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PART B

PART B

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PART B

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CHANCELLOR'S 1988 PAPERS
ON THE PRIVATISATION OF
THE ROVER GROUP

PART B
PO -CH /NL/0178

PART B



FROM: J H REED

DATE: 7 JULY 1988

- 1. MR MCGIVERN
- 2. CHANCELLOR

Note at end. July 7/88

Thank you. JHR

ROVER GROUP/BAE

Yesterday afternoon we had a meeting, chaired by DTI, with BAE to discuss tax issues. DTI's tax advisers, Slaughter and May, were present. This is a brief report of the outcome. I attach a note handed to us by BAE at the meeting which formed the basis for the discussion.

Leasing

2. BAE propose to set up a leasing company to purchase new capital items for the Rover trade and lease them to Rover. The length of each lease would not be longer than the economic life of the asset. The lease rents would be very low initially and high at the end but overall the terms of the lease would give a reasonable commercial return. The point of this type of lease is to maximise tax relief in the BAE part of the group in the early years, while relying on Rover's brought forward trading losses to cover Rover's profits. We said that this was acceptable in principle and that we would be willing to look in advance at particular leases to confirm that we were satisfied with the details. BAE were content with this.

3. We also said that we would not expect this leasing arrangement to fall foul of an anti-avoidance provision which prevents the losses of a trade being carried forward if within

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- cc Chief Secretary
 - Financial Secretary
 - Sir P Middleton
 - Mr Anson
 - Mr Monck
 - Mr Burgner
 - Mr Waller
 - Ms Roberts

-
- Chairman
 - Mr Painter
 - Mr McGivern
 - Mr Deacon
 - Mr Campbell
 - Mr Reed
 - PS/IR

a period of three years there is both a change of ownership of the trade and a major change in the conduct or business of the trade. But again we offered to look in advance at particular proposals and say whether we thought that the anti-avoidance provision would apply. BAe said that at present they were not able to say what was likely to happen to the Rover trades over the next three years. In response to a request from them we said that before applying the anti-avoidance provision the matter would be considered by the Board.

4. We told them that we did not think we could accept any scheme for the sale by Rover to a BAe leasing company of its existing capital items with a lease-back under which the lease rents would be loaded towards the latter part of the lease. This we would normally regard as tax avoidance and challenge under the principle laid down in the Ramsay case. We explained that we could not lawfully refrain from challenging a BAe proposal if we would challenge it if carried out by a different taxpayer.

Divisionalising Rover's trades within BAe

5. BAe said that many of their activities were carried out as divisions of one company (BAe) and that they might want to do the same with the Rover trades. They suggested that we should agree to a "favourable" attribution of the company's overall profits or losses to each division - in other words Rover's activities would be made to appear more profitable than they might otherwise be. The purpose of this would be to maximise the use of Rover's tax losses. We said that the transfer of Rover's trades to BAe might well be caught by the anti-avoidance provision to which I have already referred. But even if it were not, the legislation makes clear that the attribution of the profits and losses would have to be on a "just" basis, so there is not much scope for creative accounting to obtain tax reliefs. We made this clear to BAe and said that our advice to DTI was that no value should be placed on the scope for tax reduction by putting the Rover trades into a division of BAe.

Figures

6. We, and DTI's tax advisers, said that the value placed by BAe on some of the tax proposals seems low and we asked if they could tell us more about their assumptions and calculations. We said that DTI would anyway need this information so that they could, if questioned, explain how much the deal was worth. BAe declined to supply the figures - they said there was no need to go into this yet. This tends to confirm ^{vs} as in our view that BAe are underplaying the value of the various proposals for making best use of Rover's tax losses, but of course we cannot be sure unless and until we see the detailed calculations.

Conclusion

7. As a result of this meeting BAe can have no doubt about what we would find acceptable and they can make up their own minds about how much this is worth to them. So, as far as we know, there is nothing more to discuss with them about tax until such time as the deal goes ahead and they put particular proposals to us.

w
J H REED

We told BAe that, within the constraints imposed on us by law, we wanted to be as helpful as we could on the various tax issues; but that we could not treat them differently from other taxpayers in broadly similar circumstances. What they were really after was our approval to some device to enable them to set Rover's losses against BAe profits and, in effect, a blanket clearance that we would not invoke the relevant anti-avoidance provisions. We explained we could not go that far.

I believe they are underestimating the importance of our offer to look at, and if possible clear, particular proposals in advance - a point which was strongly underlined by DTI's tax adviser. We have gone as far as we properly can.


E MCGIVERN

BRITISH AEROSPACE AND ROVER

Introduction

This paper measures, however provisionally, the value to British Aerospace of various methods of accelerating the benefit from Rover's tax losses. These methods can be grouped under three heads.

- (i) Methods that are available to British Aerospace as a matter of course.
- (ii) Methods that require the removal of the "ring fence" under the funding agreement.
- (iii) Methods which, in view of tax complexities, call for prior agreement with the Inland Revenue.

In valuing the benefits of the second and third heads the paper assumes that British Aerospace would in any case carry out transactions under the first head so that the value of the remaining methods is only their incremental tax saving. The paper also assumes a fixed corporation tax rate of 35%.

Basic tax benefits

As matters now stand British Aerospace can enjoy certain basic benefits from Rover's tax losses. It is the prerogative of British Aerospace

- (a) to set against its taxable profits in 1988 and 1989 group relief from Rover,
- (b) to procure that Rover disclaims capital allowances so as to enlarge those losses by writing down allowances and,
- (c) to ensure, by capital injection or simply group funding arrangements, that Rover bears the minimum amount of interest expense.

The calculations are complicated but it is assumed that the basic tax savings from the best disposition are

- (a) from group relief £18m of tax in 1988 and 1989,
- (b) from capital allowance disclaimer £35m of tax but not until the mid 1990's, and
- (c) from relocating interest, to accelerate from the late to the early 1990's £210m of tax losses (assuming that after the capital injection but before relocation Rover bears interest of £30m p.a.). This could be worth about £20m using a compound discount of 10% p.a.

Removing the ring fence

The next step is to enquire what additional benefit would come from removing the ring fence. The ring fence is designed to counteract any financial benefit to British Aerospace from using Rover's tax losses in any of three ways.

- (i) If British Aerospace uses any Rover capital gains losses against its own capital gains, it is to be deprived of the benefit. Removing this restriction would make no practical difference since British Aerospace would probably not use Rover's capital gains losses. Ha!
- (ii) Rover has tax losses carried forward at 31st December 1987 of £1.4 billion and the second limb of the ring fence counteracts any benefit from using more than £500 million of these.
- (iii) A taxpayer can disclaim capital allowances; they then come into play in a later year. It is open to Rover to disclaim capital allowances and so convert losses that could be carried forward only against its future profits into losses that could, as current year losses, be set against British Aerospace's profits. But the third limb of the ring fence counteracts the benefit of using disclaimed capital allowances on pre-instrument expenditure outside a Rover trade.

Removing the first limb is worth nothing. Removing the second limb means that more Rover losses can be used. But in valuing this there are two important points: the losses probably cannot start to be used until 1996 and the larger the capital injection - which uses up the losses - the less is the benefit of removing the ring fence. To take two examples if the injection is £800m, £100m more of losses can be used in 1996 and 1997 if the £500m limit goes. If the injection is £700m, £200m more losses can be used but between 1996 and 1999.

Removing the third limb produces £68m of group relief over 1988 and 1989 and saves £24m of tax for those years. (But of course the losses so used cannot be carried forward.)

Using a leasing company and divisionalising Rover's trades within British Aerospace

It could be possible to use Rover's tax losses earlier if Rover leased its plant from a group leasing company or transferred its trades to British Aerospace which would carry them on as divisions. But either of these courses is complicated and prior Revenue confirmation of their tax results would be advisable.

A leasing company would be formed to acquire and lease to Rover plant that Rover would have otherwise acquired itself and possibly also plant that Rover had acquired over the past five years. Appendix I indicates Rover's plant acquisitions in 1983 to 1987 inclusive. Confirmation is

sought that the leasing company would be regarded as carrying on a trade, would receive writing down allowances on the cost of any new or existing plant, could surrender any excess allowances by way of group relief, rentals paid being deductible to Rover and assessable on the leasing company. To quantify the rentals at this stage is difficult; much would depend on whether the lease was a finance or operating lease, residual values and interest rates. But Appendix I illustrates the results of a sale and leaseback using a purchase and sale price reflecting net book value based on depreciating plant evenly over eight years and charging a rental of 12½% of the tax written down value.

These figures are used for illustrative purposes; a rental of this amount may need to be supplemented by a further payment at the end of a lease, the tax treatment of which would be assumed to follow that of the rentals.

The second transaction on which clarification is sought is the divisionalisation of the Rover trades within British Aerospace. British Aerospace carries on in divisions the trades of its predecessor companies and Austin Rover Group and Land Rover UK might transfer to British Aerospace the assets and undertakings of their trades. It would be of fundamental importance that British Aerospace should inherit the losses (and that section 343 should, and that section 768, should not, apply to such a transfer). Beyond that it would be intended that in calculating the profits of the Rover trades against which the losses could be set for tax purposes, as much profit would be allocated to the

Rover Group as could be tenably sustained. Confirmation is sought that a tenable basis of allocation - for example by turnover alone - would not be challenged on the footing that a different or more precise basis would disclose less profit for the Rover divisions.

The following is a rough measure of the benefits.

