



Chancellor of the Duchy of Lancaster

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David Norgrove Esq
 Private Secretary to the Prime Minister
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Dear David,

BL: LRL AND ARG

The Chancellor of the Duchy, as you will know, is unable to attend the meeting of E(A) on 28 January which is to discuss E(A)(86)3 and E(A)(86)4. He has, nevertheless, had an opportunity to see the papers. This letter reflects his views.

The political and industrial environment in which the sale of LRL or ARG has to be considered has been changed in recent weeks. The effect of the heated debate on Westland has been to focus attention on the extent of US ownership of sectors of British industry. While the effect in absolute terms is slight, and the dichotomy between a US or European focus for industrial cooperation is a false one, undeniably there has developed a growing strand of political opinion which professes itself deeply disturbed at the extent of US influence over UK industrial sectors and the transfer of production and technology out of the UK which flows from it. In cooperation with European countries, so the argument runs, a counterbalance is found to US or Japanese industry. The temperature of this debate has been heightened, within the vehicle industry itself, by GM's recent acquisition of Lotus Cars.

The Chancellor believes that it is necessary, first, to consider these propositions on their industrial merits.

The need for rationalisation in the commercial vehicles sector has been clear for some time. In the absence either of a link-up with GM or another major truck manufacturer (and none other seems likely to step forward), or a continuing financial guarantee from Government, Leyland Trucks and Bus would be loss-makers, a continuing potential charge on the Exchequer, and would not contribute to the necessary rationalisation of the industry. The arguments set out in paragraph 16 of the Secretary of State for Trade and Industry's paper point to the improbability of success

attendant on options (c) or (d) as described in paragraph 5. Equally improbable, it seems, would be a negotiated sale to another party. But the transfer of the business to the private sector is the course most likely to introduce greater competitive edge to the business and Bedford has a sound image as a UK-based producer. On its merits, therefore, the Chancellor believes that it would be right to proceed with a negotiated sale to GM. He would wish to emphasise the importance, however, of a public Declaration of Intent from GM, including a commitment as to the use of the Land Rover marques on UK-built vehicles. Indeed, there may be an enforceable agreement that only UK-built vehicles would be badged as Land Rover or Range Rover.

As regards the proposition set out in E(A)(86)4, the Chancellor accepts that the unit fixed costs of car production have grown to the point where in some cases, they match the variable costs. The pressures, therefore, to spread those fixed costs over a larger volume of production are almost inescapable. Even the most efficient and flexible production techniques, such as those used by Mazda, can hardly compensate for the need to spread the growing costs of model design. A shortage of engineering resources has hampered ARG's progress and, while ARG's cooperation with Honda goes part of the way to spreading these design costs, it will fall short of the merger proposed by Ford, and will not enable ARG to retain less than a full design and build capability.

But the arguments against a Ford acquisition are powerful. It would significantly reduce the competition in the UK market in the short-term. It would risk a further increase in import penetration into the UK market, during a period of rationalisation between ARG and Ford operations and during any dislocation to plans for ARG's model range if Honda feel obliged to withdraw from their agreements.

The continuation of ARG on its present basis is, however, not an easy option. The prospects for privatisation are distant and likely to be delayed further in the current state of over-capacity in the European passenger vehicle sector. It is in the private sector that the management of ARG are most likely to implement the strategies necessary for survival. The protracted discussion leading up to the 1986 BL Corporate Plan showed the constraints which public ownership have placed on the company. On its industrial merits, therefore, the Chancellor would wish to proceed further with the Ford discussions.

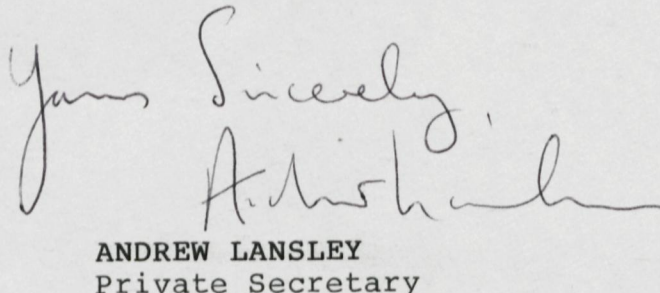
But these proposals need to be put in a wider political context. The Chancellor believes that the combination of these proposals in the current climate of opinion will make them very controversial indeed. The support of the BL Board for the GM proposal and, conversely, the deep mistrust of the ARG management for Ford's intentions, are likely to be crucial. The impact of a covert campaign by the ARG management against a Ford sale could be highly damaging politically in the West Midlands, particularly when placed alongside the redundancies expected at Leyland and Freight Rover in Birmingham in 1988.

The Chancellor of the Duchy could not recommend that it would be right to proceed with the Ford proposal as at present constituted.

However, the Chancellor would consider it worthwhile to explore further variants on the Ford proposal, which would seek to merge ARG and Ford (Europe)'s capacity into a European holding company, separate from, and not subsidiary to, the US Ford company, but in which equity holdings would be held by Ford of the US, by a range of European institutional shareholders, and by HMG itself. While this company could continue to collaborate with Ford worldwide on design and sales, it could be represented as an important step towards the creation of a European car industry operating on the scale necessary to counter the weight of the US and Japanese majors.

The Chancellor would wish E(A) to invite the Minister of State for Industry to re-open discussions with Ford on this basis.

I am copying this letter to the private secretaries to members of E(A), to Joan MacNaughton (Lord President's Office), Len Appleyard (FCO), Murdo Maclean (Chief Whip's Office), Michael MacHardy (Office of the Minister of State for Industry), and to Michael Stark (Cabinet Office).

Yours Sincerely,

ANDREW LANSLEY
Private Secretary