

SECRET

PRIME MINISTER

22 May 1985

BL: AUSTIN ROVER GROUP (ARG) REVIEW

Three canards in Norman Tebbit's note could be killed at the start of the meeting. E(A)(85) 28

- A.
1. That ARG are asking for no more cash (paras 2 and 4) - true, but they are asking for guarantees on £500m of extra overdraft and creditors!
  2. That Barings have offered independent and expert advice which should be relied on (para 1, 5 and 15) - none of the Barings team had any industrial experience or engineering expertise. Their motor industry knowledge was provided by Dan Jones, a Sussex University economist. He is not independent: see the statement below made in the middle of the 10 day Baring review.
- B

UP TO 11,000 West Midlands motor industry jobs could be lost if the Government refuses BL's plan to develop a new car engine and gearbox. Mr Dan Jones, senior research fellow at Sussex University's Science Policy Unit, said yesterday.

If the Government insisted BL's Austin Rover lopped £250m from its investment budget and the engine development went to Honda of Japan instead, that would tear the heart out of the business. Austin Rover would cease to be a major car maker. It would be a national disaster," Mr Jones told a West Midlands County Council seminar on industrial decline.

However, if Austin Rover achieved a vehicle output of 550,000 by 1988, West Midlands could expect a net gain of 3,500 jobs even if the proportion of imported components in the car rose from the current level.

Please find out whether Dan Jones has ever done work for D. Highland or any part thereof.

Annex 6  
E(A)(85) 28

You may also want to read out the caveats highlighted in the Barings report (attached), and to emphasise that their endorsement of the ARG plan is more of a negative statement that, from their limited knowledge, they could not refute ARG's claims.

SECRET

- C
3. That, by inference, interdepartmental officials have agreed the report annexed to NT's paper (paras 1 and 5) - only the Official Group report (E(A)(85) 29) has been so agreed.

#### THE NEW 1986 'OUTLINE PLAN'

The outline plan shows profit £64m worse and cash £135m worse than the original 1985 plan. The 1985 plan itself had profits a further £102m worse than the 1984 plan. (Comparisons not on same basis). Dan Jones predicts a still lower market share (19/20%). Barings say, even on ARG's market share figures, that the plan will not necessarily ensure ARG's survival.

→ ARG claim emissions regulation was unexpected and not incorporated in the 1985 plan, and that they have done well to contain additional capital costs to £48m. Barings and DTI agree but they all overlook that the 1985 plan already contained £62m on engineering test cells for just this purpose. ARG also claim that they have had to defer the AR16/17 (Montego replacement) by two years, reducing profit by £160m, because engineering resources have to be diverted to handle the emissions problem. D

BL are back to Edwardes tactics: demanding total endorsement of their strategy or closure of the business. Additionally, they say if the plan is not approved then the Unipart sale could be prejudiced, and the negotiating position for the sale of Land Rover-Leyland would be seriously weakened.

#### COLLABORATION

'H'

The plan is for ARG to ultimately assemble 100,000 cars for Honda. ARG will spend £50m modifying facilities and claim Honda will have to spend £100m. (In fact most of this will be in Japan and on press tools they already need

for their own production). ARG will purchase the cars in kit form (say £3,000 each) and if Honda require the security of, say, a four year agreement then total contracted purchases over the period could be £1.2 billion, all of which could end up being guaranteed by HMG in addition to the £500m increase ARG already want.

Even if collaboration improves ARG's profitability, HMG should still withhold approval unless it is sure that the ARG plan as a whole will produce a viable business.

#### ALTERNATIVE STRATEGIES AND ENGINES

All of the alternative strategies that ARG consider would show better results than the outline plan if realistic assumptions were adopted. However, buying engines is easily the best of these, and will be the deciding issue for the future course of ARG.

MOU.  
1:7.  
← It is true that Honda will not collaborate on engines but they will supply them. It is ARG that are blocking it: the draft Memorandum of Understanding (MOU) that ARG wanted approved before Easter stated "ARG would not in principle accept engines from such a facility [Swindon] for incorporation into ARG badged vehicles". See also Appendix II.

Arguments that 'the engine is the heart of the car', although literally true, can only have commercial logic if buyers are aware the engine is foreign (how many Vauxhall and Ford buyers are aware that their whole car may be foreign?) and that, if they knew, they would choose an ARG engine rather than a Honda one (which would contradict Barings argument that Honda adds to ARG's image!)

This is exactly the mistake Leyland Trucks made in the mid-70s: the economics of engine design and manufacture were

forcing more and more manufacturers to consider buying engines, but Leyland Trucks held fast to the engine as a totem of their virility. Buying engines is now common practice for commercial vehicles and Leyland Trucks delay has cost the taxpayer dearly.

It defies economic logic to claim that it can be cheaper for ARG with its small volumes to manufacture engines than buying them from an efficient mass producer. Naturally the supplier will want guarantees on volume, but these should equate to no more than the incremental capital expenditure required. ARG would probably need double the expenditure to manufacture on their own, and this is money they have to pay out, not just guarantee! Other arguments on engines are rebutted in Appendix I.