Arranging for new plant to be leased to Rover accelerates the use of the writing down allowances by £40 million a year. How much time is saved is difficult to quantify - for one thing it depends on how much capital is injected into Rover - but the real benefit would start at the earliest in 1990 and probably consists in moving relief from the mid-1990's. Again in the roughest terms, what is probably at issue is moving about £200 million of tax relief from the mid 1990's forward in blocks of £40 million a year beginning in 1990 and ending in the mid-1990's.

The benefits from sale and leaseback are set out in Appendix I and accelerate relief by £40 million in 1988 tapering to £12 million in 1992. But the real benefit begins only in 1990 since in 1988 and 1989 group relief could produce the same result as sale and lease back.

Divisionalisation by itself may bring £32m more losses in 1988 to 1992 - the limit of our forecasts with perhaps a further £20m per year

thereafter. But leasing new plant as well could move £73m more relief to 1988/1992 from the mid-1990's with perhaps a further £50m from sale and leaseback in those years.

Peat Marwick McLintock

6th July 1988

APPENDIX I

<u>Additions</u>	<u>AUSTIN ROVER GROUP</u>		<u>LAND ROVER UK</u>
		<u>£ million</u>	<u>£ million</u>
1983		46.5	26.4
1984		85.9	12.6
1985		118.4	14.4
1986		88.9	14.9
1987		87.8	10.4

Net book value if depreciated evenly over 8 years

1983	3/8	17.4	9.9
1984	4/8	43.0	6.3
1985	5/8	74.0	9.0
1986	6/8	66.7	11.0
1987	7/8	76.8	9.1
		277.9	45.3

Net book value and consideration at transfer to leasing company £323m

	<u>Tax Allowances</u>	<u>Rental</u>
	<u>25%</u>	<u>12.5%</u>
1988	80.8	40.8
1989	60.6	30.3
1990	45.5	23.0
1991	34.1	17.0
1992	25.5	12.0



Ch. Ld. Y. has asked for this meeting. He is due to go back to Switzerland at 12.00 tomorrow. See Mike Walker's note, opposite.

I understand that when Ld Y saw BAE this (Theo) p.m., they said "no deal". DTI officials believe there is room for manoeuvre, however.

2. On further sweeteners, Ld Y has ruled out:

- deals for the minority s/holders;
- Kenneth Aid;
- help with EFA.

He is prepared to consider further:

- deferred arrangements
- raising the limit on BAE's foreign s/holding (currently 15%).

AF

SECRET

FROM: M A WALLER

DATE: 8 July 1988

CHANCELLOR

cc: Chief Secretary
 Financial Secretary
 Sir P Middleton
 Mr Anson
 Mr Monck
 Mr Burgner
 Ms Roberts
 PS/IR
 Mr Reed (IR)

*Thanks.
 Re Pt (iv) of 6
 Smith's letter
 'advise developments'
 This cannot proceed
 include capital
 requirements (as
 you mentioned)
 (y) this is not
 include
 not
 clean up
 this amount
 2-1 am
 on-sale
 claim*

ROVER GROUP (RG)

This is (yet another, I fear) position report on the RG disposal. It includes elucidation of the more problematic elements of BAe's demands in Professor Smith's letter to Lord Young of 6 July on which you commented (Mr Taylor's minute of 7 July to me).

BAe Conditions

2. The conditions set out in paragraph 3 of Smith's letter reflect BAe management's contention that they are unlikely to be able to sell the acquisition of Rover to their non-executive directors and institutional shareholders at the current cash value of the deal (ie £547 million). They say they cannot accept a reduction in excess of £200m.

3. Their attitude reflects their assertion that the additional value of unringfencing capital allowances and capital losses, coupled with the leasing arrangements discussed in Mr Reed's submission of yesterday, are only worth about £35 million. As Mr Reed's submission makes clear, both the Revenue and DTI's tax advisor believe this to be a very substantial underestimate of the value of the tax elements of the deal (including prior Revenue clearance) - this is borne out by BAe's point blank refusal to provide any detailed figures justifying their estimate. Our, very conservative, view on the value of the tax concessions remains £50 million. In principle, therefore, the tax concessions alone serve to close the gap between the amount of cash which the

Commission are prepared to see injected into Rover Group and the maximum reduction in the net worth acceptable to BAe. Against this background, those BAe's conditions which involve HMG putting more cash into the deal look unjustified, particularly given their problematic nature (see particularly comments on items (iii) and (iv)). Nor, on the face of it, do they look to be deal breaking issues.

4. Taking the six points in turn:-

i. You have indicated agreement to the cash injection of £547 million. The rider BAe placed on the regional aid element relates to their uncertainty about the conditions under which it would be repayable. This will probably be in the form of a 'notional' RSA (ie it will form part of the capital injection under the 1980 Industry Act). But it will be subject to the normal clawback conditions attaching to RSA, notably repayment if the capital expenditure to which the payment relates does not take place. BAe may, however, be looking for some flexibility in relation to the capital expenditure to which the RSA would relate: this is unexceptional provided we can get it through the Commission who now appear to be flexible. (The Commission at official level are, however, now insisting on repayment of any unspent money from the 1987 commercial vehicle restructuring injection, a point which DTI thought they had dropped. DTI are pursuing this with the Commission.)

ii. As you have pointed out, the removal of the ringfence is incorrectly ascribed to the trading losses as well as capital allowances and capital losses. I understand, however, that this is essentially a presentational device which BAe intend to adopt in selling the deal to their various audiences. In other words, they will be saying that there will be no ringfencing of any of the tax losses and allowances (glossing over the fact that the historical trading losses cannot be moved sideways in the group). I cannot see that this will fool the experts. But, on the other hand, it does not seem to be a presentational device to

Mr Walker says that latest info. is that Commission are pressing this hard. This would reduce the value of the deal by £40 m - and this blow it out of the water.

which you need object, provided BAe understand that if the Government is asked a direct question about the sideways movement of the trading losses it will need to explain the position.

iii. You have already agreed to a 12 month deferral of receipt of the consideration without any interest charge (worth about £15-18 million). But there are potentially quite serious handling problems vis-a-vis Parliament given that Lord Young - on UKREP advice - is not intending to tell the Commission about the deferral. If the Commission are not to be told then it will be necessary to find some mechanism for avoiding it becoming public that HMG is not receiving the consideration for 12 months. DTI's legal advisors believe it will be possible to come up with the necessary mechanism (eg by making receipt of the payment conditional on the execution of certain legal documents by HMG which, in practice, would not take place for 12 months). But failing to make it clear to Parliament that a 12 month delay is the practical effect of the legal arrangements would come perilously close to misleading Parliament and the PAC. And it would not go easily unnoticed anyway since the Supplementary Estimate currently before the House, which we will now need to withdraw, ^{to replace} includes provision for Appropriations-in-Aid in 1988-89 of £150 million. I suggest therefore that you might wish to press Lord Young on the difficult Parliamentary handling aspects of this proposal.

y/1 iv. DTI's advisors say that BAe's proposal to allow trading losses/capital requirements to be set sideways from one RG company to another to offset gains from disposal would effectively remove any disincentive to BAe selling off RG companies or trade marks within the five year proscribed period. (The maximum amount repayable will come down in any case as a result of the reduction in the net value of the injection.) The obvious disposal option for BAe would be Land Rover - there are a number of ready buyers for the company, including Volkswagen. DTI's current intention is therefore to advise Lord Young to offer only a letter of

comfort amplifying the conditions under which HMG might be prepared to waive invoking repayment. This would be based on statements to the House by Kenneth Clarke and Lord Young at the time the deal was announced at the end of March. If BAe are prepared to accept this it would be much by far the best outcome since it would avoid potential political embarrassment over the Government being seen to have no effective sanction over disposals within the five year period - a significant weakening compared with the original terms of the deal announced to Parliament.

v. Meeting acquisition/minority costs is, as you have indicated, subject to Commission clearance. Lord Young is putting this to Sutherland but, that obstacle apart, there is again a difficult issue of Parliamentary handling. This is because, even if the Commission agree, Lord Young is currently not intending to announce this element of the cost of disposal as part of the overall deal. Instead, he proposes to announce that the Government has made a contribution towards the costs of requiring a minority shareholding sometime in the autumn. It is difficult to see how such an approach would avoid sharp criticism of misleading Parliament about the net cost of the deal, even if BAe were to agree to the idea (DTI's financial advisors believe it would have to be disclosed to BAe's shareholders). Moreover, a Government contribution towards minority acquisition costs immediately raises difficult issues about the valuation of the minority shareholding: it invites unwelcome comparisons with the low price per share being received (on a deferred basis) by HMG, as well as the logic of the size of the contribution in relation to the current market price. I suggest you press Lord Young on the Parliamentary and presentational aspects if the minority buy out assistance stays on the table.

vi. BAe are asking that the effective acquisition date would be the date of the provisional agreement (ie early March). This is not unusual or problematic in terms of usual commercial practice.

5. As for the fourth and penultimate paragraphs of the letter, DTI recognise the prejudicial nature of this material and will be advising Lord Young to write back in non-committal terms on the foreign shareholding and rebutting any suggestions of preferential treatment in other areas of BAe/HMG business.

Placement Option

6. DTI have had a further meeting with Rover Group to discuss the placement option. Despite Graham Day's confidence, the whole deal still looks to be woolly, both in terms of where the money is coming from and the terms of the consideration to be received by HMG. But it seems clear that there would be substantial deferral of the consideration, perhaps by HMG receiving preference shares in Rover Group to be redeemed at a later date depending on profit performance etc. The overall deal still looks to be very problematic and you should avoid Lord Young making any public commitment to it if BAe withdraw early next week until the key details are sorted out.

