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Prime Minister

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DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

Mus 2/6

TELEPHONE DIRECT LINE 01-212 5902
SWITCHBOARD 01-212 7676

From the
Minister of State

Norman Lamont MP

The Rt Hon Leon Brittan MP
Chief Secretary
HM Treasury
Parliament Street
London SW1

28 May 1982

Dear Leon

We have been asked by BL for approval for the proposed collaboration between the Leyland Group (the commercial vehicle business) and the Cummins Engine Company on a light truck diesel engine. The proposed collaboration is being put to the Government under the terms of Sir Michael Edwardes' letter to Keith Joseph of 26 January 1981 (copy at Annex A). The purpose of that letter was to give the Government an opportunity to determine whether a proposed collaboration which was sensible from a commercial point of view did not preclude other possibilities for the future of the company or Group concerned which might be more attractive to the Government. We are not therefore at this stage involved in a detailed appraisal of and approval for the investment required; the investment programme will, as it exceeds £25 million, be submitted for Government approval under the Memorandum of Understanding later this year.

The details of the proposed collaboration are set out in Sir Michael Edwardes' letter of 22 April 1982, a copy of which is at Annex B. Your officials have been involved in discussions with BL about the proposal, and can provide further details.

The issues which face us at this stage with this collaboration are three-fold: whether we have reason to doubt the Board's overall commercial judgement of BL's interests; whether there is any national interest argument against the collaboration, especially given our level of financial support for Perkins, a UK-based engine manufacturer; and whether the collaboration helps or hinders the Government's objectives of extricating itself from BL. I have looked carefully at all three aspects.

On the commercial interest point, we have identified no reason to doubt that the Board have misinterpreted the company's commercial interests. Cummins are an extremely technically competent and commercially sound company with a good reputation for designing, manufacturing and selling large diesel engines, who should be

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fully capable of successfully developing a small engine range they have hitherto been involved in. The economies of scale to which the collaboration will give the Leyland Group access are perfectly satisfactory for this size of engine (about 130,000 units a year) while still allowing BL a large measure of value added at Bathgate. I am therefore quite content with the choice of Cummins from a commercial point of view as a collaborative partner for the Leyland Group.

There is, in addition, the question of whether BL should be aiming for collaboration on this engine, rather than out-sourcing it. You may recall that the 1982 Leyland Group Plan which we approved at the end of last year contained radical proposals to reduce the vertical integration of the commercial vehicle business in order both to reduce costs and to provide access to greater economies of scale than were otherwise available. This involved, amongst other things, the ending of stand-alone engine manufacture by the Leyland Group on any of its four engine ranges. The Plan proposed that two of these four ranges would be bought from other manufacturers, and two would be made by Leyland in collaboration with other manufacturers. This proposal covers the first of these collaborations. While out-sourcing is certainly a lower-risk option, BL have two main reasons for rejecting it: that their approved corporate strategy was not for them to become simply an assembler of trucks, and that the proposed collaboration generates a 21% incremental rate of return over out-sourcing. Moreover, in view of this prospective rate of return, out-sourcing of this engine would have major industrial relations implications.

Although we are not able at this stage to verify the rate of return, the commercial advantages of collaboration over out-sourcing are important, and progress now on collaboration will not preclude withdrawal (without significant cancellation costs) and a switch to out-sourcing later this year if the commercial balance should alter.

We have had frequent representations from Perkins that the proposed collaboration cannot be right on national interest grounds, given the US base of Cummins and the UK base of Perkins. The argument is not, however, nearly as clear-cut as this. Cummins have three factories already in the UK and are an established part of our industrial infrastructure as, of course, are Perkins, who do have the added benefit of a UK-based research and development effort. We have no reason to suppose that, if Cummins were not collaborating with the Leyland Group, they would ignore the UK and European market for their new engine; instead, they are likely to meet the demand from their new American factory instead of, under this proposal, from assembly by the Leyland Group at Bathgate. Nor does it seem as if Cummins' entry into the European market in this engine size (they are already a well-established supplier of large engines) will hit Perkins disproportionately; Cummins' proposed sales amount to 5% of European demand, and are not projected at the agriculture sector where Perkins are strongest. I therefore consider that there are no overriding national interest arguments in favour of Perkins,

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still less any which would lead us to deny approval for a collaboration with an excellent American company which we believe to be fully in BL's commercial interest.

On whether this collaboration will help or hinder the Government's aim of extricating itself from BL, the issue is whether potential purchasers who are themselves integrated truck manufacturers would be put off by Leyland Group's collaboration with an independent engine maker. There may, of course, be problems associated with this, and with any other, collaboration on a major component, but their extent will depend above all on the other company involved. But in any takeover there would be many aspects of synergy or conflict to take into account, and I see no reason to regard this as overriding: it is in any case heavily outweighed by the beneficial effect the Cummins collaboration is likely to have on Leyland Group's viability.

I therefore support BL's decision for collaboration with Cummins, and I propose to give Sir Michael Edwardes the clearance he seeks to sign the agreement with Cummins to enable detailed work to proceed - of course, without prejudice to our views on the investment associated with the collaboration when the investment appraisal is put to us. Sir Michael has hinted that the signing may be deferred until the current discussions on Land Rover are concluded - I consider that this is a matter for his commercial judgement and I propose to leave this aspect to him.

