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CIVIL SERVICE

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PSDED 728/88

TO: 1. PS/MR VIGGERS (L & B)
2. PS/SECRETARY OF STATE (L & B)

cc PS/SOS (L&B)
PS/PUS (L&B)
① PS/Sir K Bloomfield
Mr Burns
Mr Semple
Mr Gibson
Mr McDonnell

FROM: DAVID FELL, DED

HARLAND AND WOLFF

ISSUE

② Mr. Spence

③ Mr. Wilkins

Mr. Burns
had 2/4
Mr. Jones

1. To seek Ministers' confirmation that they are willing to provide Mr John Parker with further encouragement to develop a proposed Management and Employee Buy Out (MEBO) of H&W, on the assumption that it is based on constructing the Ultimate Dream (UD).

BACKGROUND

2. I am attaching a letter, and enclosures, which I received from John Parker today, in the wake of a useful meeting I had with him and his Executive Director colleagues yesterday. In the letter to me, he makes it clear that he will be willing to proceed with the MEBO only if he believes that he and his team have a sporting chance of success, that they can do a deal that will establish the Company on a sound basis from the outset, and that the Secretary of State will "positively run with the MEBO proposals".
3. John Parker would argue that his decision to inform the workforce of the MEBO proposal, on the date of announcing the breakdown of negotiations with Ravi Tikkoo, has been the main contributory factor in retaining the goodwill of the workforce, and preventing demonstrations or strike action. In addition, the MEBO proposal is being increasingly talked about, both in the media, and in business circles, as offering the best hope for the future of the Yard. It is clearly important that H&W carry on as normally as possible towards constructing the two existing vessels in the Yard (SWOPS and AOR). The longer we can retain the goodwill of management and workforce, the longer this objective can be sustained. For that reason alone, therefore, there would seem to

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be value in allowing John Parker to further work up his MEBO proposals. In addition, for Government to reject the idea, without even having accepted detailed proposals, would lead to accusations both that Government was unwilling to have anything to do with Mr Tikkoo (a notion which we have sought vigorously to disabuse to date), and also that this was proof positive that Government was involved merely in a cynical exercise to close H&W.

4. But I feel that there are more substantial reasons for encouraging Mr Parker further. The first is that, whatever the problems of the MEBO may be, the problem surrounding the other two significant bids, the Turkish UM or from Bulk Transport (BT), are also substantial, though for different reasons. The proposition which we currently have from UM would require terms from ECGD which are beyond anything which ECGD would be able to deliver; they are based around productivity levels at H&W which both Mr Parker and Mr Nielsen consider to be unachievable; and the bulk carrier ships which UM proposes would require a level of subsidy higher than the 28% maximum permitted under the EC Sixth Directive.
5. At time of writing, we do not yet have the formal bid from BT which was expected yesterday, but we have been given some advance notice of the costs associated with the BT bid, and it is clear that the proposition is built around the assumption that each of the four ULCC's will be constructed at a cost of \$138m (substantially down from H&W's own initial assesement of \$180m), and sold at a price of \$75m. It will be apparent that the cost/price gap is vastly in excess of the 28% maximum permitted under EC rules, and although the BT figures may merely be a negotiating stance, I frankly have grave doubts as to whether the gap can be bridged.
6. Even if we were able to find a way of providing "opaque" subsidies in excess of 28% to either UM or BT, it seems likely that we would face very considerable opposition from DTI and HMT

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Ministers, and a protracted investigation by the EC Commission, who will be looking for evidence that we have offered subsidies in excess of 28%. The prospects of bringing either of these propositions to a successful conclusion are therefore, in my view, rather slim.

7. That is not to say that the MEBO proposal, built around the Ultimate Dream, will be free of problems - far from it. However, Mr Parker and his management team claim a much higher degree of confidence in their ability to build this vessel within 28% of price than they have for any other type of ship. (And this, incidentally, would enable us to get back to the point where we could force John Parker to defend the costings for the UD, which had always been our original intention). In addition, H&W have completed much of the design work on UD, and could introduce it into the Yard at a relatively early date, which they could not do with the BT or UM proposals, both of which will require substantial design work. The UD project is also better suited to the existing structural breakdown of the H&W workforce than are either ULCC's or bulk carriers; and the MEBO built around the UD would be unlikely to present us with as many problems in Brussels as with either of the other two options.
8. The papers attached to Mr Parker's letter spell out in a good deal more detail his own view as to why he should build the MEBO around the Ultimate Dream project. I fully accept that John Parker's emotional attachment to the Ultimate Dream would require us to discount some of his more extravagant claims in these papers, but equally, I would want to put on the record my personal view that the MEBO proposal, built around the Ultimate Dream, offers what is likely to turn out to be the best of the three proposals for achieving privatisation. On the basis of what is known of the other bids on the table at the moment, the alternative to encouraging MEBO could be the closure of the Yard.
9. I would not, however, want to view the MEBO proposition through rose-tinted spectacles: there are very major issues to be addressed. But the separation of Mr Tikkoo as ship owner, from Mr Tikkoo as shipyard owner, offered by the MEBO proposal, does,