Next Steps

7. Lord Young is unavailable until Monday. In the meantime DTI and their advisors are doing further work on the BAe conditions and on trying to pin down the details of the placement option. I would expect Lord Young to consult you and the Prime Minister on the final shape of the deal when he has had a chance to speak to Smith in the course of Monday. By then time will be very short, given that the Commission intend to meet on 13 July to discuss the terms of closing the procedure on the RG case. Assuming BAe sign up and the Commission agree, there would be a Parliamentary statement on 14 July with BAe's EGM to ratify shareholders acceptance of the acquisition terms sometime in the week beginning 1 August.

Summary

8. Assuming deferred consideration and a contribution to the minority buyer remain on the table, I suggest you raise with Lord Young how he intends to approach the difficult question of Parliamentary handling in such a way as to avoid running into problems with either the Commission or with Parliament over withholding information on important elements of the deal. As far as relaxation in the disposal conditions are concerned, it would seem desirable to stick broadly to the existing agreement provided BAe are happy with some form of comfort letter. If, however, this becomes a sticking point with the company then Ministers will need to be aware that a substantial move in BAe's direction would effectively remove any significant deterrent to disposal within the five year period originally set out in the agreement.



M A WALLER

SECRET

FROM: N MONCK

DATE: 12 July 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
 Financial Secretary
 Sir P Middleton
 Mr Anson
 Mr Burgner
 Mr Waller o/r
 Ms Roberts

PS/IR
 Mr J Reed, IR

ROVER GROUP

You will be attending the meeting at No 10 this afternoon with the Prime Minister and Lord Young. Lord Young's letter of 12 July to Professor Smith sets out his offer. Professor Smith has not accepted it. (See para 3 below)

2. The letter from Lord Young's Private Secretary of 11 July says that the main outstanding problem is the handling of restructuring in Rover Group. This may leak from the Commission papers for tomorrow's meeting, but Professor Smith insists that closure plans must not be mentioned in the Government's announcement. That issue is more for Lord Young and the Prime Minister than for you. A draft of the announcement may well be handed round at the meeting.

Present Position

3. Lord Young met Smith this morning. Smith is now considering the terms as they now stand. The changes compared with the letter are:

- (a) on (iii), deferred payment, Lord Young has conceded payment ^{on} 31 March 1990 - beyond the latest date in his letter. BAe value this at £22 million. An addition of £7 million;
- (b) on (v), acquisition of minority shares. Lord Young has offered £9½ million for the shares plus up to £2 million for associated costs, or £11½ million. In addition Lord Young will waive BAe's agreed contribution of £5 million to the space programme. Taken with (a) he has given an extra £8 million or 9 million.

Lord Young is planning to omit both these points from his statement.

4. Lord Young has made it clear to Professor Smith that BAe will have to bear the risk that the Commission will challenge one or both of these: he is probably omitting them from the statement in order to minimise the risk of intervention by the Commission and sees this as the Government's side of this bargain.

5. He has told the Commission about 3(b). Sutherland has said he will turn a blind eye unless a member country objects strongly. He has not told the Commission about (a).

6. Smith is resisting being at risk from Commission intervention to the tune of at least £33 million. He is pressing Lord Young for an assurance that the Government would make good any losses to BAe in some way or other. Lord Young has firmly and rightly resisted this.

7. Lord Young's proposal would be understandable if we were dealing only with the Commission and BAe. But Parliament is involved too. There are two objections to what he proposes. First, there is the broad point that a statement on the lines we understand he is proposing would be misleading Parliament by giving an incomplete account of a highly controversial deal.

8. Secondly, there is a narrower but important point of propriety in relation to estimates. At present DTI have presented an estimate for a payment of £800 million and a receipt in the form of an appropriation in aid of £150 million. This ought to be revised to show the lower payment and the receipt of £150 million would have to be deleted as the Government will not get it until the end of 1989/90. There is plenty of time to make these changes as we have up to the end of next week to do it. I understand that Sir Brian Hayes is not worried by these propriety problems on the grounds that time is so short. But we do not think that argument runs. We have received no definite proposal from the DTI but they presumably have in mind introducing a revised supplementary estimate in the autumn.

9. We recommend you to question Lord Young's proposal both on the broad grounds that it would be or would be represented as misleading Parliament, for example if information about the delayed payment and the contribution to ^{the cover of} acquiring the shares dribbles out public and Parliamentary consciousness in the weeks following the statement, perhaps assisted by the circulation of papers for the BAe EGM early in August; and also because of the arguments of propriety in relation to estimates.

10. If you persuade your colleagues, there will be a choice between risking a break with BAe, though my personal bet is that they would not push it at that point, and agreeing to some form of comfort on the lines Smith has asked for. Smith is apparently keen to be able present to his board a package with a value of £612 million. He could do that if he would put a higher value on the tax side (say, 547 + 50 (tax) + 16 (minority plus waiver of space contribution) = 613). This is a difficult choice but my advice would be in favour of taking the risk and not offering any comforting form of words.

Tax

11. The other point of concern to you is the presentation of the tax side of the deal (which BAe still say is worth only £35 million without demonstrating it). The Inland Revenue are somewhat concerned about the attached report in The Guardian. The value of the tax concession is implicitly put at £70 million which is not far out (the foot of the first column). But the first full paragraph of the second column exaggerates what has been agreed. The key point is that there will not be any special dispensation from the tax law which will be the same for BAe/Rover as for anyone else. We will want to make sure that the final text and the briefing gets this point across.



N MONCK

Government softens blow as £800m aid package cut

B Ae tax deal paves way to Rover sell-off

Michael Smith and Andrew Cornelius

BRITISH Aerospace is about to clinch the Rover Group takeover after securing access to the firm's past tax losses to help offset the £250 million cut in the Government's aid package being demanded by the European Commission.

B Ae will now get a smaller cash handout from the taxpayer, but it will get a cut in its own future tax bills by using Rover's previous losses against its own future profits.

After lengthy negotiations in London and Brussels, the Rover deal seems likely to be settled within days.

The solution to the long running wrangle with the European Commission over the Government's original £800 million aid package allows B Ae a tax windfall which will effectively reduce the £250 million cut demanded by the EC to £180 mil-

lion. Under the original terms, B Ae was only allowed access to £500 million of Rover's £1.6 billion backlog of tax losses on condition they were offset against future Rover profits.

Under the new deal, B Ae will be able to offset £500 million of Rover's past losses against future B Ae profits, bringing an immediate windfall to B Ae's accounts.

On the basis of last year's financial results, B Ae's profits would have increased by more than a third if it had been able to avoid paying its £63 million tax bill by offsetting this against past losses.

Although the package will still need EC approval, there are firm hopes in London that the deal originally revealed in March will be cleared at the Commission meeting in Brussels tomorrow or next Wednesday, at the last gathering before the summer recess.

Failure to secure agreement before the recess would increase the possibility of the deal foundering, and a great deal of

political and industrial effort has been directed to speeding it through.

The Trade and Industry Secretary, Lord Young, and the B Ae chairman, Professor Roland Smith, the two central figures in the affair, have staked a lot of personal credibility on securing the Rover bid.

B Ae has also been cheered by Rover's improved trading performance so far this year. Rover car sales rose by 5 per cent in the first half of 1988 and the firm is expected to make a profit of around £80 million this year, according to some City speculation.

The EC's demand that Lord Young cut £250 million off the £800 million injection had raised fears that B Ae would withdraw and open up the politically unwelcome possibility of a foreign company such as Volkswagen buying Rover. The Young-Smith deal is expected to be acceptable to the Commission and to B Ae's shareholders.

City notebook, page 10

FINANCIAL TIMES

Ridley appoints advisers on water changes ...

By Richard Evans

MR NICHOLAS Ridley, Environment Secretary, has appointed the members of the National Rivers Authority advisory committee, set up to advise on restructuring water authorities in England and Wales before privatisation.

Lord Crickhowell, formerly Mr Nicholas Edwards, Welsh Secretary from 1979 to 1987, has already been named as chairman.

The six other members are Mr Peter Brandt, chairman of Atkins Fulford, engineers; Prof Ronald Edwards, Professor of Applied Biology at the University of Wales Institute of Science and Technology and deputy chairman of the Welsh Water Authority; Mr Hugh Fish, chairman of the Natural Environment Research Council; Lord Mason, formerly Mr Roy Mason, the Labour Defence Secretary; Mr Dennis Mitchell, member of the board of South West Water Authority; and Mr John Norris, former president of the Country Landowners' Association.

70

6/12

SECRET & MARKET SENSITIVE

DRAFT PARLIAMENTARY STATEMENT

I informed the House on 29 March that the Government had entered into a conditional contract with British Aerospace for the sale of the Government's shareholding in Rover Group. I am pleased to inform the House that the Government, the Board of British Aerospace and the Commission have today approved the final terms of the acquisition subject to certain changes in the structure and scale of the agreement. This means that, subject only to approval at an Extraordinary General Meeting of British Aerospace, we ^{shall} have returned to the private sector the last of the constituent parts of British Leyland.

2 In approving the arrangements, the Commission have recognised the important implications for competition in the vehicles market through the return of Rover Group to the private sector. It has also taken note of the prospects for the development of the company, on the basis of Rover Group management's plans which British Aerospace have endorsed.

3 Under the revised arrangements it has been agreed that some residual debt should remain on the balance sheet. The revised terms also take account of the continuing improvement in Rover Group's financial performance since the talks with BAe were launched. I am sure the House will have welcomed the announcement by Rover Group this morning of its half-year results which show a profit before interest of £28.8m compared with a loss of £7.3m for the same period last year.

