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CONFIDENTIAL

DRAFT E(A) MEMORANDUM

HARLAND AND WOLFF

Introduction

1. I wish to advise colleagues of a serious deterioration in H&W's financial performance in the current financial year. Following a review of the yard's prospects I have reluctantly concluded that the closure of H&W is now only a matter of time. This paper seeks agreement to revised funding in the current year and considers the most appropriate strategy for the run down and closure of the yard.

2. We last considered Harland and Wolff (H&W) in March (E(A) 87,5) when we set an EFL of £49.5m for the 1987/88 year; this comprised £23m to cover normal trading, £17m to meet the costs of redundancies, £0.5m for H&W Enterprises (a counselling and information scheme for redundant employees), and provision to allow H&W to borrow up to £9m to fund work in progress on the AOR vessel. I also indicated that I was not prepared to authorise any major expenditure on the yard's planned cost reduction programme without a detailed financial analysis. These decisions were taken against a strategy which envisaged the future of the company being determined by commercial realities, not Government direction, and which recognised the inevitability of closure after AOR, in the absence of further orders.

3. In June the company informed me that it would be unable to live within the trading element of its EFL but it could not quantify at that stage the required increase in the funding for the full year. I asked for a full justification for this bid but before it could be prepared, the company warned in late June that receipt of a SWOPS instalment due from BP would be delayed because of slippage in the work programme. This threatened an immediate breach of the EFL. I also withdrew the arrangements for the Contract Support Limit and required the company to obtain Government approval before entering into any further contracts.

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4. I was concerned not only that the company should be experiencing EFL difficulties so early in the year but also that it was apparently unable to assess its cash requirements properly. These unwelcome difficulties pointed to the need to undertake a thorough review of the company's financial requirements and the effectiveness of its financial management. Deloitte Haskins and Sells were retained to undertake this assignment. I wrote to the Chief Secretary on 16 July and in response he agreed to a temporary increase of £12m in the trading EFL until I was in a position to report more substantively on the position in the company.

Contract Performance

5. Because of the weak merchant shipbuilding market H&W has turned to contracts, on a design and build basis, for highly specialised and complex ships. The ATS, now forecast for delivery in December 1987, is substantially complete and is undertaking sea trials. SWOPS which is proving to be even more complex than envisaged, has a revised delivery date of December 1988. The company points to considerable difficulties with subcontractors, especially GEC, as the major cause of delay. The AOR contract is still at an early stage - most of the current work is in the design area, with steel fabrication due to begin shortly - and H&W forecasts that delivery will occur on the April 1990 contract date. Recent problems with the other contracts, and indeed with the drawings for AOR, lead Touche Ross (the independent consultants retained by my Department to monitor progress on the contract) and my officials to believe that the company's forecast is optimistic. However there is little firm evidence to support this view not least because detailed design has still to be completed. The monitoring regime, put in place when the AOR contract was awarded, provides for sanctions to be activated only when total cost, ie costs incurred to date and costs to complete, exceed the contract price.

Financial Controls

6. Whilst recognising the general problems facing the company, I have been particularly concerned at its apparent inability to assess accurately the financial impact of progress on contracts and its future cash requirements. Deloittes have been examining these and other aspects of the business and

have now reported to me. Deloittes have strongly criticised both the quality of H&W's production and financial control systems. As a result of identified shortcomings in these systems, some of which are common to the shipbuilding industry in general and some to H&W in particular, the company has been unable to provide reliable cash forecasts and costs to complete. Deloittes have recommended a number of significant changes to financial systems and a restructuring of the senior management organisation, including the appointment of a new Assistant Managing Director to take responsibility for the commercial activities and finance function. In the meantime a Deloittes partner is being seconded to fill this position and oversee the implementation of the financial system recommendations. They have also recommended restructuring and strengthening the Board and I am reviewing possible changes both at executive and non-executive level.

1987/88 Cash Requirements

7. In addition to reviewing the financial controls, I asked Deloittes to agree with H&W a statement of the company's cash requirements for the remainder of the year. The company has not yet completed the necessary thorough reassessment of its production plans and I do not expect to receive cash flows based on these until the end of September. Nevertheless the figures contained in this paper represent the company's expectation of its need for funds for the remainder of the year. Deloittes believe that the company's forecasts are realistic.

8. The revised forecasts, a comparison with the figures previously agreed by E(A), and the reasons for variations are at Annex 1. The total cash requirement is now £63.2m of which £50m covers trading losses, £8.3m is to meet the cost of redundancies, £0.3m is for H&W Enterprises and there is a £4.6m provision to fund work in progress on AOR. Although the in-year position on the NI Block is already very difficult my objective would be to finance the additional public expenditure arising from the cash requirements from existing Block resources.

