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IND POL
8 January 1981

Policy Unit

PRIME MINISTER

BL

1. BACKGROUND

1.1 On 30 December you accepted Keith's proposal that the Policy Unit - and perhaps outsiders - should talk to officials about BL's future, to try to obtain a fresh view of our options.

1.2 We held a meeting with Robin Ibbs and officials from the Department of Industry and Treasury on 7 January. This note endeavours to represent their views fairly, but we take full responsibility for its contents. The whole of our discussion was confined to BL Cars.

1.3 We asked ourselves the following questions:

- (a) What are BL's prospects?
- (b) Have the costs of closure been realistically assessed? Would a further exercise involving outsiders be worthwhile?
- (c) Is there any special condition we could place upon BL (through their management) like a nominal wage cut, which would help them to succeed?
- (d) If BL receives further support, what is the best future ownership strategy? What pressures should be put on Michael Edwardes to achieve it?
- (e) If BL receives further support, for what period should there be a commitment?

2. BL's PROSPECTS

2.1 The BL Board admits there there is no commercial case for supporting the cars plan. We all agreed that, at the very best, BL is likely to be still dependent on Government guarantees in five years' time. We and the CPRS are confident that BL will also need cash during the second half of the 1980s for new model development, for which it will be unable to find risk-takers. We think the only

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source for these funds will be further cash support from Government throughout the rest of the decade. In other words, CPRS and ourselves are convinced that BL are and will remain permanent state pensioners. Treasury and DoI think there is a chance - less than 50% - that this will not be so.

3. THE CLOSURE OPTION

3.1 Against this background, should the Plan be supported? On commercial grounds, there is a unanimous view that it should not. But there are several wider considerations, none of which is overwhelming, which add up to a strong case against closure now:

- (a) BL's contribution to maintaining the component industry infrastructure that could support future Japanese investments and the expansion of Ford UK (this factor will diminish as the new investments arrive and if BL declines further).
- (b) The massive PSBR costs of closure. (These will not diminish much if we withdrew support at a later stage. We understand Geoffrey Howe does not think these costs constitute a sufficient reason for supporting the Plan.)
- (c) The political unpopularity of withdrawing support. (It seems likely that this will be a growing obstacle as the next Election approaches. We elaborate on it at Section 3.2 below. The arguments are not all one way.)
- (d) The addition to unemployment. (The cost of this is subsumed in (b) above; the politics are subsumed in (c). It is not really a separate point.)

3.2 The Political Judgment

3.2.1 The proposition that refusing to support BL further would be politically unpopular deserves more critical examination. Edwardes stands for improved industrial discipline and is able to show some results for his efforts to achieve it. The Metro is widely seen as a new and successful UK product. Withdrawing support for both would no doubt be heavily criticised by some sections of the population for these reasons. On the other hand, how many

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people resent paying taxes to continue support for BL? Do most people feel that Edwardes has succeeded on the industrial relations front, or do they still regard BL as synonymous with bad industrial relations, petty attitudes and economic unrealism? Some quick opinion research on this could be helpful. It could easily be that for every voter who would criticise us for refusing further support, there are at least two or three who would applaud it. Even in the West Midlands, where there are a number of marginal seats, many taxpayers must resent the subsidy they have paid over the last five years to BL workers.

3.2.2 Although the news of a further closure has an obvious negative aspect, there is also a positive one: refusing further support for BL would send a shock wave through British industry. It would reinforce -- far more than speeches ever can -- our commitment to economic realism and to companies and individuals paying their way. It would signal the end of the message for which BL acts as a beacon: that if it is big enough -- and politically embarrassing enough -- a company can count on support from Government regardless of its performance. That message is wholly damaging to our efforts to instil a sense of economic realism.

3.2.3 Of course the political judgment also depends on many other factors, including our intentions towards the possible liquidation of BSC -- to whose strategy the early closure of BL would deliver a severe blow.

4. COSTS OF LIQUIDATION

4.1 The estimates of closure costs are imperfect. But even if they could be refined -- and there is no avoiding a large measure of uncertainty -- they would not provide the answer to the closure question. In very broad terms, the cost of maintaining BL if it does badly is likely to be in the same league as the cost of closure. But the judgment rests on the wider political and economic factors.

4.2 DoI officials think that the balance of argument for closure could change over the next few years. For example, if the pound stayed high, Government might decide on closure in 12 months' time. CPRS thinks that once the Japanese are safely committed to the UK, the component industry will feel less

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dependent on BL. The Policy Unit feels that the political anxiety about closure will probably increase as the Election gets nearer; if we are unwilling to close now, we are unlikely to close before the next Election.