4 On this basis, BAe will still pay £150m for the Government's shareholding in Rover Group; and the Government, BAe and the Commission have agreed a new cash injection of £547m, comprising:-

- £469m in recognition of historic debt;
- £78m to support part of Rover Group's investment programme in the assisted areas.

5 In addition, we have also agreed that important tax benefits surrendered by BAe under the terms of the March agreement should be restored. British Aerospace will therefore have the same freedom as any other company to utilise RG's losses which comprise:-

- some £200m of capital losses;
- up to £300m of disclaimed capital allowances;
- £500m of trading tax losses

B. Smith → The value of these tax benefits is a matter for BAe, though they are clearly very significant. *← separate out*

6 I am certain the return of Rover Group to the private sector will prove to be in the best interests of the company, its employees and dealers as well as the many thousands of others in their supplying industries whose livelihood depends upon the health of Rover Group.

7 I should also like to pay tribute to the contribution made by Graham Day, his management team and workforce whose skills and hard work have permitted the return of 18 Rover Group businesses to private ownership since May 1986. They have now raised the performance of Rover Group to the point where it can look with confidence at its final return to the disciplines of the market place, as part of one of the major engineering groups in Europe.

SECRET

FROM: N MONCK

DATE: 12 July 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
 Financial Secretary
 Sir P Middleton
 Mr Anson
 Mr Burgner

Mr J H Reed, IR

ROVER GROUP

This submission offers advice on the best way of implementing the proposals which emerged and were agreed at the meeting at No 10 this evening.

Deferred payment and clarification of tax position

2. Mr Reed and I think that the best link is not agreement on the value of the tax loss but the delivery of the Inland Revenue opinion on whether proposals by BAe and Rover will or will not fall foul of ^{an} anti-avoidance provision. Mr Reed will want to consult the Chairman rapidly in the morning about this.

3. I attach a draft passage for the agreement with BAe; and a line to take about the timing of payment if questions are asked about it.

4. DTI will be including a square bracketed sentence after the reference to the £150 million in the draft statement on the lines of "Payment is linked to clarification of certain tax matters".

5. I also attach a revised passage ^{for the statement} covering the tax provisions largely provided, like the other attachments, by Mr Reed.

The Estimate

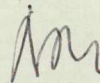
6. I understand from Paul Gray that the balance of opinion at the meeting was to assume that the £150 million would be deleted from the estimate. I have thought more about this and I think it would be better to delete it. I think that in the circumstances to include the £150 million would be highly vulnerable to criticism. Even if the statement does not include a sentence about timing, as I understand the meeting at No 10 may have envisaged, the Q&A seems extremely likely to be used. Once it had been used, MPs and the PAC would be very likely

to press Ministers on why the payment had been included for 1988-89 if we were not sure of receiving it. I have taken this line with the DTI who have shown no surprise.

7. I have at this stage had to leave open the treatment of the payment for acquiring the shares. We will try to settle this first thing in the morning. For propriety it should be covered. But if Ministers decide they wanted to delay publication of this, the least bad approach would be to make the payment of £9½ million in August by viring unspent provision from other sub-heads on the Vote and making a supplementary estimate in the winter round to cover this. Though not wholly proper this course can be justified in that Parliament will be told retrospectively, the statutory powers under the Industrial Development Act allow the payment of £9½ million for this purpose and the sub-head narrative on the estimate covers expenditure allowable under the Act. The Act's powers have been determined by DTI lawyers and DTI Accounting Officer would be answerable to the PAC for this in due course. This approach may not, however, be available for the £1½-2 million of associated costs.

8. Para 9 of my earlier minute of today remains relevant. But in my view the position will be significantly less vulnerable to criticism than otherwise if the estimate excludes the £150 million.

9. We have passed all the attachments to the DTI this evening except for the final one which is an explanatory note by Mr Reed, for use within the Government, about the tax risks on which the Revenue will be giving an opinion.



N MONCK

FOR DRAFT AGREEMENT

The payment of £150 million from BAe will be due on the earlier of:

(i) 30 March 1990; and

(ii) the date when the relevant opinion is given by the Inland Revenue.

2. The relevant opinion is a statement by the Inland Revenue of their view as to whether Section 768 of the Income and Corporation Taxes Act 1988 would apply to a proposed course of action described to them by BAe and Rover.

SECRET

*Timing of No*LINE TO TAKE ON DATE OF PAYMENT BY BAeWhen will the £150 million due from BAe be paid to the Government?*The payment is linked to the clarification of certain tax matters*

The agreement for the sale of Rover provides for the Inland Revenue to give their opinion as to whether a particular anti-avoidance provision (Section 768 of the Income and Corporation Taxes Act 1988) would apply to any proposed changes to the running of the Rover trades which have ~~brought forward~~ ^{existing} trading tax losses. This will enable BAe to obtain reassurance that they can re-organise the Rover trades to improve their operation and to make best use of their tax losses, without running the risk that they will lose all of these tax losses as a result of this anti-avoidance provision. Until they obtain this reassurance they will be reluctant to make substantial changes and so any delay in obtaining it will be to their detriment. We have therefore agreed that they should not make the payment due to the Government until they have received the Inland Revenue's opinion. But as a fall-back the payment will fall due on ~~31 March 1990~~, even if an opinion has not been given.

*before the end of the next financial year*Why are the Inland Revenue giving ~~to~~ their opinion in advance about the application of an anti-avoidance provision?

The Revenue do not usually give their opinion in advance about the application of Section 768 of the Income and Corporation Taxes Act 1988. But in this case the reassurance that this will give to BAe will enable them to make best use of the Rover Group tax losses and this is reflected in the terms of the sale agreement with BAe.

Why has the £150m been deleted from the Estimate

It would be wrong to include it if we cannot be sure of the timing of the payment (which is linked to the clarification of certain tax matters).

SECRET

Revised draft of end of para 4 and para 5 of draft statement

- £469 in recognition of historic debt;
- £78m to support part of Rover Group's investment programme in the assisted areas.

~~A revised estimate will be presented [today/as soon as possible]~~

5. In addition, we have agreed ^{instead} ~~some~~ changes to the tax provisions of the March agreement. There has been no change in the provision that only £500 million of Rover Group's existing trading losses will be available after it has been acquired by BAe. These will, in the usual way, be available only for set-off against the future profits of Rover. But we have agreed to remove two other tax restrictions which were in the earlier agreement. This will give the BAe group the same freedom as any other company has under tax law to utilise

- some £200 million of RG's capital losses; and
- up to £300 million of disclaimed capital allowances.

Estimating the value of these tax benefits is a matter for BAe, although it is clearly very significant.

SECRET

Details of the Proposal - *explanatory note for the Inter-Government*

Section 768, ICTA 1988 applies where within a period of three years there is both a change of ownership of a trade and a major change in the nature or conduct of the trade. Where it applies all of the existing trading tax losses cease to be available. So in the Rover Group case the £500 million of trading losses is potentially at risk.

2. There are two aspects to this risk. First, any changes to the running of the trade that BAe may wish to make for normal commercial reasons (eg changing suppliers or distributors). Second, any changes they wish to make to maximise the usefulness of the trading losses (eg transferring debt out of Rover and into BAe, or acquiring new capital equipment for Rover through a BAe leasing company and leasing it to Rover so as to get the benefit of the capital allowances into the BAe part of the group).

3. There is some uncertainty about the application of Section 768 in this sort of case and because the consequence of falling foul of it is so serious (all the tax losses cease to be available) companies steer well clear of the area of uncertainty. So the agreement of the Revenue to vet proposals in advance is of real value to BAe and will enable them to go further than they would otherwise have risked. But they will be reluctant to do this until they have the Revenue's opinion, and this is the justification for linking the payment of the £150 million to the giving of this opinion.

SECRET AND MARKET SENSITIVE

Paul Gray Esq
Private Secretary to the Prime Minister
10 Downing Street
London
SW1

**Department of
Trade and Industry**

1-19 Victoria Street
London SW1H 0ET

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01-215 7877

Telex 8811074/5 DTHQ G
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CH/EXCHEQUER	
REC.	13 JUL 1988 ✓ 13/7
ACTION	MR MONCK
COPIES TO	

Direct line
Our ref
Your ref
Date

215 5422
13 July 1988

Dear Paul

ROVER GROUP PRIVATISATION

It has now been agreed with BAe that payment of the £150m consideration should be made when certain tax matters have been finally clarified, subject to a long-stop date of 31 March 1990 to prevent BAe from dragging out their discussions indefinitely.

I am attaching a draft statement, revised to reflect this fact. The key sentence is in paragraph 4. The Inland Revenue have supplied a form of words to be used if Ministers are pressed to give details of the tax matters to be clarified. If pressed on whether this means that payment could be delayed indefinitely, Ministers would refer to the long-stop date.

Lord Young has not yet seen the revised statement (or the related notes for supplementaries) but it would be helpful if you could let me have any comments the Prime Minister has by 9 am today, so that I can incorporate them in the version that Lord Young brings to E(A).

I am copying this letter with a similar request to Alex Allan (Treasury).

Yours

Jeremy Godfrey

JEREMY GODFREY
Private Secretary

I informed the House on 29 March that the Government had entered into a conditional contract with British Aerospace for the sale of the Government's shareholding in Rover Group. I am pleased to inform the House that the Government, the Board of British Aerospace and the Commission have today approved the final terms of the acquisition subject to certain changes in the structure and scale of the agreement. This means that, subject only to approval at an Extraordinary General Meeting of British Aerospace, we shall have returned to the private sector the last of the constituent parts of British Leyland.