Strategic Options

9. The strengthened financial control in the company should ensure that we are in future provided with more reliable, accurate and up to date information. However better financial control will not in itself cure the underlying problems of very weak markets, substantial overcapacity in the industry and extensive price cutting with which the company is faced. In addition the recent EC Sixth Directive, sets maximum government support at 28% of contract cost for merchant orders.

10. In the light of the current situation, I instructed officials and Touche Ross to examine the strategic options the company now faces. A summary of the options, together with an indication of the likely costs involved, is attached at Annex 2. For obvious reasons it has not been possible to approach the company for more accurate figures nor is it possible to assess accurately the heavy liabilities which the Government would undoubtedly incur if H&W failed to complete its existing contracts, including claims by sub-contractors. This summary, which is based on the company's existing production plans, indicates that:

- the additional support costs in keeping the company open would be largely offset by the penalties payable if closure was immediate. Consequently there is little to choose on cost grounds between closing now and closing at a sensible point in the future. However the longer that closure is delayed, the greater is the risk of lower productivity and hence increased cost.

- the earlier the closure, the easier it will be for opponents to claim that it has been brought about by Government taking work from the Province, rather than as the inevitable result of market forces. Moreover the physical difficulties associated with towing away a partly completed SWOPS or AOR (on which some £10m has already been spent) would be considerable and Government would have to meet the additional costs.

- closure in three years time (after completion of AOR) provides scope for a more orderly rundown and time for the introduction of measures to deal with the political, economic and social impact of closure.

11. H&W has a particularly high profile in Northern Ireland especially among the Unionist community, and is still the second largest manufacturing employer. A Government decision to close the yard immediately, when it has work until 1990, carries a high risk of alienating the Unionist community, possibly associated with industrial action aimed at delaying or preventing completion of SWOPS and AOR, or even civil disturbance. Such responses could clearly prejudice the current round of discussions with political leaders in Northern Ireland. Although I am aware of the risk of cost overruns in completing existing contracts I do not believe that immediate closure offers sufficient cost advantage to offset these difficulties and I therefore consider that we should prepare for closure after AOR has been completed and draw up contingency plans on that basis.

12. To announce now a closure in three years time would clearly exacerbate the existing problems within the yard. I therefore propose to inform the company's Board that closure is inevitable in the absence of further orders and that the Government will not approve any major capital expenditure on the proposed cost reduction programme. In reiterating my requirement that any such orders should have prior Government approval I will remind the company that any merchant orders must comply with Sixth Directive rules, and any contracts for naval vessels must be fully costed and unsubsidised. In addition the manpower resource implications of any proposed new order should be fully analysed to ensure that there is no impact on the timescale for completion of current orders. This approach recognises the reality of market forces and would allow closure to be presented as a result of those forces and not directly as a Government decision.

13. This strategy will bite as and when different parts of the yard run out of work; steelworkers are likely to be affected in the first half of 1988. My officials will be considering with H&W the company's contingency plans for dealing with such a situation. In order to mitigate the effects of the now inevitable decline in the company's workload I also propose to develop a package of job creation and other measures intended to maximise the potential of the Queen's Island site with its deep water facilities.

14. I shall endeavour to meet the costs of this strategy (ie run-down and job-creation measures) from the NI Block although it is under considerable pressure both currently and prospectively. I would only bid for assistance from the Chief Secretary in a situation where the severity of the trading requirement or the concentration of redundancy costs would place unreasonable demands upon the Block in a particular financial year.

Ministry of Defence interest

15. I have not had an opportunity to consult the Defence Secretary about my recommendations but the implications of these options for the Ministry of Defence are described in Annex 3. The removal of AOR 01 from H&W later this year (under Options 3 and 4) would delay completion of such a ship by up to 3 years with some operational risks. By that time about £20m will have been sunk in AOR 01. It would not be possible to place a second AOR with Swan Hunter this autumn as planned and there would be a delay of at least a year in that yard beginning work on an AOR (even if it were successful in competition). Removing AOR 01 after launch in early 1989 (Option 5) would involve extra costs estimated at £15m in completing her elsewhere and a delay of up to 2 years.

Recommendations

I recommend that we:

- approve an increase of £13.7m to the current year's EFL, taking it to £63.2m (paragraph 8 and Annex 1);

- agree to prepare for closure of the yard after completion of the AOR (paragraph 11).

T KING