4.3 Of course a further massive deterioration would in theory oblige the BL Board to close the business. But the Policy Unit is sceptical. We note that the deterioration in BL's prospects which took place last year - leading to the eight-fold increase in the request for Government finance (a twelve-fold increase on the high pound assumption) - did not cause the BL Board to abandon hope. Already the pound is higher than the top end of BL's contingency allowance; the BMW prospect, on which much hope was pinned, has gone; and next year's financial target looks unachievable to us. Nevertheless, we all agreed that it was important for Edwardes to write an improved version of last year's public letter about the Board's intention to withdraw the Plan if things go badly.

4.4 Neither we nor Departments felt there was the case for further outside guesses about the cost of closure. The currently available estimates are summarised at Annex A. The most expensive outcome would be to support the Plan and then find that - either on the Board's or the Government's initiative - it had to be closed in a year's time.

5. FRESH CONDITIONS

5.1 We discussed the idea that a fresh condition like a nominal wage cut should be required. We found this had nothing to commend it if it was applied to BL alone, even if the management could be persuaded to impose the condition themselves. BL have been able to bring off some of the lowest increases in basic wage rates in the public sector during the last two rounds - in both cases involving substantial real cuts. Attempts at further cuts are likely to be counter-productive; they would make a very small contribution to solving BL's real problems. If the workers agreed to them, it would make it more difficult to close BL later. If they refused, it would appear that we have provoked the closure.

5.2 Productivity is much more important than reducing wages. But improving productivity is already a central feature of the BL Plan. We see no way in which a condition could reinforce the Board's existing commitment to it.

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It is for consideration whether some broader approach to limiting or even eliminating basic wage increases in loss-making nationalised industries or Government-supported funds would be possible. We suggest the CPRS are asked to think about this further, but see no case for singling out BL.

6. FUTURE OWNERSHIP

6.1 If Ministers decide to support the Plan, the best chance of success lies in getting as much foreign involvement as possible in BL's activities. Ideally, BL would enter a comprehensive relationship with another company leading eventually to a take-over. The advantages of this happening quickly are so great that we should be prepared to support Edwardes in almost any way if he sees a chance of achieving it (eg threatening import controls, offering firm commitments to the support of collaborative projects, etc). More realistically, we should strongly encourage Edwardes to seek collaborative arrangements with other companies that have the potential to develop into a more comprehensive relationship. We understand that he himself now recognises the importance of this. This is welcome news, but should be incorporated in agreed, revised terms of reference. Edwardes is apparently willing to send us a letter (privately) stressing the priority he now attaches to finding a partner. A draft of the kind of letter we have in mind is at Annex B.

6.2 We have discussed whether it would be better to oblige Edwardes to dispose of Landrover or Jaguar at an early stage. On Landrover, there is a unanimous view - endorsed by Hill Samuel - that it would be premature to attempt disposal now. A much better price could probably be obtained in a year or two. On Jaguar, the case for early disposal is that Jaguar's performance could start improving once free from BL. This view is strongly contested by DoI and BL itself, because it could weaken the prospects for collaboration and damage BL management morale. On balance, we agreed that the Jaguar issue is marginal to the main issue of the future of BL's volume cars. It is therefore probably not worth a confrontation with the BL Board over the early disposal of Jaguar when its benefits are questionable, no buyer is in prospect, and there are much more important issues

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at stake. Nevertheless, Edwardes could be told that we would need proof of the benefits of keeping Jaguar in 12 months' time.

7. COMMITMENT OF FURTHER FUNDS

7.1 If Ministers do decide to fund BL, we agreed with officials that a drip feed approach would weaken BL's attractiveness for collaborative projects. What is needed is a proviso which allows us to withdraw in extremis - preferably through the management taking the initiative - but gives fairly strong commitment for one year. The commitment to year two should be subject to review after 12 months.

8. NEXT STEPS

8.1 We think the next step is for Ministers to decide whether they are willing in principle to support BL further or whether they would prefer to face the consequences of withdrawal of support now. In the Policy Unit's view, an equally clear opportunity for ending support is unlikely to recur until after the next Election, though others disagree about this. A defensible public case could be made for this now based on: statements last year that they were being given one more chance; the massive increase in their public funding requirements; the limited progress in industrial relations; and the Board's own admission that there is not a commercial case for further support. We therefore think it should be given very serious consideration now, before massive further injections of money are made.

8.2 If Ministers are willing to face these consequences, they could decide to proceed with a refusal now. Alternatively, they could decide to negotiate with Edwardes from a position of considerable strength, asking him to have one more chance at finding a partner for the business over the next 6 months (or 12 months). Since this outcome would save a great deal of money and give at least part of BL a chance in the future, we think it is worth trying. But if Edwardes is unwilling to pursue it wholeheartedly, then we think Government should refuse further support and take the consequences.

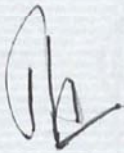
8.3 If, on the other hand, Ministers are unwilling to face closure now, our negotiating position with Edwardes is obviously far

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weaker. We still think it worth getting the best commitment we can from him to finding a partner - because this course offers the best prospect of limiting BL's further call on Government resources and maximising the chance that some of it might succeed.