2 In approving the arrangements, the Commission have recognised the important implications for competition in the vehicles market through the return of Rover Group to the private sector. It has also taken note of the prospects for the development of the company, on the basis of Rover Group management's plans which British Aerospace have endorsed.

3 Under the revised arrangements it has been agreed that some residual items of debt should remain on the balance sheet. The revised terms also take account of the continuing improvement in Rover Group's financial performance since the talks with BAe were launched. I am sure the House will have welcomed the improvement in the half-year results which Rover Group announced this morning. These show a profit before interest of £28.8m compared with a loss of £10m for the same period last year.

4 On this basis, BAe will still pay £150m for the Government's shareholding in Rover Group. *no power to* This payment is linked to final clarification of certain tax matters. The Government, BAe and the Commission have also agreed a new cash injection of £547m, comprising:-

- £469m in recognition of historic debt;

- £78m to support part of Rover Group's investment programme in the assisted areas.

5 In addition, we have also agreed that important tax benefits surrendered by BAe under the terms of the March agreement should be restored. British Aerospace will therefore have the same freedom as any other company to utilise RG's losses which comprise:-

- some £200m of capital losses;
- up to £300m of disclaimed capital allowances;
- £500m of trading tax losses

Estimating the value of these tax benefits is a matter for BAe, though they are clearly very significant.

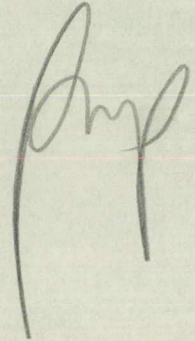
6 I am certain the return of Rover Group to the private sector will prove to be in the best interests of the company, its employees and dealers as well as the many thousands of others in their supplying industries whose livelihood depends upon the health of Rover Group.

7 I should also like to pay tribute to the contribution made by Graham Day, his management team and workforce whose skills and hard work have permitted the return of 18 Rover Group businesses to private ownership since May 1986. They have now raised the performance of Rover Group to the point where it can look with confidence at its final return to the disciplines of the market place, as part of one of the major engineering groups in Europe.

The Rover Group plc
 7-10 Hobart Place
 London SW1W 0HH
 Telephone: 01-235 4311
 Telex: 926880

13 July 1988

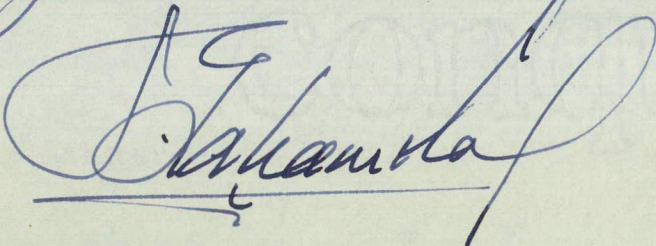
CH/EXCHEQUER	
REC.	14 JUL 1988 ✓ 14/7
ACTION	MR WALLER
COPIES TO	PS/CST, PS/BT
	SIR P MIDDLETON
	MR ANSON, MR MORRIS
	MR BURGER



A Allen Esq
 Private Secretary to the
 Chancellor of the Exchequer
 Her Majesty's Treasury
 Parliament Street
 London SW1P 3AG

Dear Mr. Allen

I enclose for your information a copy of the announcement of the Rover Group half-year results to 2 July 1988.

Yours sincerely


J GRAHAM DAY

Enc

The Rover Group plc
7-10 Hobart Place
London SW1W 0HH
Telephone: 01-235 4311
Telex: 926880

Release Immediate

13 July 1988

ROVER GROUP STATEMENT ON THE HALF-YEAR RESULTS TO 2 JULY 1988

Rover Group's improving performance has been maintained during the first half of 1988 with a profit before interest and tax of £28.8 million, compared with a loss of £10.0 million for the equivalent period of 1987. This represents the best first-half financial performance since 1979.

The main factors were the achievement by Austin Rover of an operating profit of £17.5 million, against an operating loss of £16.4 million, and a strong recovery by Land Rover, following the pay dispute earlier in the year, to increase its operating profit to £10.8 million (first half 1987: £7.5 million).

The overall Rover Group operating profit of £19.9 million (first half 1987: £13.2 million operating loss) was achieved on total sales which rose by two per cent to £1,553 million.

The Group's share of profits from associated companies, formerly subsidiaries, rose to £8.9 million (first half 1987: £3.2 million) with all companies trading profitably.

Pre-tax profits of £7.1 million compare with losses of £39.9 million, the first time a profit at this level has been recorded since 1979.

Market conditions remained generally buoyant in Europe during the first half of the year, with the UK achieving record sales. The Group's UK car sales (including Range Rover) rose by nearly six per cent to 166,668 units. However the effects of the strong pound in key overseas markets coupled with a significant downturn in the United States imported executive car sector reduced export revenue by 13 per cent to £460 million.

Vehicle production rose by 14 per cent to 281,000 mainly accounted for by Austin Rover. Land Rover recovered production lost through strike action by subsequently achieving higher production levels on both Land Rover and Range Rover vehicles and voluntary holiday working by employees. Range Rover production is currently at record levels.

Two new models were launched during the first half of the year; the Rover 800 Fastback and the Range Rover Vogue SE. With the introduction of the Fastback Austin Rover has further broadened the appeal of the range in the executive car sector. The Fastback will be progressively launched into export markets later this year. The Range Rover Vogue SE firmly establishes Range Rover in the luxury sector of the world's car markets.

Issued by Corporate Affairs: Tel 01 235 4311

The Rover Group plc - Half Year Results to 2 July 1988

The Board of The Rover Group plc has announced unaudited results for the six months ended 2 July 1988.

	1988		1987	
	£million Turnover	£million Profit (Loss)	£million Turnover	£million Profit (Loss)
Continuing activities				
Austin Rover Group	1,339.1	17.5	1,314.9	(16.4)
Land Rover Group	289.1	10.8	250.5	7.5
Divested activities	-	-	47.5	2.6
Other and consolidation	<u>(75.0)</u>	<u>(8.4)</u>	<u>(84.7)</u>	<u>(6.9)</u>
Turnover	<u>1,553.2</u>		<u>1,528.2</u>	
Operating profit (loss)		19.9		(13.2)
Share of profits of associated companies, formerly subsidiaries		<u>8.9</u>		<u>3.2</u>
Profit (loss) before interest and taxation		28.8		(10.0)
Interest		<u>(21.7)</u>		<u>(29.9)</u>
Profit (loss) on ordinary activities before taxation		7.1		(39.9)
Taxation on ordinary activities		<u>(2.1)</u>		<u>(2.1)</u>
Profit (loss) attributable to shareholders		<u>5.0</u>		<u>(42.0)</u>
Exports from the UK	£m	460		* 529
Vehicle Unit Production '000		281		* 246
Vehicle Unit Sales '000		259		* 259

Profit (loss) per share 0.1p (0.8p)

Certain 1987 figures have been restated to reflect the current Group structure.

The pensions contribution holiday, as noted in the 1987 Report and Accounts, continues to apply.

Divested activities for 1987 comprise ISTELE Limited, Leyland DAB A/S (Denmark), and the Indian businesses Ashok Leyland Limited and Ennore Foundries Limited.

Associated companies formerly subsidiaries comprise DAF BV; UGC Limited; JRA Holdings Limited and ISTELE Holdings Limited.

*Excluding divested activities.

This document is circulated to the Ordinary Shareholders of the Company.

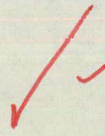
Copies are available to the public at the registered office of the Company, 7-10 Hobart Place, London SW1W 0HH.



the department for Enterprise

SECRET AND MARKET SENSITIVE
COMMERCIAL IN CONFIDENCE

PRIME MINISTER



ROVER GROUP

BAe's last-minute postponement of the deal at 2.20 pm yesterday reflected their concern at one of the conditions certain to be attached by the Commission to the state aid when communicating their formal decision.

2 Their expressed worry was that the Commission would have the legal right to demand repayment of the entire £469 million debt-related aid in the event that by 1992 there was a significant underspend of the £1.3 billion Rover Group capital expenditure programme forecast in the Corporate Plan and endorsed by BAe. They would not be prepared to recommend to shareholders that BAe should carry that risk given, for example, that a down-turn in RG's business (or problems within existing Aerospace businesses) might force a cut-back in capital spend. BAe were unmoved by arguments that the Commission were only likely to challenge if there were a major reduction in expenditure; that, in the event of this happening, there would be full opportunity to justify this shortfall to the Commission who could be expected to be sympathetic if there were convincing reasons to support it; and that in reality the Commission would in any event only require a repayment pro rata to the underspend.

3 In subsequent discussions with Roland Smith, I asked him to let me know precisely what modification in the Commission's stance would be required to enable the deal to go ahead. I have received the attached letter in response. I judge that it will prove quite unacceptable to the Commission. BAe are either being naive or they are not genuinely looking to settle. Nevertheless I propose that David Hannay see Commissioner Sutherland later



the department for Enterprise

SECRET AND MARKET SENSITIVE
COMMERCIAL IN CONFIDENCE

this morning to see how far the Commission would be prepared to go to facilitate the deal. David Hannay spoke to Sutherland yesterday evening and it appeared then that he would be prepared to be as helpful as he reasonably can be to produce a settlement. But unless BAe are themselves ready to be flexible (and their letter does not indicate this), the prospects of a deal are slim. One additional element we might throw in if it would clinch a deal (but only if it would) would be to offer to waive the on-sale restrictions if the Commission forced a significant repayment. This would only be likely if the company was already in trouble and in those circumstances we have already indicated we would be prepared to consider waiving the on-sale restrictions.