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I believe, remove some of the obstacles which resulted in the breakdown of our earlier discussions with Mr Tikkoo. For example, there seems no good reason whatsoever why Mr Tikkoo, if he is serious about building the ship at H&W, should not now provide irrevocable proof that he can raise the finance for the ship. Previously he argued that it was impossible to do that, because he did not know what commitments he would have to take on in the Yard. Also, I believe that the MEBO proposal provides an opportunity to John Parker, his management colleagues and his workforce (and possibly some other Northern Ireland investors) to do the one thing which Mr Tikkoo refused to do, and that is to invest real money in the Yard.

10. But if we are to give John Parker the green light to proceed, I suggest that it must be on the basis of a clear understanding on his part that there are a number of key criteria to be addressed, and a number of hurdles to be jumped. In particular:-

- (i) We should advise him not to proceed at all, until he has evidence from Mr Tikkoo of firm commitments for the financing of the cruise liner.
- (ii) It should be made clear to him that Government will be looking to the new owners, and other investors, to bring in real money upfront. (I have already suggested to Mr Parker, without prejudice, that we might be talking here of a sum of up to £15m).
- (iii) Mr Parker should reassure us that the costings on the Ultimate Dream are reliable. If they are not, then in his own interest, he must recost, and seek to obtain from Mr Tikkoo a higher price for the vessel.
- (iv) Furthermore, he must undertake these recostings against a background of acceptance that, if there are cost overruns on the vessel, it will be the initial investors (ie people like himself) who will lose their money, in the first

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instance; that (I suggest) Government might find a way of sharing, or topping up, the provision by the initial investors towards cost overruns, by a very limited amount of money; that cost overruns beyond that limit would be a matter for the ship owner or financier; that no further assistance beyond the limit will be provided by Government; and that the consequences of major cost overruns would be the liquidation of the company, and substantial losses suffered by the investors.

- (v) Government would require to have a precise view from the outset of its total exposure both in cash terms, and in contingent liability terms, over the four year build-period of the Ultimate Dream.
- (vi) Government would expect the new owners, or the ship owner, to meet the recourse guarantee, during the building of Ultimate Dream, whether by commercial insurance or other means. (We are almost certain to be asked to review our stance on this as we go through the negotiations, but I believe we should take a firm stance at the outset).
- (vii) Government would recognise that no investor is likely to put money into the Yard, unless the acquisition terms provide, in some way, for the generation of profit.
- (viii) Mr Parker would have to demonstrate that the workforce supported the MEBO.

11. That is a formidable list of hurdles to be overcome, and indeed Mr Parker may balk at the task. If he is willing to proceed on this basis, however, I have in mind that the deal which we would offer would be constructed along similar lines to that which has been put to the other bidders, namely, the MEBO team would acquire a new company (Newco) into which the assets, but none of the liabilities of H&W would be transferred; contributions would be made by Government towards redundancy costs, unrecovered

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overheads during the first two years, and new capital investment; Government would provide full IF assistance towards the vessel; and Government, which would retain the old company, would subcontract to Newco the completion of the existing SWOPS and AOR orders.

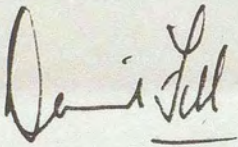
CONCLUSION

12. I would recommend that the Secretary of State should tell Mr Parker that he may proceed to develop his MEB0, for consideration by Government, even in the knowledge that it is built around the Ultimate Dream. He could indicate that he will be prepared to give the proposal a fair run, although he clearly should not, at this stage, indicate that that will be the only proposition which Government will entertain.
13. Mr Parker has asked for a meeting with officials, and his proposed advisers, Morgan Grenfell, before the end of this week, followed by a meeting with the Secretary of State. I can see little point in bringing in merchant banking advisers, until there is a clear indication by Ministers that they are willing to encourage Mr Parker to proceed, on the basis that I have outlined above. I would, therefore, be very grateful to have both Mr Viggers' and the Secretary of State's response before close of play on Thursday, so that if they agree, I can proceed with the meeting which Mr Parker has requested on Friday of this week.
14. Finally, I should note that, if Mr Parker does proceed, he will be looking to Government for some assistance towards the cost of merchant banking advice. We have consulted with DTI about this, and learnt that, in the case of the Swan Hunter Management Buy Out, DTI (through British Shipbuilders) undertook to meet 50% of the cost of merchant banking advice, to be paid only in the event that the MBO bid was unsuccessful. I would propose, subject to approval by DFP, to offer the same terms to Mr Parker.

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15. In view of the relative urgency, I am side copying to the Secretary of State's office.



DAVID FELL

1 November 1988

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