g) Loans of £3.68m from H&W to the lessors which will be provided on an interest free, unsecured basis for the 15 year period of the charter. These loans are the main element of the restructuring proposed by Ministers and will correspondingly benefit H&W by an increase in the contract price for the vessels.

5. It should be emphasised that the eventual cost of aid under (c), (d) and (e) will depend upon the level of interest rates during the next 15 years. Any changes affecting (c) and (d) will have an opposite, and partly balancing, effect on (e).

6. In addition to alterations to direct aid, other changes are proposed to circumvent problems posed by the poor credit rating of Blue Star.

These are:-

(a) The original SMFC recommendation was that the lessors should guarantee repayment of the first 4 instalments of the Section 10 loans even if the charter should collapse before the first instalment was repaid. The lessors refused to accept this condition and following further SMFC advice the risk has been accepted on Northern Ireland Votes with the approval of the Secretaries of State for Industry and Northern Ireland and the agreement of the Treasury. Maximum risk, immediately after delivery of ship 4 in May 1985, is £11.73 million which reduces to nil after 2 years;

E.R.

(b) The syndicate led by Hambros, which is funding ships 3 and 4, is not satisfied by the security provided by the ships and by the assets of Blue Star (and its parent, Frederick Leyland). They have therefore sought from H&W a guarantee of last resort of up to £10.4 million (on the assumption that Corporation Tax would be payable at 52%) (see Appendix C). (On this basis £5.4 million of the gross sum would therefore return to the Exchequer). Circumstances which would lead to this risk crystallising would reduce the risk at (a) (see Appendix D) and calculations done by Hambros, using worst case assumptions, show that the gap in the lessors' security, and therefore the risk (in the form of cash shortfall) they wish to cover, peaks at £10.4 million (net £5 million) at only one point in time. If for example the charter were to collapse after 3 years the risk (and therefore cash shortfall) to be covered would be £5.8 million and £0.6 million after 10 years.

7. The risks described at para 6(a) and (b) above will crystallise only if certain events occur <u>together</u> and their potential maximum cost (shown above) is reduced by the improbability of concurrence. The events which need to occur for maximum exposure are:-

(a) a collapse of the charter - within 2 years of the delivery of each ship in the case of (a) and within 11 years of the delivery of ships 3 and 4 in the case of (b);

<u>AND</u> (b) sale of the ships for less than the outstanding balance of the Section 10 loans (repayable over 8½ years);

<u>AND</u> (c) that the other assets of Blue Star (and its parent company) will be insufficient to cover the residual guarantee which it has provided;

<u>AND</u> (d) in the case of (b), that there is an actual cash shortfall to Hambros' syndicate (see Appendix C).

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8. It should be emphasised that as these risks will crystallise only in the event of collapse of the charter there will be compensating savings in the interest make up agreements, para 4(c), (d) and (e) above. At this stage the object of the assistance, ie the maintenance of employment, will, of course, have been achieved.

9. The funding of the ships and the order in which security is called is presented diagrammatically at Appendices A and B. Appendix D attempts to show on a worst case basis the net costs under the proposed arrangements of a collapse of the deal at certain points in the charter.

Assessment

10. While the revised terms represent a deterioration from those agreed last September, the aggregate additional public expenditure implied amounts to not more than £5 million (on a present value basis) over the four ships - and of this £4.4 million is attributable to the interest indemnity mechanism approved in principle by Ministers last September. There would in addition be further contingent liabilities as described at para 6 above which the Government would have to accept. The major part of the overall deterioration has arisen in respect of vessels 3 and 4 following prolonged and difficult negotiations during which Hambros was in a position to insist on the maximum degree of security (see Appendix C - para 3).

11. The consequences of confining the yard to an order for 2 ships only would be:-

(1) construction costs would increase because of diseconomies of scale in building only 2 ships. The increase is estimated at £1.25 million per ship;

(2) the immediate effects on H&W, on the most favourable assumptions about labour reaction, would involve some 850 redundancies over and above the 900 already planned by March 1984 at a cost of some £1.5 million

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to the company (pus £4.5 million to the Government under SRPS). However, especially in the light of present market conditions, it must be more likely that the workforce reaction would be adverse and this would create further costs, eg through resistance to the current cost-cutting programme.