#### THE BEST PLAN

If ARG accepts Honda supplied engines then:

1. Work on emissions is dramatically reduced  
Saving: capital £36m minimum, R&D work £30m
2. As a consequence the AR16/17 (Montego replacement) need not be deferred  
Saving: £160m profit reinstated
3. The K series engine and gearbox can be dropped  
Saving: Capital £215m (but offset by Honda purchases)
4. The V6 engine for the XX can be dropped  
Saving: Capital £44m (but offset by Honda purchases)
5. The AR8/9 (Maestro/Rover 200) collaboration need not be compromised to accept different Honda and ARG engines  
Saving: Some capital and also cheaper car

6. AR6 (Metro) can be deferred until end 1991 (see Appendix 1,d). Ideally this would be replaced by collaboration - the Honda Civic (a large Metro) is scheduled to commence sub-contract manufacture in 1992.

Saving: Capital £195m deferred by two years, possible reduction.

The net effect of this revised strategy is improvements of some £200m profit and £550m cash over the period to 1991.

If one accepts the very surprising £220m jump in BL borrowings between 1984 and 1985, then this strategy would give a revised BL borrowing requirement as below.

Borrowing  
V-M  
Flag E

£ million	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Original:	459	679	744	747	729	702
Revised:	459	679	711	629	494	329

RECOMMENDATIONS

1. Collaboration: this can only produce a viable plan if ARG are prepared to buy Honda engines. ARG should:
  - a. drop plans to manufacture their new K series and V6 engines and buy from Honda instead. (If they are worried about being overcharged for engines, ARG should link the pricing of these to what they themselves are to charge for sub-contract assembly);
  - b. revise their other plans accordingly and explore collaboration on the Metro replacement.
  
2. A borrowings cap: this is the right approach but £680m is too generous for 1985 in view of the £220m jump forecast between 1984 and 1985. You could:

- a. start from a £600m limit;
  - b. deduct £100m proceeds of the Unipart sale from this.  
(BL are 'committed' to its sale by the year end and NT accepts that the cap should be adjusted for disposals);
  - c. therefore set a rigid cap of £500m and make clear that there will be no adjustment to the cap even if BL fail to sell Unipart by the agreed date;
  - d. hold the cap at £500m for 1986 and then reduce.
3. Land Rover-Leyland: the secret discussions with GM have been going on since last summer. This has been used as an excuse to shelve all other bids for parts of the business (we are aware of at least five). This has gone on too long: serious negotiations with all interested parties should start now.
  4. Minor recommendations: the rest of the BL Official Group Report should be endorsed.
  5. The BL Board is now little more than a postbox for its two operating arms - BL Cars and Land Rover-Leyland. It should be dismantled and BL divided into two entirely separate companies (as even Michael Edwardes wanted).

*Peter Warry*

PETER WARRY

REBUTTAL OF ARGUMENTS AGAINST ARG BUYING ENGINES

- a. They don't know what Honda's engine plans are and Honda won't tell them

No: Para 11 of NT's notes lists the engines that will be made in Swindon. The MOU also makes it clear that there will be full cooperation in the transfer of information.

- b. The Honda engines will not meet European emission requirements

No: Japan already has tougher standards than those proposed for Europe and their engines are already emissions compliant including the 1342 cc, which they supply for the Rover 213.

- c. Even if they do meet emission standards they will not be optimised for European conditions

No: Europe is too important a market for Honda to allow second best. The Swindon plant proves this. Honda are one of the world's leading engine producers. The Rover 213 has better performance than its rivals (eg Ford Orion) even though the engine was originally designed for Japan.

- d. Even if Honda did cooperate it is too late because the Metro replacement is needed in 1989.

No: The Honda 1342 cc engine can be used. In any event emissions standards below 1.4L do not bite until October 1991 (EC proposals for lead-free petrol would also come into force in 1991, but the UK are asking for 1989!). The Metro is not old: in 1989 it will be 9 years old compared to an average life cycle of 10 years for small cars (ARG figure) and 25 years for the Mini. The Mini, which has the same engine as the Metro, is currently sold in Japan (but actually it doesn't fully meet their emission standards).

- e. It is unlikely that any other manufacturer would be prepared to supply them with engines.

No: There is already a small trade in engines - ARG itself buys engines from VM in addition to Honda - and significant evidence of a growing trend, eg Ford/Fiat, GM/Toyota.

- f. Even if they were prepared to supply they would demand a truly extortionate price.

Unlikely: Economies of scale apply, so manufacturers would in fact make excess profits purely by charging ARG the same price as it would have cost ARG, with their small volumes, to make the engines themselves. In any event, competition and the laws of economics will not be suspended merely to justify ARG continuing as an engine manufacturer.

- g. If ARG cease engine manufacture then 4,000 jobs would be lost and two plants would close.

No: ARG should continue manufacture of the 'O' and 'S' series engines, only the K series would be dropped. The labour content of the proposed K series is half that of the old A series it replaces and thus at most 1,000 jobs would be lost. This could be more than offset by manufacturing engine parts for Honda as envisaged in the MOU.

