

dti

the department for Enterprise

Ext. Copy 1 of 4.

cc PG
GG

SECRET - MARKET SENSITIVE

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref PS4ASZ
Your ref
Date 16 June 1988

Dear Paul,
at 11.00

... As agreed, I attach a draft letter for the Prime Minister to send to M Delors which has been approved by my Secretary of State and cleared by our lawyers.

The letter has been prepared with a view to possible public use in the event of a major public breakdown in discussions with the Commission. Unless and until that happens, its content and existence is of course market sensitive.

The letter concentrates on the merits of the Rover aid case. Bearing in mind the possibility of publication, our advice is that the strongest political argument - the effect on UK attitudes to the Community - is better delivered orally, either by the Prime Minister or by Sir David Hannay in Brussels.

... The supporting Annex is not included in view of the detailed note on the background already provided to Delors on 10 June (copy enclosed). Any additional note would need to go into a level of detail which in this case my Secretary of State does not feel appropriate.

I am copying this letter and enclosure to Geoffrey Howe and Nigel Lawson, and to Sir Robin Butler.

Yours ever,
Neil Thornton

NEIL THORNTON
Private Secretary

the
Enterprise
initiative

S E C R E T
M A R K E T S E N S I T I V E

DRAFT LETTER : PRIME MINISTER TO PRESIDENT DELORS

I was very concerned to learn from David Young that, at a further meeting on 15 June with Commissioner Sutherland, no progress was made towards resolving the outstanding issues related to the British Aerospace acquisition of Rover Group.

As the Secretary of State has stressed, this venture would represent the final and most important stage in the return of Rover Group businesses to the private sector. The British Government would no longer stand behind the obligations of the company which would be exposed fully to the disciplines of the market-place - a development which, in the context of the European motor industry, I assume you would welcome.

Rover Group has made encouraging progress in the past year or so but there remain substantial commercial risks attached to the long-term development of the businesses. Its viability depends critically on a restructuring of the balance sheet to remove the huge burden of debt which has accumulated during many years of losses. This is a fundamental condition of the agreement with British Aerospace and, without it, the deal will not go ahead.

David Young has explained to Commissioner Sutherland in exhaustive detail the background to the acquisition and the basis of the financial package he has negotiated. I firmly believe this represents a reasonable balance between the opportunities and risks confronting British Aerospace. I am therefore anxious that in the appraisal there should be full recognition of the significance of the deal and the commercial realities which underpin it.

I am equally concerned at the potential damage to the businesses if there is continued uncertainty about their future.

I urge you to make every personal effort to ensure that progress is rapidly made towards a mutually satisfactory solution.

THE ROVER GROUP STATE AID CASE

Note for the President of the European Commission

Policy Objectives of the UK Government

1. The UK Government believe that the sale of its 99.8% shareholding in the Rover Group plc (RG) to British Aerospace plc (BAe) will achieve shared UK and Community objectives by:

- i) enabling the UK Government to complete its withdrawal from intervention in the vehicle manufacturing industry;
- ii) enabling RG to contribute to restructuring in the European vehicle industry by responding freely to the disciplines of the open market;
- iii) preserving competition between European and other vehicle manufacturers.

The Terms of the Deal

2. Following a time limited exclusive negotiation with BAe, on 29 March 1988 the UK Government announced agreement to sell its shareholding in Rover Group to BAe for £150m. The agreement is subject to EC Commission approval of the state aid element involved in meeting RG's £800m indebtedness, and to BAe shareholder approval.

3. RG's tax losses have been constrained by extinguishing two thirds of its trading tax losses, and by preventing any RG tax losses being offset against profit or capital gains in other BAe businesses. The residual value of these tax losses has thus been reduced.

4. The Government have declined to give any warranties to BAe relating to RG's performance or products. BAe will assume responsibility for all RG's existing, future and contingent liabilities. The result is a clean break for the UK Government from all future financial risks and liabilities of RG.

5. BAe have given an undertaking to retain the RG businesses for at least five years. Should BAe sell either the RG cars business or Land Rover within five years, the UK Government is empowered to recoup any economic benefits. BAe will thus bear very major risks in running these businesses for five years.

6. The UK Government have not sought to constrain in any way BAe's freedom to manage the RG businesses. This includes the freedom to make such changes to capacity as market conditions suggest necessary.

Exchanges with the Commission

7. The development of exchanges with the Commission is set out at Annex A. The UK Government have endeavoured to keep the Commission as fully and promptly informed as possible about the progress of commercial negotiations and the details of the terms agreed with BAe.

8. On the substance of the case Commissioner Sutherland has expressed concern that the exclusive negotiation with BAe failed to establish a market price; and that the price is too low. However, the UK Government agreed with the independent commercial judgement of the RG Directors that the RG businesses were too fragile to survive an auction. The disclosure of preliminary talks with Ford in Spring 1984 led to RG's share of the UK car market falling two percentage points and to RG losing £250m in sales revenue; RG has never recovered.

9. The price negotiated with BAe reflects the very poor past record of RG which last made a profit (before extraordinary items) in 1976; the current minimal trading profit; the constraints on the use of RG's tax losses; and forecast negative cash flow and poor profits for several years to come.

10. On debt Commissioner Sutherland has expressed concern that £300 million of the estimated £800 million indebtedness at completion is composed of what the Commission regard as ineligible items. The UK Government have explained that £725 million of the indebtedness is derived from the independently audited RG 1987 statutory accounts. The remainder is accounted for by the adverse effect of the strike at Land Rover this Spring and the interest charges on the historic debt between 1 January 1988 and estimated completion in Summer 1988.

11. Commissioner Sutherland has also expressed concern that Rover Group is being sold debt free. BAe will not purchase RG except on a debt free basis given its track record, poor financial prospects for the rest of the decade and the risks associated with the RG businesses.

Timing Constraints

12. RG remains a highly fragile business. There is a grave danger that any prolonged uncertainty about its future ownership will severely damage it. The commercial vulnerability of the Group is compounded by the acute level of political interest in RG. Doubts about the outcome of negotiations with the Commission are already attracting attention in the UK Parliament. If it does not prove possible to announce Commission clearance before the UK Parliament rises in the second half of July political speculation and commercial uncertainties will threaten the future of RG. If this is to be avoided Commission approval is needed by early July at the latest.

CONFIDENTIAL: MARKET SENSITIVE

ROVER GROUP STATE AID CASE

Timetable of key events

- | | |
|-------------------------------|---|
| 1 March | HM Government announced its intention to enter exclusive negotiations with British Aerospace for the sale of Rover Group. Lord Young had telephoned Commissioner Sutherland in advance of the public statement. |
| 14 March | HM Government formally notified Commission under Article 93(3) of its intention to provide capital to Rover Group. |
| 23 and 28 March | Lord Young reported developments in commercial negotiations to Commissioner Sutherland. |
| 29 March | Terms of agreement between UK Government and British Aerospace announced, subject to approval of European Commission and British Aerospace shareholders.

European Commission opened formal procedure. |
| late April | Commission letter circulated to other member states seeking comments. |
| April/May | Provision of detailed information to DGIV. |
| 26 May
7 June
[15 June] | Lord Young discussed DGIV appraisal of Rover case with Commissioner Sutherland. |