4 I think we should pursue consultations with the Commission this morning if only to keep BAe in play until we are ready to announce alternative plans.

5 I believe strongly that we must make a further statement this afternoon. This will end the present uncertainty and will enable us to take the initiative over BAe who will no doubt try to place the blame for any breakdown at the Government's door.

6 Our objectives must be:

- (a) to stabilise the company in the most critical sales period of the year.
- (b) to proceed towards privatisation in an orderly manner without blocking off any options.
- (c) to prevent an immediate and embarrassing bid from Volkswagen.





the department for Enterprise

**SECRET AND MARKET SENSITIVE
COMMERCIAL IN CONFIDENCE**

If we achieve these, we should minimise the political damage to the Government.

7 The effective options for the statement are to indicate:-

- (a) that we shall be reviewing all options for the RG businesses including the possibility of a trade sale. I do not believe that we could sustain this line.

Graham Day is certain to argue that, in the run-up to the critical August sales period, we should not add to his problems by generating fresh controversy about the likelihood of a foreign sale, particularly after the recent interest shown by Volkswagen.

Unless we proceed by open tender we might face an awkward time with the Commission. This could limit our scope for another exclusive deal or limited tender.

- (b) that our objective remains to return the RG businesses to the private sector within the lifetime of this Parliament and that we shall be examining with Graham Day the prospects for a placement/flotation of RG. This would not block off trade sale opportunities if the placement option emerged as too high risk but it would remove the threat of an immediate bid from Volkswagen. Although a placement would preserve the independence of Rover Group (with all the benefits that brings to employees, suppliers and dealers), we would have to be satisfied that an institution-led management buy-out could be launched and also that the new company would be robust enough not to require rescue over the next 3-4 years.





the department for Enterprise

SECRET AND MARKET SENSITIVE
COMMERCIAL IN CONFIDENCE

Such a statement would be welcomed by Graham Day and his senior management, and by Honda. It is also my preferred option.

(c) that for the present we shall retain RG in the public sector with privatisation only as an ultimate aim. This might bring a measure of stability to the situation but would achieve little else and would leave us with Varley Marshall, an area which has assumed a higher profile with the Commission who may in due course wish to challenge. I do not recommend it.

8 I should welcome the opportunity to talk through these options this morning.

9 I am copying this minute to Nigel Lawson and Geoffrey Howe.

D Y

14 July 1988

DEPARTMENT OF TRADE & INDUSTRY

DWLAGR





From: CHAIRMAN

Direct Line: 01-389 3923

13th July, 1988

Rt. Hon. Lord Young of Graffham,
Secretary of State for Trade and Industry,
Department of Trade and Industry,
Room 803,
1 Victoria Street,
London, SW1H 0ET.

My dear Lord Young,
ROVER GROUP

I am writing to set out the reasons that led us to require further clarification of certain of the conditions upon which the EC's consent was likely to be forthcoming to the proposed agreement for our purchase of Rover Group. There are two inter-related factors which were for the first time disclosed to us early this afternoon. They are :-

The Rover Corporate Plan

We will apparently be required to complete the Rover Group Corporate Plan by the end of 1992 in accordance with details communicated by HMG to the Commission. Failure to do so could apparently result in the obligation to repay the entire £469 million state aid.

Investment and Restructuring Costs

As part of the Plan (but it is a significant item) it is envisaged that capital investment and restructuring costs would be incurred up to the end of 1992 totalling £1.5 billion. Failure to spend this money could, it seems, result in the repayment of the whole or part of the £469 million State Aid.

These two factors seemed to remove from the Board of British Aerospace the power that it would normally have in relation to the management of one of its principal subsidiaries. Non-compliance with the Rover Corporate Plan could have a severely detrimental financial effect were the E.C. to require repayment of the £469 million. It is possible that by agreement with HMG and the E.C. the Corporate Plan could be modified, but such modification would not necessarily be within the control of the BAE Board.

.../...

Against a background where we had all along been led to believe that the payments to be made by H.M.G., which have (since our original agreement) been reduced by £253 million, would be akin to the write off of historical debt in other Government privatisation exercises, these new features appearing at so late a stage radically altered the nature of the transaction.

We have all along declared our support for the Rover Corporate Plan, but with sensible caveats and not as if that were immutable. Whilst you and your Officials have kept us informed from time to time of the negotiations which H.M. Government has had with the Commission in Brussels, you will appreciate that British Aerospace is unaware of all that has passed in those discussions which may have affected the final determination and that we have proceeded thus far and, if the problems which emerged today can be satisfactorily resolved, we propose continuing to Completion on the basis that all material disclosure of relevant facts and circumstances has been made to the relevant authority for the purposes of Articles 92 and 93 of the Treaty of Rome and that there is no foreseeable risk of subsequent invalidation of the EC's approval of the State Aid as being compatible with Treaty requirements. Likewise, we have assumed that H.M. Government's communications with the Commission, to which the Commission refers in the conditions attaching to its approval of State Aid, are wholly consistent with Rover's Corporate Plan seen by British Aerospace.

As you suggested during our meeting this afternoon, I enclose a draft letter that we hope the EEC will give to you and to us clarifying the conditions which we understand from your Officials are associated with the approval given to State Aid for Rover Group.

Yours sincerely,

Roland Smith

Draft letter from the E.C. to HMG: cc: BAe.

1. We confirm the following conditions associated with our approval of state aid totalling £ to The Rover Group.

[Insert 1-6 of draft letter]

2. We are responding to your request for clarification of some of the above conditions. That request was made in the context in particular that British Aerospace is a listed company whose Board of Directors has legal duties to its institutional and private shareholders. These include retaining reasonable flexibility and independence in its decision making based on legitimate commercial factors consistent with the best interests of the Company. Accordingly, we now confirm :

Paragraph 3 The award of £78 million assumes an investment by British Aerospace/Rover Group of £477 million over the period of the Corporate Plan. If that investment is not made in full, then we may require, following discussion with you and British Aerospace and consideration of the circumstances involved, the repayment of a pro rata share of up to the £78 million awarded. It is our policy not to require repayment where there is justification for a failure to make the investment concerned.

Paragraphs 4 and 5 We accept that, in the normal course of a privatised company's business and sound management principles, the Rover Group Corporate Plan, upon which is based the expenditure figures disclosed to us, will be the subject of periodic review and modification in response to altered business conditions and projections, although we expect you to advise us of any material modifications. We appreciate

that British Aerospace has not yet had the opportunity of a close examination of Rover Group's business.

In these circumstances, there is no obligation upon British Aerospace to complete the Corporate Plan in all its aspects, including the expenditure referred to above. This being so, we accept that compliance by British Aerospace with the Corporate Plan as modified should not give rise to a requirement for repayment of the state aid (other than the £78 million referred to above) to be made by H.M. Government to the Rover Group to clear its historical debt.

General Except as stated in paragraph 2 of this letter and except for conditions numbers (1), (2) and (6) set out in paragraph 1 above, British Aerospace/Rover Group will have no potential liability to repay state aid awarded to Rover Group and such liability will terminate on 31st December, 1992.



X of prep
to game,
but there
is so
Statement
out.

Ch.

RG/B Ae.

Agreement has been reached

2. I attach:

(i) Lord Young's reply to Smith's letter of yesterday, covering

(ii) an agreed note of a meeting with Sutherland, which parallels content to B Ae.

B Ae have said they are with content.

Ld. Young proposes to make the statement at (iii) at 7.00 tonight.

3. Mr Monck + Mr Walker have seen the pp. + the statement, + have no comments.

2/ 14/7

dti

pmj

Professor Smith

Thank you for your letter of 13 July. I fully recognise that in the light of the information you received yesterday, British Aerospace was justified in deciding not to proceed with formal agreement of the revised terms which we have discussed for acquiring HM Government's shareholding in Rover Group without clarification of some of the conditions attached by the Commission to their decision on the grant of state aid. As a result, I arranged a further meeting with Commissioner Sutherland. I enclose a copy of an agreed minute of that meeting, held between Sir David Hannay and Commissioner Sutherland. You can rely upon that minute as an agreed interpretation of the effect of the conditions indicated to you yesterday as attaching to the state aid approval given by the European Commission. You are at liberty to draw on the minute, but should not publish it in its entirety.

HM Government accepts that in the normal course of a privatised company's business and sound management principles, the Rover Group corporate plan will be the subject of periodic review and modification in response to altered business conditions and projections, although we would expect you to advise us of any material modifications so that we can discharge our responsibilities to the European Commission. We appreciate that British Aerospace has not yet had an opportunity of a close examination of Rover Group's business. In these circumstances, neither HM Government, nor, it believes, the Commission would place an obligation upon British Aerospace to complete the

corporate plan in all its details, though the Commission must reserve its right to investigate and, if necessary, seek some repayment in the event of a serious departure from the conditions of its decision.

HM Government further accepts that

(a) British Aerospace's understanding (and our intention) has always been that of the £547 million state aid approved, £78 million would relate to regional aid, and the balance of £469 million would be used entirely for the reduction of Rover Group's debt (as the Commission itself recognises in the third paragraph of its press announcement dated 13 July 1988);

(b) To the extent that British Aerospace wished to depart from Rover Group's corporate plan for commercially valid reasons, HM Government would prosecute vigorously with the Commission British Aerospace's case against any clawback of aid. If the European Commission were to indicate that it considered that any of its conditions had not been met, HM Government would promptly and fully consult with you at all stages in the process; and

(c) British Aerospace must be free to manage its investment in the Rover Group and the business of that group without constraint on its ability to respond to changes in business conditions and projections, and in full compliance with the Board of British Aerospace's duties to its shareholders.