- h. Buying engines will not solve the emissions problem because a lot of the work goes into vehicle engineering

No: if this were so, every model variant (eg 1.0L Metro, 1.3L Metro etc) would require a similar massive resource input. Expert opinion (eg Robin Nicholson) confirms the only significant changes are to the engine, not the vehicle.

Some questions for ARG:

1. Why do ARG propose to spend £44m to build their own version of V6 for the XX?
2. Why are ARG compromising the design of the AR8/9 (Maestro/Rover 200 replacement) by insisting it should take both ARG and Honda power trains?



Appendix II

This is a telex (dated Tuesday 21 May) from Professor Bhattacharyya in Japan. To preserve his identity it would be best to say only that you have received information directly from Japan confirming that Mr Ishykowa (the Managing Director of Honda) would happily supply any engines ARG wants and that the engines would meet European emissions standards and have a fully competitive performance.

The Telex reads:

As part of my Japanese tour I today met the senior Managing Director of Honda and his staff. In our discussion he mentioned that Honda's 1.3L, 1.5L, and 1.6L engines are so well advanced as not to need any further major development. Honda is going to manufacture all three engines at Swindon.

The three engines would meet all the European emissions standards and have a fully competitive performance. It is essential that this is so, as these engines will be incorporated in Honda vehicles. 90% of Honda cars are for export.

The senior Managing Director of Honda hopes that Austin Rover will purchase 1.3L, 1.5L and 1.6L engines beyond the current contractual agreements.

PRIME MINISTER

BL

This will be a difficult meeting. Mr. Tebbit's paper considers various ways in which BL's capital expenditure could be cut back, thereby reducing the growth in liabilities covered by the Varley/Marshall assurances. The "no small car" and the "restricted medium car range" options do not look effective as ways of achieving this. Discussion is likely to centre on the issue of buying-in engines and gearboxes.

ARG, supported by Barings (although somewhat luke-warmly), supported by Mr. Tebbit, argue that buying-in engines would be bad for ARG in the long run and impossible anyway because Honda would not supply.

Policy Unit are sticking to their guns in arguing that the outstanding liabilities can be reduced if collaboration with Honda is extended to buying-in engines. They argue that not only is Honda willing to supply but that this will produce significant benefits for ARG. Discussion will be difficult when there is not even agreement on the facts. This is an issue which will have to be argued through.

The other key issue, on which you will have Lord Young's support, is whether BL should be divided into two parts, ARG and Land Rover-Leyland. This would effectively wind up BL as a holding company. The business is already operated in this way and bringing the legal framework into line would finally lay the ghost of the old philosophy of bigger is better.

There is a lot of paper but it can be read selectively.

Essential

- i) Mr. Tebbit's paper, ie the first seven pages of E(A)(85)28.

ii) Cabinet Office brief

iii) Policy Unit brief

Optional

i) Summary of the Corporate Plan beginning on page 72 of E(A)(85)29.

ii) A summary of Barings' report ie the first page of Annex B to E(A)(85)28.

(iii) *The draft Memorandum of Understanding which you have already seen.*

We have set aside 45 minutes in the diary tomorrow before Cabinet for you to look again at the papers and to discuss the issues with John Redwood and Peter Warry.

AT

ANDREW TURNBULL

22 May 1985

VC2AGS

DUTY CLERK

NO 10

BL file

27582 CABOFF G

ATTN: A. TURNBULL ( PRIVATE SECRETARY )

THIS INFORMATION SOURCE IS STRICTLY CONFIDENTIAL.

AS PART OF MY JAPANESE TOUR I TODAY MET THE SENIOR MANAGING DIRECTOR AND HIS STAFF OF OUR COMPANY. <sup>My. V. M. G. G.</sup> IN OUR DISCUSSION HE MENTIONED THAT OUR COMPANIES SIZE 3-5-6 ARE SO WELL DEVELOPED AS NOT TO NEED ANY FURTHER MAJOR DEVELOPMENT. <sup>MY COMPANY IS</sup> GOING TO MANUFACTURE THE SIZE 3, 5 AND 6 AT S.

THE SIZE 3, 5 AND 6 WOULD MEET ALL THE EUROPEAN STANDARDS AND HAVE A FULLY COMPETITIVE PERFORMANCE. <sup>AF</sup> IT IS ESSENTIAL THAT THIS IS SO SINCE THESE WILL BE INCORPORATED IN OUR PRODUCTS. 90 PERCENT OF OUR PRODUCTS ARE FOR EXPORT.

THE SENIOR MD OF MY COMPANY HOPES THAT YOUR COMPANY WILL PURCHASE SIZE 3-5-6 BEYOND CURRENT CONTRACTUAL AGREEMENT.

THE INITIAL OBJECTIVES OF MY COMPANY WAS TO DEVELOP FACILITIES FOR C-B-1 AND 3-5-6 AT S. YOUR COMPANY PROTESTED AND SUGGESTED THAT THEY WERE UPDATING ASSEMBLY FACILITIES AND THERE WAS NO NEED TO HAVE MY OWN FACILITY FOR C-B-1 AT S.

KMR

CENHYATT J29411  
27582 CABOFF G