12. This order represents the only prospect for new work in the short term and, in the considered view of the H&W Chairman and NI officials, is indispensable to H&W's survival. Ministers will therefore wish to consider carefully the economic, political and security consequences of not authorising the order.

EC Dimension

13. Ministers decided last September that the aid proposed, while legally notifiable, should not in practice be notified to the European Commission, largely on the grounds that notification could expose the use of soft credit in this and earlier orders. This might well cause the Commission to ban its future use and also to unpick previous cases for both H&W and BS. There can be little question that not only soft credit but also other elements in the revised terms are legally notifiable and the Commission could be expected to object to them (particularly H&W's assumption of certain liabilities, since these facilities can be offered only by reason of Government loss-financing support). Their discovery by the Commission would make future use of soft credit - on which both H&W and BS might rely more heavily in future - more difficult to propose. In weighing up this question, however, Ministers will wish to bear in mind that the same considerations which persuaded then against notification last September apply to the revised terms, and possibly with greater force.

14. Under the proposed terms H&W would assume certain liabilities towards the lessors. Both Lombard and Hambros are anxious to have confirmation that the Government continues to stand behind H&W for the discharge of these liabilities. Accordingly they have sought sight of a letter of assurance (Appendix E), which reiterates past

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confirmation by the Government that it stands behind all of the company's liabilities. The intention is to provide Lombards and Hambros with a copy of this letter. The NIO's legal advisers have concluded that this draft does not constitute a contract of guarantee between the Government and the lessors, but represents merely the confirmation of an existing relationship between the Government and H&W. As such the issue of the letter does not appear to have any implications under Community competition law in relation to this order.

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APPENDIX A

H & W - BLUE STAR ORDER

Funding and Security Arrangements for ships 1 & 2

COST

Construction Cost - £39.34m

DIRECT AID

Intervention Fund Aid - £5.9m
(18% of Contract Price)
Shipbuilders Relief - £0.7m
(2% of Contract Price)

PRICE

CONTRACT PRICE - £32.8
(Sale by H & W to Lombard North Central Ltd)

FUNDING

DOI guaranteed loan by Nat West to Lomabrd North Central Ltd - £26.24m (80% of contract price)

H & W loan to Lombard North Central Ltd - £2m

Nat West loan to Lombard North Central Ltd - £4.56m

DOI Guarantee

SECURITY

DOI Guarantee secured by:-

(a) First charge on ship

(b) Recourse to Frederick Leyland/Blue Star Group

(c) Recourse to DED for £6.18m

unsecured

(a) second charge on ship

(b) recourse to Frederick Leyland/ Blue Star Group

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APPENDIX B

H & W - BLUE STAR ORDER

Funding and Security Arrangements for ships 3 & 4 (Note 1)

COST		Construction Cost - £39.8m	
DIRECT AID		Intervention Fund Aid - £5.5m (15/18% of Contract Price) Shipbuilders Relief - £0.7m (2% of Contract Price)	
PRICE		CONTRACT PRICE - £33.6m (Sale by H & W to the Leasing Company)	
FUNDING	DOI guaranteed loan by Hambros to the Leasing Company (Note 2) £26.9m (80% of contract price)	H & W loan to the Leasing Company - £1.7m	Hambros loan to the Leasing Company - £6.7m
	DOI Guarantee		
SECURITY	DOI Guarantee secured by:- (a) First charge on ships (b) Recourse to Frederick Leyland/Blue Star (c) Recourse to DED for £6.32m	unsecured	(a) second charge on ships (b) recourse to Frederick Leyland/Blue Star Group (c) Recourse to H&W up to maximum to £5m (net)

Notes 1 - references to Hambros includes other members of the syndicate led by Hambros

2 - it has been assumed that a separate leasing company will be established for the transaction.

