Economic Perspective

RSD: A COMMENT

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This quarter saw the British Steel Bill go through its Committee stage in the House of Commons and receive its Third Reading. After a discussion in the Lords, the bill will become law, thus allowing the government to privatise BSC at a time of its choosing. The Bill is a relatively short document which does not in itself privatise the Corporation but provides for the assets and liabilities of BSC to be transferred to a successor company which will be structured to conform with the requirements of the Companies Act (1985). This involves the reduction and extinguishing of the present public dividend capital to be replaced by ordinary shares to be wholly owned, in the first instance, by the Treasury. In addition, the capital of the Corporation is to be restructured. This involves a capital write-off to eliminate the losses evident in BSCs profit and loss account. There is no intention to write off debt which would not be possible under present ECSC regulations. When all assets are transferred to the successor company, the existing British Steel Corporation will be wound up. At the completion of this procedure, the successor company should possess a capital structure similar to other Companies Act companies. This will allow the government to undertake a flotation of the equity of the business at some appropriate point. Whilst it does not privatise BSC, the British Steel Bill clears the path for this exercise to go ahead.

The Bill has provoked considerable controversy across a range of issues. Of particular interest to Scotland was an amendment to Clause 1 proposed by Dr Jeremy Bray which read:

"Before the appointed day the Secretary of State shall lay before parliament a report giving quantitative estimates of the advantages and disadvantages to the Exchequer, to the Corporation, to the customers and employees of the whole and of the several parts of the Corporation of the disposal of the successor company and its subsidiaries as a single entity or as more than one entity". Hansard, 17 May 1988, c 803.

Ostensibly, this asks the Department of Trade and Industry to consider the advantages and disadvantages of privatising BSC as a whole or as two or more independent units. In reality it asks the Government to contemplate the so-called Ravenscraig - Shotton - Dalzell (RSD) proposals promulgated in a study commissioned by Motherwell DC and undertaken by management consultants Arthur Young (AY).

The first section of the report presents an analysis similar to that enunciated in previous commentaries but dealt with issues in greater detail than has previously been the case. The AY consultants demonstrate that, given widely accepted assumptions about the future demand for UK steel, it would be in the commercial interests of BSC to run down the existing Scottish operation at Ravenscraig and Dalzell over the next six or seven years; thus moving BSC from a 5 to a 4 integrated plant operation. The report argues that this would result in annual savings of circa £100 m to BSC without loss of output. However, it is stressed that locational savings are not available immediately and that the continuing phased run down of bulk steel-making in Scotland can only be achieved by investment or transfer of assets to other sites. Given present and likely investment intentions the report concludes that the Hot Strip Mill will be superfluous in 1989, whilst steel making at Ravenscraig could be eliminated by early 1991. The Dalzell plate mill is in a stronger position but, as we have repeatedly argued, it is vulnerable to the strategic requirement for BSC to modernise its platemaking facilities. The report concludes that this could be resolved as early as 1993.

In our view, this report adds weight to the position adopted over the past 4 years in this

Commentary which sought to demonstrate that BSC was engaged in a phased withdrawal from bulk steelmaking in Scotland.

We restated our conclusions in November 1987 thus:

"Because BSC's heavy end is large relative to the rolling capacity grouped round it, the attractions of consolidating on four sites are evident. . . Given scarce investment capital it is only in relatively disastrous states of the world that any abrupt move would make sense. However, a long term strategy designed to achieve this is available to the Corporation and the Scottish Lobby must guard against this." (Fraser of Allander Institute, Quarterly Economic Commentary, November 1987, p37).

The contribution of the AY consultants is to specify exactly how the final stages of the run-down can be achieved and to provide estimates of the locational savings inherent in this exercise. This study was carried out by personnel who were, in the main, all former BSC employees and who do not lack experience or expertise about the UK steel industry.

