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the department for Enterprise

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Our ref  
Your ref 17 June, 1988  
Date

Dear Paul,

As agreed on the telephone this morning, I enclose briefing on Rover for the Prime Minister's meeting with M. Delors at the Toronto Economic Summit.

There are three points worth mentioning:

- (i) the briefing assumes flexibility on the part of the BAe to the extent of £100m on the £800m proposed injection. At present, BAe set a limit of £50m although my Secretary of State believes that, if pressed, they would be prepared to live with the higher figure. He is not, however, confident that BAe could be pushed to move significantly beyond this;
- (ii) we are looking for a settlement with the Commission in terms of the overall number by which the financial injection should be reduced. It would be for the Commission in conjunction with ourselves and other interested parties to determine how best this sum should be allocated and presented to the various audiences; and
- (iii) M. Delors has expressed interest in our view of how Commission treatment of Renault compares with the current treatment of RG. We have already provided some material (see Annexes) to suggest that the differences are apparently marginal though we do not know the confidential detail of frank exchanges with the Commission.

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I am copying this letter and enclosures to Alex Allen (Treasury)  
and Lyn Parker (FCO).

*Yes*

*Stephen Ratcliffe*

Stephen Ratcliffe  
Private Secretary

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PRIME MINISTER'S MEETING WITH DELORS: 19 JUNE

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Briefing note already provided to M. Delors

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## PRIME MINISTER'S MEETING WITH PRESIDENT DELORS, 19 JUNE

OBJECTIVE

To secure support for a settlement of the Rover Group (RG) state aid case at not more than a £75-£100m worsening of the net terms negotiated with BAe.

LINE TO TAKE

- 1 Support Commission's forceful application of the state aid rules. We co-operate fully and promptly as demonstrated in the present RG case.
- 2 Issue is the return of RG to the private sector and the disciplines of the market. No more state intervention. Fully in line with the Commission's objectives.
- 3 Extreme commercial and political sensitivity surrounds Rover Group. Sale to BAe viewed as popular by workforce, dealers, suppliers and general public. Failure would be placed firmly at the Commission's door. Major political and public backlash would damage general UK perception of the Community and frustrate progress on many fronts.

Price

4 The price BAe have offered reflects RG's real situation. Commission must be realistic. RG has not made a bottom line profit since 1976. Its current trading profitability is marginal in an unusually strong domestic market. Its US business faces serious problems. Its overall strategy depends on its achieving a position as a 'niche', high quality producer.

Major risks.

5 And businesses too fragile to stand a public auction to establish a 'market' financial package. Controversial history (Ford) proves that.

Debt

6 Fundamental BAe condition is that the company should be acquired debt-free. Understandable condition given that RG will not be able to fund investment in new models etc from own resources. Reality is that, over next five years, BAe will need to contribute several hundred million pounds to support essential investment.

7 Aware that there is dispute between the Commission and HMG on the definition of debt. But £724m of the £800m is either audited debt (£585m) or sums (£139m pay-out on previous Leyland-Daf privatisation) which auditors confirm remains appropriate.

8 Ready to juggle on the margins but Commission must also show recognition of the real costs involved for BAe.

#### Future Restructuring

9 Commissioner Sutherland has been briefed in the strictest confidence of the real, substantial degree of closure/restructuring inherent in the BAe-endorsed plan. 28% on car assembly capacity. More on components. Believe he is broadly satisfied. There will be alongside better utilisation of other existing capacity but changes confirm that RG has no ambitions to become a 'volume' producer. Total production over next decade will be more or less flat.

#### Timing

10 Serious risk that if formal Commission approval is not forthcoming by mid-July, public and Parliamentary speculation will further damage the business irrevocably. Should not be allowed to drag through the summer.

17 June 1988

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## DEFENSIVE BRIEFING

(i) PRICE

LINE TO TAKE

1 £150m is reasonable for the following reasons:

RG track record appalling - last made a bottom line profit in 1976;

improvements achieved in last two years only in exceptionally favourable climate;

budgeted trading profit in 1988 (ie before interest and tax) is very small - £30m odd on turnover of over £3bn.

negative cash flow until early 90s, if everything is on track;

major investment of well over £1bn required in next 5 years, to which BAe itself will need to contribute several hundred million;

risks for any purchaser are enormous.

Value of minority holdings

2 DAF (RG hold 40%) link relevant to BAe military interests.

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3 Unipart, Istel etc vital functional links to Austin Rover.

4 Total book value of minority holdings c£100m. But not immediately realisable. And any analysis must set risks and liabilities against assets.