8.4 The next step is for Ministers to decide whether they are willing to face the possibility of withdrawing support or not. Then we recommend that you should see Edwardes on his own and explore his willingness to accept new terms of reference. His objectives need to be brought closer into line with ours - which are to minimise the future call on public funds.

8.5 I am copying this note to Geoffrey Howe, Keith Joseph, Robin Ibbs, Sir Robert Armstrong, and those officials who attended our meeting.



JOHN HOSKYNS

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PSBR COSTS OF ALTERNATIVES FOR BL

	<u>£M CURRENT PRICES</u>					TOTAL 1981-6
	1981/2	1982/3	1983/4	1984/5	1985/6	
1. <u>SUPPORT PLAN</u>						
(a) <u>As proposed by BL</u>	620	370	100	50	---	1,140
(b) <u>Possible Variances</u>						
i. Optimistic ¹	570	175	---	---	---	745
ii. Pessimistic ²	710	445	215	180	90	1,640

The Policy Unit and CPRS believe the cost of continued support could be very substantially higher over this period and continue into the late 1980s.

2. LIQUIDATION OF BL CARS

(a) <u>Central estimates, as in Treasury sub-group report</u> ³	1,190	885	730	---	---	2,805
(b) <u>Possible variances</u>						
i. Optimistic ⁴	900	535	440	160	160	2,195
ii. Pessimistic ⁵	1,600	1,045	440	---	---	3,085

This table pulls together the estimated PSBR costs of alternative courses on a comparable basis. Line 1(a) is what BL seeks approval for. Line 2(a) is the Treasury sub-group estimate of the cost of closing BL Cars (including Jaguar) in early 1981, together with keeping Leyland Group going until a buyer is found and selling Land Rover. The other figures are illustrations of possible ranges around these central estimates, and as regards liquidation, summarise work done on the detailed effects of alternative assumptions. The variances on the cost of supporting the Plan are the arithmetical effects of alternative exchange rate assumptions, as proxy for changes of various kinds: but if things went significantly worse than BL's figures, they could in fact be expected to withdraw the Plan. The Policy Unit is sceptical, believing the Board might ask for more if they needed it.

NOTES

- Assuming effective exchange rate in 1981 7% lower than Plan as proxy for "favourable" effects.
- Assuming effective exchange rate in 1981 5% higher than Plan as proxy for "unfavourable" effects.
- Assuming buyer for Leyland Vehicles can be found during 1982.
- Assuming LVL, LR, Jaguar and parts of volume cars disposed of, and debt repayment spread over 5 years (ie to maturity of debt). No allowance made for keeping LVL going until sale.
- Assuming LR disposed of for £75m, part of LVL fails to find a buyer and has to be closed, and BL debt has to be repaid in 2 years (assuming Bank of England could use influence to prevent immediate settlement of all debts).

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DRAFT SECTION OF A LETTER FROM BL TO THE GOVERNMENT ON
COLLABORATION AND DISPOSAL

We appreciate the time you and your colleagues gave to us on 18 December, and we welcomed the frank and constructive nature of your questions. I trust that the discussion will have helped you to indentify the realistic options and to be reassured about the Board's objectivity in viewing these options.

The Board's strategy in the 1981 Corporate Plan is designed to restore the main businesses within BL to a sufficient degree of viability to enable their dependence on Government support to be removed progressively. This can be achieved more quickly and with greater certainty in the case of the profitable Land Rover and Unipart businesses than for BL Cars and the Leyland Group.

In the case of BL Cars, the Board sees collaboration with other manufacturers as a central and integral part of their strategy for recovery and for removing or reducing dependence on Government support. This might take the form of complementary collaborations on major components or particular parts of the business; but the Board would also welcome, and actively seeks, a relationship of a more comprehensive kind which might well grow out of more limited collaboration of the kind referred to. The Board would by no means exclude outright sale of the whole BL Cars business if a commercially sensible opportunity arose, though they think that most unlikely in the near future. The achievement of a wider relationship could involve the sale of equity stakes in the Land Rover and Unipart groups if appropriate, as part of an arrangement

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covering also the volume cars business of BL Cars. The search for such comprehensive relationships, or major collaboration which holds out a reasonable prospect of going into a comprehensive relationship, will be a principal priority for BL over the next 12 months.

Similar considerations apply in the case of the Leyland Group. As for Land Rover, the Board regards the introduction of private equity into the business in the next two or three years as a distinct possibility; but the first priority is to see whether Land Rover can be used as part of a wider arrangement holding out prospect of eventual reduction of the Government involvement on the volume cars side.

There would obviously be constraints on how much of this could prudently be said publicly in conjunction with any approval of the Plan. But we would certainly be prepared to say that we would seek to inject private capital into appropriate sectors of the business as part of our total strategy, and we would accelerate announcement of some aspects of our reorganisation into four main businesses if this were helpful.

Department of Industry
9 January 1981