The AY consultants did not receive the co-operation of either BSC or the DTI and their analysis can thus be viewed as that of "outsiders". However no serious response to these conclusions has been advanced other than to fall back on the "guarantees" on strip, steel and plate production outlined by Mr Kenneth Clarke in his statement of 3rd December 1987. As is widely known these "guarantees" are subject to market conditions" which even according to Scottish Secretary, Mr Malcolm Rifkind, means that they are "not fully bankable".

Our view on this was set out in the previous Commentary.

"It appears that otherwise serious government ministers rest content on a promise by BSC to sustain the Scottish Steel industry if the business as a whole is making commercial rates of return. This logic compels one to enquire why government spokesmen don't stand up every day in the House of Commons and guarantee everyone's job on that basis. Stripped of pseudo economic jargon, the main element of the bargain states that if you can sell your output at acceptable levels of profit then your job will be safe. This is little different from the situation facing most workers and enterprises in the traded goods sector. . . . In actual fact. . . these guarantees . . . are not really guarantees but signals to the financial institutions of the room to manoeuvre provided by the current location of plant within the Corporation . . . Given expected returns and investment programmes a reduction to 4 or fewer sites can only take place over a relatively long time period. The 7 year guarantee on steel and platemaking sets out the timescales of locational change and signals this constraint to potential future owners. Naturally, in exceptionally good future scenarios further investment and continued operation can be justified although no-one in the Corporation believes in this eventuality. If the trading environment remains favourable, as at present, then after 7 years the Corporation would be able, through its investment programme, to rationalise at fewer locations without serious curtailment to the product range. If market conditions deteriorate then the private sector company has the facility to make locational savings as part of a more intense and dramatic upheaval. Thus the rules of the game post-privatisation are clearly set out and valuation can proceed on this basis. However, the Motherwell workforce have been guaranteed little over and above what would happen in any event." (FAI, Quarterly Economic Commentary, March 1988, pp 28-29).

Thus, the guarantees form a necessary backdrop against which valuation can take place. The capital re-organisation is the second vital ingredient. As yet we do not know the proposed capital structure, but a clear picture emerges of a privatised BSC being able to increase its return on capital employed and its equity value substantially in the medium term through further rationalisation. BSC suggest that there is a "commercial requirement" for Ravenscraig slab and Dalzell plate for a further 7 years. The AY report concludes that the elimination of this capacity could be undertaken more quickly. Whichever view is accepted, it adds up to the end of bulk-steelmaking in Scotland by the mid 1990s with no loss of output or market share to BSC. This is the "doom and gloom scenario" which everyone except Government Ministers regard as the most probable outcome.

In order to avert this likelihood, the AY report proposed the so-called RSD option which calls for the Ravenscraig steelmaking and hot strip mill, the Dalzell plate mill and Shotton CR mill and coatings complex to be privatised separately from the rest of BSC's capacity. This proposal was not well received. It cut across the conclusions of the 1986 NEDO study, which suggests that:

"the unity and dominance of BSC has been a significant factor in the successful restoration of the UK steel industry's overall performance. It is suggested that any steps to split up BSC's overall corporate and management unity should not be taken lightly. . .severing of BSC links to user markets through complete hiving-off of the joint ownership companies or further arbitrary complete corporate divorce of the remaining BSC operations by region or product group could weaken the UK steel industry's overall stance against principal overseas competitors who are strengthening their own links between steel production and the market." (NEDO: The world market and the UK steel industry, July 1986, pp 11-12).

The purpose of citing these views is to illustrate a set of propositions which those inside the industry and within Whitehall regard as axiomatic. This is the conventional wisdom accepted and promoted by steel executives, politicians, civil servants, trade union leaders and shop stewards. The RSD proposal explicitly denies this and as such was always destined to meet with a cool response in many circles.