5 Total break up cost £2bn.

Value of fixed assets

6 Readily disposable assets sold already by Day.  
Only major disposable site remaining is Bathgate in Scotland. Planning permission uncertain. Might perhaps realise £15m.

7 But must put this in perspective. Set risks and liabilities against assets.

8 Redundancy costs at least £½bn.

9 Total break up cost £2bn.



## NAMED DISTRIBUTION ONLY

Value of tax losses

Mechanical addition of trading tax losses, capital losses and capital allowances leads to total amount of £265m-£345m.

But with the tax losses ring fenced within the Rover Group businesses uncertainty of utilization means tangible value is substantially less.

Have indicated to Sutherland we are willing to look again at the extent to which carried forward tax losses are constrained.

## DEFENSIVE BRIEFING

## (ii) DEBT

Debt at 30 June estimated at £801m composed of:

A £585m audited debt at 31 December 1987. (This includes  
B £25m long term accruals.)

C £139m provision for restructuring of commercial vehicle  
businesses.

D £25m cost of Land Rover strike.

E £51m increase in debt due to normal operations in first  
half of 1988.

—————  
£801m

AREAS OF COMMISSION ATTACK

Within A £155.8m provided by Wholesale Vehicle Finance.

LINE TO TAKE Audited by Coopers & Lybrand as part of total debt  
at end 1987.

Fragility of banking confidence in RG led to growth  
in importance of this financing option.

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No different from other finance raised on pledges on current assets.

Finance would come from a clearing bank if it did not come from Wholesale Vehicle Finance.

Not working capital.

**BACKGROUND**

Constitutes finance provided by WVF against finished goods on consignment.

Commission argue that this element in fact represents a revolving working capital arrangement.

Previously netted off against stocks in 1986 accounts.

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B      £25.1m long term accruals

LINE TO TAKE    Represent long term liabilities of RG - due after more than 12 months - in relation to warranties etc.

Reflect the true level of debt in RG.

BACKGROUND    Represent mainly liabilities in relation to second and third year of warranties given on cars sold in US.

Arguably working capital.

Weakest area of our argument on debt.

C      £139m provision for restructuring of commercial vehicle businesses.

LINE TO TAKE    Part of the £680m settlement reached with the Commission on the Rover truck and bus businesses.

Coopers & Lybrand confirmed in May 1988 that they still consider the provision appropriate.

Most costs will need to be met within next year but some relating to contractual agreements on redundancies between Rover and DAF run on until 1991.

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Interest benefit to Rover Group in the interim taken into account in £680m settlement.

No reason now to envisage either overspend or underspend likely.

BACKGROUND

Commission have strong suspicions that there could be a major underspend - perhaps of the order of £50m. But on information provided they certainly cannot substantiate a specific figure.

Best defence is auditors reaffirmation in May '88 that the accounting provision is still appropriate.

Tight management by RG of the plants to be closed and a slower rate of expenditure than originally envisaged may indeed result in an underspend.

During BAe's due diligence investigation, Rover Group told them they thought an underspend of £21m likely. But it could be higher. We have pointed out to BAe the prospect of an underspend ie a cash reserve to set against any reduction imposed by Brussels. But to date we have defended with the Commission the proposition that an underspend is no more likely than an overspend.

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D £25m cost of Land Rover strike.

LINE TO TAKE In addition to immediate loss of contribution to fixed costs of £25m, the loss of goodwill, dealer confidence, and damage to company image is likely to add a further £10m.

Self evident that immediate loss of revenue and damage to company image will have to be funded.

BACKGROUND In latest exchanges two new Commission arguments emerged. First, the effect of the strike was positive in that the management "won". We dismissed this as totally speculative while the effect on revenue and company image was real.

Second, Commission asked how the strike would be treated in the 1988 accounts. It will not be treated as an extraordinary item. The Commission are likely to argue in consequence that the strike costs are already taken into account in reducing 1988 trading profit. Therefore it cannot also be counted as a funding cost in the debt calculation.

The £25m charge was necessarily an imprecise estimate; we now have some reason to believe that most of the strike costs will be offset by better than anticipated trading conditions.

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E £51m debt increase in first half of 1988.

LINE TO TAKE Estimate was composed of accumulating interest charges (£42m) and crystallisation of legal claims and other non- trading liabilities (£10m).

In addition recent requirement to buy out American partner in US distribution subsidiary has added £24m to costs previously estimated to Commission.

RG trading profits in 1988, will not offset these costs.

BACKGROUND Commission suspect that this is an artificial "make up" item to reach £800m.