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APPENDIX C

HARLAND AND WOLFF - BLUE STAR

HAMBROS COLLATERAL

1. The need for the additional recourse to H&W arises from the requirement of Hambros and the other members of its syndicate for adequate security for their investment in the leasing transaction. Initially 80% of their investment is to be secured by a guarantee given by DOI which in turn will take a first charge on the ships. The initial balance of 20% of the investment provided by Hambros is to be secured by a second charge on the ships and recourse to the assets of Blue Star/Frederick Leyland. This proportion is not fixed throughout the period of the transaction and the funding not covered by the DOI guarantee increases to 39% during the first 2 years of the charter. Hambros assessment is that the value of the Blue Star/Frederick Leyland assets does not cover their exposure by a sufficient margin and so an additional recourse to H&W is being sought. Hambros normally expects the net worth of any party providing assets as security to be 10 times the amount being secured.

2. The amount of the maximum risk has been assessed by Hambros as 15% of contract price, ie £5 million. This assessment is based on forecast cash flow statements of the leasing partnership which show the cash shortfalls which could arise if the charter were to collapse at any time within the first 11 years of the charter period. The methodology used by Hambros in drawing up the forecast cash flow statements has been examined by the Department and is considered reasonable. Because any payment to cover the risk would be taxable in the hands of the leasing company, a gross amount of £10.4 million would be required to produce after tax income of £5 million (assuming a 52% rate).

3. The additional recourse is needed because those investors whom Hambros is seeking to bring into the leasing company will, in Hambros' view, agree to participate only on a no risk basis. Advice received from our professional advisers, Slaughter and May, is

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E.R.

that in view of the scarcity of investors willing to participate in transactions such as this and the other (usually more attractive) leasing opportunities being offered to them they would not disagree with Hambros' assessment.

4. The additional recourse will be called only if the charter collapses within the first 11 years of the charter; there is an actual cash shortfall suffered by the leasing company; and the value of the second charge on the ships and recourse to the Blue Star/Frederick Leyland Group is insufficient to cover that cash shortfall. Should the charter collapse within this period, H&W (and therefore DED) will achieve savings in 2 interest make-up agreements which it proposes to enter into with the leasing company; these savings will of course vary according to the date of the collapse. Hambros point out that it would be reasonable to set against any call under the additional recourse of up to £10.4 million (net £5 million) the fact that H&W would be released from the need to make interest make-up payments under the 2 interest make-up agreements.

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APPENDIX D

HARLAND AND WOLFF - BLUE STAR

NPV OF COST TO GOVERNMENT ON COLLAPSE OF CHARTER AT TIMES INDICATED

	Collapse within 6 months	Collapse within 3 years	Collapse within 10 years
	£M	£M	£M
Direct Aid Payable During Construction Period			
Intervention Fund	11.4	11.4	11.4
Shipbuilders Relief	1.3	1.3	1.3
	12.7	12.7	12.7
Indirect Aid Almost Entirely Payable After Delivery			
Interest Subsidy on SIO loans	1.2	4.5	6.3
Soft Credit	0.2	1.6	3.4
Interest Indemnity	-	2.2	4.3
Interest Free Loans	-	-	-
Security foregone on SIO Loans	11.7	-	-
Residual guarantee to H&W	-	5.8	0.6
	13.1	14.1	14.6

NOTES:

1. A discounting rate of 13.25% has been used.

2. It has been assumed that during the period of the interest make-up agreements commercial borrowings will be at a rate of 11.375% and that deposits will earn 10.375%.

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APPENDIX E

Northern Ireland Office
Great George Street
LONDON SW1P 3AJ

Chairman
Harland and Wolff Ltd

Dear Sir

I understand you have been asked about the extent of Her Majesty's Government's commitment to meeting the liabilities of Harland and Wolff Limited. As you know, I do not consider it appropriate to add to or embellish the general assurance already given by Her Majesty's Government as far as individual creditors are concerned. This assurance, which is referred to in the Department of Commerce letter of 10th May 1982 to your Company, constitutes a commitment by Her Majesty's Government to the Company's ultimate credit worthiness but is not a guarantee for the benefit of individual creditors. The assurance provides, and I confirm, that in a winding-up situation, if the assets of the Company are insufficient to discharge the creditors in full, then creditors' claims will be fully met by Her Majesty's Government.

Yours faithfully

Secretary of State

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