In the Parliamentary debates the RSD option was promoted as a measure which would constrain the market power of a privatised monopoly whilst affording the possibility of further efficiency gains through increased competition between two UK bulk steelmakers. This is a fairly weak line of attack. First there is little to suggest that likely product market conditions will foster any inefficiencies in any aspect of corporate activity. The competitive pressure on UK steel from other producers and other materials is set to become more exacting in the 1990s. Since there would be little direct, nose to nose, competition between BSC and RSD, it is difficult to argue that the creation of two separate entities would contribute significantly to the considerable existing pressure for top performance. Secondly, the home market for BSC should be properly regarded as European market, where the Corporation will be one of the larger producers but with a small share of the total market.

The issue of dynamic efficiency was raised by Dr Bray (Hansard, 17 May 1988, c 804-806). He views the emergence of a second bulk steelmaker as necessary to provide a "strong incentive to develop new materials and processes which would help it be technologically competitive". Dr Bray is perfectly correct to suggest that BSC has little incentive to develop and adopt new technologies such as direct smelting and thin slab casting which threaten to significantly lower the minimum efficient plant size for strip production. The dominant locational pressure on BSC is one of reducing sites because BSC perceives that it has adequate steelmaking capacity at 4 or less plants to service its preferred configuration of mills. Thus there is little perceived need to embrace technological innovations which hold out the prospects of a new generation of mini-mills competing with BOF plants over products which are traditionally the preserve of the large bulk steel makers. BSC has little medium term need to contemplate the locational upheavals implied by these developments which promise to revolutionise the industrial structure of both steel and steel using sectors. Thus Dr Bray may well be correct in suggesting that BSC has "no serious expectation that its modest investment in research into new processes will lead to fresh investment".

As he noted in Committee, BSC "has been selling off all the higher technology sectors and has deliberately run down its research and development so that it does not have the high technology prospects that might attract investors. We would thus be running the last generation of technology into the ground while refusing to develop the new technology of the slab casting with all the energy savings and improved metallurgical properties that it provides". (Official Report of Standing Committee D, British Steel Bill, C439 and 442). A very clear case of "caveat emptor"!

However, given the international mobility of steel technology it is a moot point whether this is necessarily bad for UK steel production as opposed to the various interests associated with BSC. Clearly there is a possibility that BSC's market will be attacked by minimills and that BSC could suffer. This technology is likely to be cheap, affording competitors opportunities to encroach on BSC's markets, and may present no great threat to the UK if there are no barriers to entry into the UK and European markets for new capacity. The true costs are those emanating from the failure to develop a leading role in the development of this technology. It is difficult to quantify these as they are highly uncertain, wide-ranging and long-running in nature. Unfortunately there is little evidence of any appreciation of this on behalf of the present administration. They appear to see no problem and no strategic issues to address through RSD or otherwise. However, like Dr Bray, we are concerned about a future in which "Britain can merely tag along behind, licensing new products and processes across the board". It is not the case that RSD would necessarily be the best solution to this given its projected size. Perhaps a better outcome would be for central government to finance the development of this technology as part of its industrial policy and encourage adoption.

Thus the competition aspects of privatising BSC as a single unit do not add up to a convincing case for RSD. The second problem with RSD is its explicit "profit penalty to the two groups reaching a peak of £100 m per annum" (AY Report pp 18). In valuations terms the whole is likely to be greater than the sum of its parts which is not a compelling argument with which to approach the Treasury. This is especially true when the compensating benefits of competition are difficult to establish. The third problem relates to the financing of RSD. The new group would require substantial capital investment in its plate mill and coke ovens on top of the purchase price. In any event without the clear blessing of government and BSC no investors are going to commit themselves to this venture. Thus RSD lacked up-front support from either capital markets or possible partners.