Recent deployment of £24m Arcona costs have buttressed our arguments. However, the interest charge in the first half of 1988 could in fact prove significantly less than £42m.

Arguments vulnerable if the Commission were to make agreement conditional on audited half year figures.

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LEAVING DEBT ON THE BALANCE SHEET

LINE TO TAKE Totally unacceptable to BAe.

Thin profits and negative cash flow cannot support  
an interest burden.



## DEFENSIVE BRIEFING

## (iii) RESTRUCTURING INFORMATION

LINE TO TAKE Lord Young has given Commissioner Sutherland confidential draft letters on the planned pattern of restructuring of capacity, and on the handling of this delicate subject.

DEFENSIVEDegree of restructuring

Very extensive. Reflects careful scrutiny of RG plans by BAe. See no scope for increasing it.

Pattern of restructuring/underutilization of Cowley North

Precise pattern of restructuring must be for commercial management to determine.

Binding commitment by BAe to restructure capacity?

HMG has discussed plans extensively with BAe.  
Received written assurances from chairman of BAe.  
Investment programmes aligned to model  
rationalisation already in train.

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Within the context of overall privatisation objective cannot go further.

Background

Copies of the draft letters on restructuring handed to Commissioner Sutherland by Lord Young on 26 May are attached.

## DEFENSIVE BRIEFING

## (iv) TIMETABLE

LINE TO TAKE Vital to reach understanding very shortly. Recent press speculation on difficulties has underlined this need.

Ministerial colleagues becoming anxious.

Relying on formal Commission decision early July at latest.

Politically untenable to leave position unresolved over the summer recess.

If the BAe deal were to break down, Ministers would need time to address other options and develop a public position in July, before the House rises.

## DEFENSIVE BRIEFING

## (v) ROVER GROUP AND RENAULT STATE AID CASES

BACKGROUND M Delors has expressed concern that the Commission should deal evenhandedly with major state aid cases, and that the RG case compares unfavourably with Renault. The following two tables have been provided to his Cabinet at their request.

## COMPARISONS BETWEEN BL/ROVER AND RENAULT

Group	1977		1987	
	<u>BL</u>	<u>Renault</u>	<u>Rover</u>	<u>Renault (2)</u>
Sales Revenue (£bn)	2.6	5.1	3.1	13.8
Manpower ('000)	194	244	45	196
Profit after tax (£m)	(5)	1	(27)	345
<u>Cars manufacturing (3)</u>				
Sales revenue (£bn)	1.7	3.0	3.1	7.8(2)
Manpower ('000)	120	106	45	[108]
Unit sales ('000)	708	1737	512	1530
Market share: (%)				
Domestic	24.3	33.6	15.0	30.5
European	2.0	15.7(4)	4.4	10.6
Profit before tax (£m)	(32)	23	(27)	18.6

Notes:

1. Exchange rates used: 1977 £1 = FF 9.65  
1987 £1 = FF 10.7
2. 1986 figures
3. Includes Austin Rover and Land Rover
4. 1982 figures

Sources:

BL documents relating to possible collaboration project with Renault in late 1970s; RG's 1987 facts and figures booklet; EC Commission documents on Renault state aid case; and SMMT statistics.

## GOVERNMENT ASSISTANCE FOR BL/ROVER AND RENAULT

	FFm	£m	ECUm
<u>BL/ROVER</u>			
Aid 1975-1981		1,770	2,700
Aid 1982-1987		1,140	1,700
		<u>2,910</u>	<u>4,400</u>
Aid 1988		800	1,200
		<u>3,710</u>	<u>5,600</u>
 <u>Renault</u>			
Aid 1945-1981	3,100	300	450
Aid 1982-1987	12,250	1,150	1,750
	15,350	1,450	2,200
Aid 1988 (2)	20,000	1,900	2,900
	<u>35,350</u>	<u>3,350</u>	<u>5,100</u>

Notes

- Exchange rates used: FF 10.7 = £1 = ECU 0.655
- Includes: Debt write-off FF 12,000  
Capital injection 8,000  
20,000  
but not: FIM loans 1,250

Sources

DTI record of Government assistance for BL/RG, and French Senate proceedings record of question and answer of 7 April 1988 on Renault.

VM2/DTI  
June 1988

SECRET AND PERSONAL

DRAFT COVERING LETTER FROM SECRETARY OF STATE FOR TRADE AND  
INDUSTRY TO COMMISSIONER SUTHERLAND

ROVER GROUP FUTURE RESTRUCTURING

I am very grateful to you and your officials for the speed with which you have taken forward the formal procedures and detailed examination of the Rover Group state aid case.