AGREED MEETING NOTE

Sir D. Hannay said that while the British Government was not seeking any changes in the decision taken by the Commission on 13 July, he had been instructed to raise with Commissioner Sutherland British Aerospace's concerns about the company's contingent liability under the Decision to repay the state aid in the event that they did not complete the Rover Group corporate plan by the end of 1992 in accordance with the details communicated to the Commission. In particular, the company were concerned that failure to spend the 1.5 billion pounds capital investment and restructuring costs by the end of 1992 could result in the repayment of the whole or part of the 469 million pounds state aid together with the 78 million pounds regional aid. This seemed to remove from the Board of British Aerospace the power that it would normally have in relation to the management of one of its principal subsidiaries. Sir D. Hannay was accordingly seeking clarification of certain of the conditions against the background that British Aerospace was a listed company whose Board of Directors had legal duties to its institutional and private shareholders. These included retaining reasonable flexibility and independence in its decision making based on legitimate commercial factors consistent with the best interests of the company.

Commissioner Sutherland said that he understood these concerns, and could provide certain clarifications which the U.K. Government could give to British Aerospace. First, the company should be aware that the provisions in the decision relating to regular monitoring and

possible repayment of aid were standard ones that appeared in all major state aid decisions affecting both public and private sector companies. Secondly in the event that the Commission considered, from the twice yearly monitoring reports, that there was, in its view, a departure from the conditions of its decision, it would, as a first step, raise the matter with the UK authorities, in accordance with its established practice. It would seek clarification as to the justification for the changes in the circumstances of the time. If, following these discussions, the Commission decided that the departures from the conditions were sufficiently serious to require repayment of aid, the volume to be reimbursed would be proportionate to the degree of divergence from the volume of planned investment and expenditure.

Commissioner Sutherland said that he could make it clear that the Commission would not be likely to challenge insignificant deviations from declared plans.

Sir D. Hannay and Commissioner Sutherland noted that the above represented an agreed record of their meeting.

DRAFT SUCCESS STATEMENT

Yesterday I informed the House that the European Commission had decided the outline terms governing the state aid for the proposed British Aerospace acquisition of the Government's shareholding in Rover Group. I also explained that BAe had asked for more time to consider the implications of other conditions attached to the Commission's decision.

I should make clear that the points of difficulty for BAe were not related to the basic financial framework of the deal which were acceptable in principle to BAe. The issue was the detailed monitoring requirements and repayment provisions which the Commission were likely to include in the formal communication to the Government approving the aid.

I am however glad to report that talks with the Commission this morning have clarified the position in terms satisfactory to the BAe board, who have confirmed that they are now prepared to recommend the deal to their shareholders.

As I informed the House yesterday, the Commission have approved the final terms of the acquisition after certain changes in the structure and scale of the agreement. In making this judgement, the Commission have recognised the important implications for competition and restructuring in the vehicles market through the return of Rover Group to the private sector. It has also taken note of the prospects for the development of the company, on the basis of Rover Group management's plans which British Aerospace have endorsed.

Under the revised arrangements it has been agreed that some residual items of trading debt should remain on the balance sheet. The revised terms also take account of the continuing improvement in Rover Group's financial performance since the talks with BAe were launched. I am sure the House will have

welcomed the improvement in the half-year results which Rover Group announced yesterday. These showed a profit before interest of £28.8m compared with a loss of £10m for the same period last year.

On this basis, BAe will still pay £150m for the Government's shareholding in Rover Group. The precise timing of the payment will follow the clarification of certain tax matters arising out of the change of ownership of the company. The Government, BAe and the Commission have also agreed a new cash injection of £547m, comprising:-

- £469m in recognition of historic debt;
- £78m to support part of Rover Group's investment programme in the assisted areas.

In addition, we have agreed material changes to the tax provisions of the March agreement. There has been no change in the provision that only £500m of Rover's existing trading losses will be available after it has been acquired by British Aerospace. But we have agreed to remove two other tax restrictions which were in the earlier agreement. These will give the BAe group the same freedom as any other company has under tax law to utilise:-

- some £200m of Rover Group's capital losses;
- up to £300m of disclaimed capital allowances;

Estimating the value of these tax benefits is a matter for BAe, though they are clearly very significant.

I am certain the return of Rover Group to the private sector will prove to be in the best interests of the company, its employees and dealers as well as the many thousands of others in their

supplying industries whose livelihood depends upon the health of Rover Group. The deal also means that, subject only to approval at an Extraordinary General Meeting of British Aerospace, we shall have returned to the private sector the last of the constituent parts of what was British Leyland.

I should like to pay tribute to the contribution made by Graham Day, his management team and workforce whose skills and hard work have permitted the return of 18 Rover Group businesses to private ownership since May 1986. They have now raised the performance of Rover Group to the point where it can look with confidence at its final return to the disciplines of the market place, as part of one of the major engineering groups in Europe.

CONFIDENTIAL

FROM: M A WALLER
DATE: 21 JULY 1988

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Ms Roberts

W/A. I agree this goes for the for the mi-... can do all... with... still... BAE.

ROVER GROUP/BAe: SIDE LETTER OF COMFORT ON DISCRETIONARY AID

1. DTI have now provided us with a full set of the documentation underpinning the BAe/RG deal.

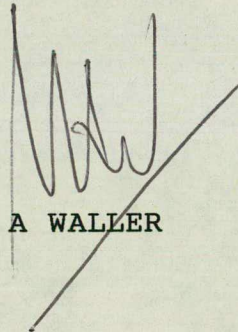
2. One of the documents is the attached side letter dealing with BAe's eligibility for discretionary Government assistance. On the face of it we think this letter goes beyond the terms agreed with the Prime Minister and yourself in relation to the Government's attitude to requests from BAe for additional assistance on Airbus etc. As such, we think it is likely to be unhelpful in any negotiations with BAe over further launch aid for the A330/340 or relaxations in the terms of the existing launch aid levies.

3. We have discussed the background to the letter with DTI officials. They say that the letter was concocted in response to BAe's concerns about the Commission enforcing repayment of the more covert elements of the deal (eg minority buy out costs). Lord Young indicated that while RG were debarred from further discretionary aid BAe could, of course, apply for offsetting assistance under other DTI schemes (ie regional assistance, Section 8 and support for innovation). This, according to the DTI, is all that the letter is intended to convey and is totally without prejudice to the Government's position on launch aid.

4. While this may have been the intention we still consider the letter to be prejudicial, particularly when read in conjunction with the penultimate paragraph of Professor Smith's letter of 6 July (copy attached) which has gone unanswered. Given BAe's

habit of using the press to exert pressure on the Government I would not rule out BAe linking this letter with launch aid if they thought they were making no progress with the Government in direct negotiations. If DTI and Smith letters were to see the light of day it would clearly place the Government at a disadvantage in trying to deny or restrict any further assistance for BAe's involvement in Airbus.

5. We understand this letter has also been drawn to the attention of the Prime Minister who was briefed to raise it with Lord Young yesterday. Forewarned of this, we understand that Lord Young stressed to the PM that he would be very firm indeed if BAe were to attempt to use arguments in relation to the Rover Group or the letter more generally to extract further assistance for Airbus.

A handwritten signature in dark ink, appearing to be 'M A Waller', is written over a diagonal line that extends from the bottom right towards the center of the page.

M A WALLER

Department of
Trade and Industry

Professor R
Chairman
British Aer
11 Strand
London WC2N

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123 Victoria Street
London SW1E 6RB

Switchboard
01-212 7676

Telex 8813148 DIHQ G
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Direct line 215 6479
Our ref
Your ref
Date 14 July 1988

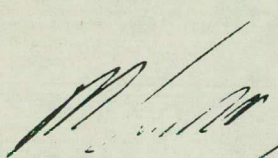
Dear Sir

ROVER GROUP

As you know, the European Commission decision authorising the payment of state aid for the acquisition by British Aerospace of the Government's shareholding in Rover Group is dependent on HMG refraining from granting any further aid in the form of capital contributions and any other form of discretionary aid to Rover Group during the 1988 Corporate Plan period (i.e. until end 1992).

I wish to make clear that this provision does not in any way constrain British Aerospace in respect of its non-Rover Group businesses from seeking financial assistance from Government under approved schemes. I further wish to assure you that any such application would be [sympathetically] considered against the criteria of the relevant scheme and that, in its evaluation, the Government would take fully into account not simply the overall financial position of British Aerospace (where this is appropriate) but also the demands placed upon it by the performance and obligations of the Rover Group businesses.

Yours sincerely


Signed for and on behalf of
the Secretary of State for Trade & Industry

- 3 -

I have separately mentioned to you my Board's growing concern regarding a number of issues affecting the relationship between the Company and H.M. Government, both in the civil and military fields, and if the Board accepts these revised terms for the Rover acquisition, you should appreciate that it is their sincere hope there will be some demonstrable evidence of HMG's responsiveness to that concern.

Finally, we must keep a close eye on the proposed timetable and all the work that remains to be done to keep to it, including the drafting of Supplemental Agreements, BAe's circular to shareholders and Rover's Scheme documentation. This will require a concerted effort by everyone involved to achieve the desired result. I understand, incidentally, that your officials have already indicated agreement to an inevitable extension of the Completion Date provided in the current Agreements.

Yours sincerely,

Roland Smith

Personal copy.