It is our view that RSD rests weakly upon certain economic arguments advanced in its favour. The government back bencher, Mr Michael Fallon was totally correct to suggest that the "new clause is a Ravenscraig protection clause". However, Mr Fallon and his front bench team are guilty of misrepresenting the nature of this protection. The opposition were not implicitly arguing that "we want to protect Ravenscraig for ever or we want to protect it for 20 years, 40 years or 60 years." There is a clear argument which suggests that under the auspices of Sir Robert Scholey and the BSC corporate planners, Ravenscraig has no chance of survival. It is not in the interest of BSC to produce on this site after the early 1990s. This will not be market outcome but the conclusion of planners and executives given market conditions. The market may determine the size of BSC but Corporation officials will determine the structure and location of the business. The RSD option was an attempt to allow the market to determine the fate of Scottish steelmaking. If RSD could market its output it would survive and flourish and any capacity reductions would be felt elsewhere. RSD was an attempt to remove Ravenscraig from BSC's internal dynamic which is loaded against it and Mr Fallon <u>et al</u> should have been more open to arguments which simply sought to allow RSD to take a market test. Another red herring introduced by the Government side, and, inter alia, by Mr Fallon was to argue that "if Ravenscraig is fully competitive" then "there will be no question of Ravenscraig being closed". It is clearly and demonstrably profitable for BSC to produce at 5 sites. However, it is relatively more profitable to produce at 4. The marginal plant may be technically efficient and capable of being highly profitable, <u>if suitably loaded and continually upgraded and modernised.</u> It is not in BSC's interests to do this in the medium term. Again a fairer solution would be to allow RSD to compete for markets with BSC and other steelmakers.

Thus Mr Fallon and the government front bench explicitly endorsed a corporate structure unfavourable to Scottish interests. They were joined in this by the majority of the Labour opposition. The former seemed more concerned with the effect of RSD on the revenue available from flotation whilst the latter seemed more pre-occupied with the potentially adverse implications for capacity at the 4 English and Welsh sites. As Mr Clarke noted, RSD had few friends outside Motherwell and given that the proposal was indeed "a political structure for part of the industry" it failed to attract significant political support. Thus Dr Bray's modest amendment when forced to the vote was deserted by both main parties and the RSD episode is effectively closed. BSC will be privatised as a single unit with the likely consequences of phased withdrawal from Motherwell over the next 5 - 7 years.

This outcome was predictable and known to those involved in constructing and advocating the RSD option. In our view it was a clever but ill-conceived attempt to protect the position of the Hot Strip Mill which is the most immediately vulnerable to contractionary pressures given the new con cast facilities at Llanwern. It would appear that the game is up for Scottish strip making although there is much to play for in the Plates division where future investment intentions are less certain and programmes less advanced.

It is clear that BSC executives regard one platemill as optimal although Scottish Industry Minister, Mr Ian Lang, insists that no firm plans exist because any development "must have Government approval and BSC have not approached the government". It is not difficult to take issue with this reasoning by recalling that the stated aim of privatisation is to obviate the requirement for BSC to seek Government permission for this or any other decision and by noting that privatisation is imminent. Whatever the discussion and views currently advanced within the Corporation, two things are evident. Firstly, unless pressed hard by prospective buyers or sellers, BSC seem intent on saying as little as possible about how they intend to resolve their medium term production arrangements in this sector. Secondly, given competing claims and the necessity to generate investment capital either internally or from market sources, it is not clear how soon BSC will be in a position to undertake major projects such as a unified platemaking facility. It will be of considerable interest to hear how BSC management react to the mounting clamour for £60 million expenditure in cooling facilities at Dalzell, given that concentration of all production at one mill is a preferred but more costly exercise. If the corporate intention is to clear the way for a retreat from Motherwell then any modernisation sanctioned may be minimal although it should be recognised that a considerably upgraded Scottish platemill could exist as an exposed island site, supplied by Lackenby until funds emerge to finance a more satisfactory long run solution.

Thus it is clear that Scottish interests should now recognise that securing plate mill investment is the best opportunity for maintaining bulk steel making in Scotland. Following privatisation this will be easier said than done. As Dr Bray remarked "those decisions will be flushed out into the open soon after the Secretary of State has lost his powers and possibly while he still owns the shares. Is that a satisfactory position for the government"? It has the merit that it frees Industry and Scottish Office Ministers of the task of announcing more "superb news" for Scottish steel.