I understand the importance you attach to the Commission's questions about future restructuring plans in respect of the Rover Group businesses. I believe the attached draft letter provides a detailed and comprehensive answer to these questions. However I must emphasise the extreme sensitivity of this information, and I would be grateful if you would treat this as provided on a strictly personal basis.

I should welcome a confidential discussion with you on how you would envisage conveying to your fellow Commissioners in due course your views on the assurances given by Her Majesty's Government in relation to future restructuring.

I fear I must also repeat the point I raised when we met on 23 March that we would wish to be very closely consulted about any reference to restructuring in the Commission's letter eventually closing the procedure.

While I fully recognise that both the letter closing a procedure and the formal notice in the Official Journal are expressions of the Commission's views, given the sensitivities it would be difficult for us to contemplate wording on restructuring beyond an indication that the Commission have received satisfactory assurances from HMG that BAe plans to ensure that Rover Group will in future operate fully in accordance with market disciplines.

I hope you will understand that in this delicate area I would find it helpful to address together discussion of the substance and handling of the attached letter.

SECRET AND PERSONAL

DRAFT LETTER FROM THE SECRETARY OF STATE FOR TRADE AND INDUSTRY TO  
COMMISSIONER SUTHERLAND

ROVER GROUP FUTURE RESTRUCTURING PLANS

The purpose of this letter is to meet the Commission's request for detailed information on future restructuring plans for the Rover Group businesses under the ownership of British Aerospace. This letter responds to the questions contained in the Commission's letter of 29 March opening an Article 93 procedure in response to HMG's notification of 14 March of our intention to provide a further capital injection to Rover Group.

Reflecting the extreme political and commercial sensitivities which surround future restructuring of the Rover Group businesses, I would ask you to treat this letter as delivered in the strictest personal confidence.

In seeking to sell its shareholding in Rover Group to British Aerospace, the objective of HMG is to return the Group to the disciplines of the market. HMG strongly believes that this provides the best possible assurance that the Rover Group businesses will operate in relation to competitive pressures and will not distort trade within the Community. In this context I would wish to emphasise that, under the terms of the proposed deal, whilst within British Aerospace's ownership no restrictions whatsoever have been placed by the Government on the normal commercial management of the Rover Group businesses.

In the negotiations which took place in March 1988, British Aerospace considered the Rover Group businesses against the background of Rover Group management's own plans for restructuring capacity. Having now had an opportunity to examine Rover Group's own management plans more fully, British Aerospace have confirmed to me that they will take forward the management of the Rover Group businesses on the basis of these plans.

These plans include major reductions in capacity as set out in detail in the Annex to this letter. In essence:-

Austin Rover's assembly capacity will be cut by 28% including the closure of the whole of the Cowley South plant in 1991;

Austin Rover's engine capacity will be reduced by 64% by end 1992 following the closure of the Drews Lane plant in 1991; and

Austin Rover's pressing capacity will be reduced with the closure of the Llanelli Pressings plant in 1990.

These physical reductions in capacity are part of the wider existing Rover Group strategy, endorsed by British Aerospace, to move Austin Rover from a comparatively small multi-product manufacturer to a producer of a limited range of up-market, highly specified vehicles. This strategy is fundamental to the focus which Rover Group have adopted over the last two years of





improving financial performance rather than expanding market share, contributing to the objective of establishing securely the long term viability of the Group.

## SECRET AND PERSONAL

## ROVER GROUP FUTURE RESTRUCTURING

PLANT AND LOCATION	PRODUCTION BY MODEL OR COMPONENT	CAPACITY 1987 (000')	CAPACITY 1991 (000')	PRODUCTION BY MODEL OR COMPONENT
LONGBRIDGE PLANT 1 (B'HAM)	MINI METRO	300	338	R6 (successor to Metro) R8 (successor to Rover 200 and Maestro) and Concerto (its Honda counterpart)
LONGBRIDGE PLANT 2 (B'HAM)	ROVER 200 BALLADE	91	85	R9 (Saloon version derivative of R8)
COWLEY NORTH (OXFORD)	ROVER 800	127	127	Rover 800
COWLEY SOUTH (OXFORD)	MAESTRO MONTEGO	242	CLOSED	
		<u>760</u>	<u>550</u>	
DREWS LANE (B'HAM)	ENGINES	n/a	CLOSED	
LLANELLI PRESSINGS (SOUTH WALES)	PRESSINGS	n/a	CLOSED	

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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.

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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	Lord Young discussed DGIV appraisal of Rover case with Commissioner Sutherland.
7 June	
15 June	