** This option - wa
stroke ✓
concern ✓
central ✓
open, this is a final
decision is not needed
immediately, Mr.*

CHIEF SECRETARY

FROM: N MONCK

DATE: 13 October 1988

cc Chancellor
Sir P Middleton
Mr Anson
Mr Turnbull
Mr Burgner
Mr MacAuslan
Mr Waller

BAe CONSIDERATION FOR ROVER GROUP : AUTUMN STATEMENT TREATMENT

Mr Turnbull's minute of 12 October mentions (in para 5(ii)) the possibility of scoring the payment from BAe for Rover in the DTI programme for 1989-90, as one of three possible routes for improving the overall public expenditure outcome for that year. He comments that there are drawbacks to this course.

2. The attached minute (not to all) of 12 October by Mr Waller considers the pros and cons of scoring the £150 million openly in the DTI main programme for 1989-90, which would need some comment in the Autumn Statement document, and the alternative of scoring it notionally and invisibly in the heavily rounded figure of £5 billion for privatisation proceeds next year. If asked about this, which seems unlikely, we would reply that the timing was still uncertain, as at the time of the July estimate attached to Mr Waller's note. Given this, it was treated as part of privatisation receipts in 1989-90 where it would not in practice affect the Autumn Statement figures.

3. We have not yet discussed this with the DTI and we will need to do so when Treasury Ministers have decided which option they prefer.

4. As Mr Waller's para 3 and the second part of para 5(i) suggest, I would expect DTI Ministers to be against revealing in November that we now expect that the BAe payment will not be made until 1989-90. Once that was known, it would probably come out that the actual date would be 31 March 1990.

5. One reason is that this open presentation is likely to be picked up either by the Commission or more likely by the French who are having an argument about state aids for Renault with the Commission. Second, it might be picked up by individual MPs or the PAC who would ask what it is we know now that we did not know at the time of the revised estimate attached to Mr Waller's note. We insisted then that the estimate should not score the £150 million for 1988-89. But the estimate said vaguely that:

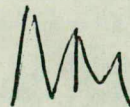
"the precise timing of receipts will follow the clarification of certain tax matters arising out the change in ownership of the Rover Group."

The Government at no point, so far as we know, made it clear when the receipts were actually expected to arrive. We cannot think how we can answer the question about the new knowledge we have satisfactorily and without the risk of revealing that in practice, as Mr Waller explains in para 2, the initiative on timing rests with BAe.

6. Nevertheless I can certainly see the attraction of producing a better overall public expenditure outcome. If you were attracted by doing so in this way, we could of course explore the possibility with DTI officials. It is conceivable that they can think of a passable presentation and that they would see advantage in volunteering information about the timing of the payment rather than risk having it dragged out of them by the PAC. But my guess is that this is unlikely. If you do want us to explore it with DTI I suggest that we should do it thoroughly but without exerting great pressure at official level. We could then come back to you and you could consider whether to put pressure on Lord Young.

7. We should also of course need to consult the Revenue.

8. You may wish to discuss this with us and GEP.



N MONCK

CONFIDENTIAL

FROM: M A WALLER
DATE: 21 OCTOBER 1988

- 1. MR MONCK
- 2. CHIEF SECRETARY

- PS/Chancellor
- Sir P Middleton
- Mr Anson
- Mr Beastall
- Mr Burgner
- Mr Moore
- Mr Turnbull
- Mr MacAuslan

BAe CONSIDERATION FOR ROVER GROUP: AUTUMN STATEMENT TREATMENT

1. As you agreed, we have spoken to DTI officials on the lines set out in paragraph 2 of Mr Monck's minute of 19 October.
2. As expected, DTI officials believe that Lord Young would resist strongly drawing attention to the timing of the RG sale proceeds in the Autumn Statement. DTI officials would also be likely to recommend against such a treatment for the following reasons:

(i) It would be contrary to the spirit (if not necessarily the letter) of the agreement reached between the Government and the BAe on the RG sale. In the final flurry of negotiations with BAe certain elements of the deal were deliberately kept from both Parliament and the European Commission, including not only the delayed payment of the consideration (worth about £26 million if payment is not received until the end of March 1990) but also; a contribution towards BAe's costs of buying out the RG minority shareholders (£9½ million); payment towards RG's legal costs (£1½ million); and relieving BAe of their contribution towards the Columbus space programme (£5 million). At the time of the negotiations with BAe it was made clear to them that, if the Commission became aware of and instituted action for repayment/restitution of any of these elements, the Government could not give a cast iron guarantee that they would agree to make good any amounts repaid by assistance in other areas of BAe/Government

[Handwritten notes in red ink:]
 To fit w/ AS: No
 DTI 21 Oct
 JTI
 lower than w/ AS
 16
 appear
 possibly until
 by w. time
 Jopark
 will have

relations. Nonetheless, the Secretary of State did write a letter to BAe indicating he would be prepared to consider sympathetically the need for some form of compensation via other Government assistance schemes. The letter is somewhat opaque and there is no legally binding obligation here but, to the extent that the Government by its own actions drew public attention to these aspects of the deal, BAe would undoubtedly argue that it violated the spirit of the overall deal.

(ii) Against the current background of debate/criticism over terms of the Royal Ordnance Factory sale to BAe, disclosure now of the delayed receipt of RG proceeds will only serve to stoke up charges that the Government has been profligate in its sale of assets to BAe.

3. DTI officials acknowledge, however, that the issue here is essentially one of timing over the revelation about the RG proceeds. They have already had to tell the NAO that the money will not be paid over until the end of the next financial year - that much is evident from the files and any attempt to cover it up from the NAO enquiry would only serve to exacerbate the difficulties of the PAC hearing. That hearing is likely to take place pretty close to the summer recess and DTI will seek to have this and any other aspects of the deal mentioned in paragraph 2(i) above side-lined on grounds of commercial confidentiality. It is difficult to know whether the PAC will agree to this so there is some uncertainty whether wider knowledge of the delay will come through this route and how politically controversial it might then be.

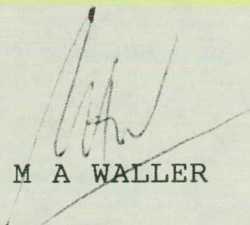
4. We will, in any case, have to include provision for the receipt in next year's Estimates. Normally this would be in the 1989-90 Main Estimates (published in March), though if Ministers so decided this could be delayed until, say, Winter Supplementaries for 1989-90 ie this time next year.

5. More immediately, it is possible that the EC will, in the course of its normal monitoring of state aid cases, ask the direct question about the RG sale proceeds. The first monitoring return is due early next year. DTI have written a letter to the Commission giving description of the final terms agree but which omits mention of the timing of the receipt of proceeds. If the Commission officials are on the ball they may come back on this issue in the next couple of months anyway.

SUMMARY

6. DTI officials accept that there is no overwhelming argument which would rule out including proceeds on the DTI main programme for next year. But they do attach considerable importance to the need to delay - as long as possible - knowledge of the timing of receipts reaching Parliament and the Commission. Inclusion of the figures in the Autumn Statement - which would require comment on the timing of sale proceeds - could cause embarrassing questions for both Parliament and the Commission and be argued by BAe to be contrary to the spirit of the BAe/RG deal.

7. In our view, the DTI arguments do have some considerable force. We therefore believe that, unless £150 million is an absolutely necessary factor in reducing the planning total, then it would be best to assign it to the privatisation proceeds, thus minimising the chances that the point will become public knowledge as a result of avoidable Government action.



M A WALLER

CONFIDENTIAL

FROM: N MONCK

DATE: 24 October 1988

CHANCELLOR OF THE EXCHEQUER

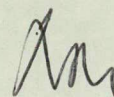
cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Burgner
Mr Moore
Mr Turnbull
Mr MacAuslan
Mr Waller

NOTES

BAe CONSIDERATION FOR ROVER GROUP : AUTUMN STATEMENT TREATMENT

Mr Taylor's minute of 24 October recorded your comment that the figure would surely not appear in the Autumn Statement if it were decided to reduce the DTI programme by the £150 million receipts from British Aerospace. We think it is most unlikely that we can get away with silence and DTI officials agree. The run of figures for DTI (central Government only as in table 2.5 of last year's Autumn Statement) from 1988-89 to 1990-91 would be 1265/1175/1280. This odd profile would probably be noticed and queried. The explanation would have to be the one-off payment from British Aerospace and silence in the Autumn Statement document would then look like a failed attempt at concealment.

2. Fortunately, however, there is a good chance that this issue will become academic. There are naturally still a number of uncertainties about the Survey figures. But if we have to take a decision today - as we must do if we are finalising figures on Tuesday evening - GEP on balance consider that we do not need to pursue the Rover option now. There are other ways of making adjustments of equivalent size, including revising either the unemployment assumption itself or the estimated cost of the 1.9 million assumption. I have just heard that the Chief Secretary does not wish us to pursue the Rover option today.



N MONCK

FROM: J M G TAYLOR

DATE: 24 October 1988



PS/CHIEF SECRETARY

cc Sir P Middleton

Mr Anson

Mr Monck

Mr Burgner

Mr D J L Moore

Mr Turnbull

Mr Beastall

Mr Waller

Mr MacAuslan

Ch: Mr Waller tells me that he is pretty sure we will need to explain the figure in the para. describing main changes to the DTI prog. 26 29/10 JMT:-

BAe CONSIDERATION FOR ROVER GROUP: AUTUMN STATEMENT TREATMENT

The Chancellor has seen Mr Waller's note of 21 October.

2. He has commented that, surely, the figure would not appear in the Autumn Statement: the DTI line would merely be £150 million lower than it otherwise would be. The figure would not appear publicly until the PEWP in January, by which time Sutherland will have departed.

A handwritten signature in black ink, appearing to be 'JMT'.

J M G TAYLOR