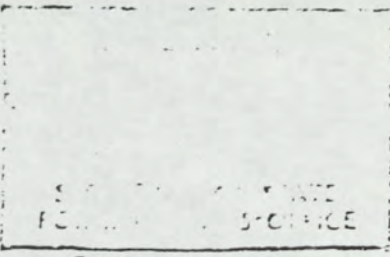
I should be grateful to know whether you agree with my conclusions on this proposal. I am sending a copy of this letter and attachments to the Prime Minister, the Secretary of State for Scotland, and to John Sparrow.

NORMAN LAMONT

Yes -
Norman

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TELEPHONE
01-496 6000



35-38 PORTMAN SQUARE

ANNEX A

LONDON W1H 0HQ

FROM SIR MICHAEL EDWARDES

26 January 1981

The Rt Hon Sir Keith Joseph, Bt, MP
Secretary of State for Industry
Ashdown House
123 Victoria Street
London SW1

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Dear Secretary of State,

Further to my letter to you of today's date which is intended for publication, I can confirm to you privately that the Board undertakes to seek Government approval for the disposal of any significant equity holding in any of BL's major subsidiaries.

If the Board at any time proposes to authorise collaborative arrangements for any of the four main business groups which might preclude either a comprehensive collaboration agreement with another manufacturer for that group or any other arrangement involving disposal, merger or substantial equity participation, the Board would clear the principles of any such arrangements with the Government before reaching a position from which it might be difficult to withdraw.

The Board emphasises that a rapid response from the Government would be necessary to avoid jeopardising desirable opportunities.

*Yours sincerely
Michael Edwards*

TO <i>Mr Douglas</i>	COPIES TO
FOR <i>Mr Douglas</i>	<i>RS/ATT</i>
DEPT REPLY (IF APPROPRIATE)	<i>RS/MLL</i>
PLEASE BY:	<i>RS/Sec</i>
<i>Noon</i>	<i>Mr Steele</i>
<i>27/2/81</i>	<i>Mr Mountgarden</i>

*No action
req'd.
27/1/81*

TELEPHONE
01-486 6000

35-38 PORTMAN SQUARE

LONDON W1H 0HQ

FROM SIR MICHAEL EDWARDES

22nd April 1982

The Rt. Hon. Patrick Jenkin, MP,
Secretary of State for Industry,
Ashdown House,
123 Victoria Street,
London SW1.

ACKNOWLEDGED

Dear Secretary of State,

TO <i>Mr Bourde</i>	COPIES TO
DATE OF RECEIPT	<i>Ps/NL</i>
DRAFT REPLY IF APPROPRIATE)	<i>Ps/JB</i>
PLEASE BY:	<i>Ps/Sec</i>
<i>ASAP</i>	<i>Mr Maurice</i> <i>Mr Mountfield</i>

LEYLAND GROUP/CUMMINS COLLABORATION

In accordance with my private letter of 26th January 1981 to your predecessor, the BL Board seeks the Government's clearance for a collaborative agreement between the Leyland Group and Cummins Engines for the manufacture of a new range of engines for light trucks, designated Family I. The agreement is in line with the 1982 Corporate Plan, under which Leyland will participate in the manufacture of only two of the four truck engine families in future - Family I and Family III. The need for collaboration on these engines was fully explained in the Plan.

The proposed collaboration involves the manufacture at Bathgate of a new Cummins-designed engine in a 4 and 6 cylinder form to replace Leyland's existing 98 series engine from 1986 and to meet all Cummins' European requirements. The engine will also be manufactured in North America under collaborative arrangements between Cummins and J.I. Case, with world-wide volumes reaching 134,000 by 1990 - thus achieving fully competitive economies of scale which Leyland could not hope to generate without collaboration. A breakdown of the forecast markets and uses for the engine is attached.

Continued

The Rt.Hon. Patrick Jenkin, MP,
Secretary of State for Industry.

22nd April 1982

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All engines for Leyland and Cummins' use in Europe (rising to 40,000 per annum by 1990) will be assembled and tested at Bathgate. Fully machined cylinder blocks and heads will be supplied from the new Cummins/Case plant at Rocky Mount, North Carolina, while Leyland will manufacture the crankshaft and con-rods not only for Europe but also to meet 20% of the North American requirements. Other components are expected to be sourced within Europe (including some in-house) to meet European demand only. The balance of trade involved in the proposed sourcing and sales pattern is likely to be heavily favourable to the UK (details attached).

Capital investment by Leyland in the project is currently estimated at £33.6m, compared with provision of £34.9m in the Corporate Plan. The investment will introduce a high level of automation in the higher-volume component manufacture, resulting in major productivity improvements as well as built-in quality control. Consequently, hourly-paid manpower employed on this family of engines at Bathgate will fall from 713 employed on the 98 series in 1981 to 381 employed on Family I by 1990.

Leyland Group are satisfied that the Family I engine will be fully competitive in both performance and unit cost with the available alternatives, including the new Q20 engine being developed by Perkins with whom they have also had discussions. Compared with the most likely alternative course of buying in proprietary engines from Perkins- (which would have serious implications for Bathgate) the Family I engine project is forecast to generate an internal rate of return of 21%, with an average year return on assets of 26%. If for any reason the final phase of negotiations with Cummins were unexpectedly to reveal insuperable difficulties, it would be possible for Leyland Group to explore Perkins' offer of collaboration on their new engine, but this course would carry greater risks in view of uncertainty over Perkins' commitment to the project (Perkins having been responsible for the breakdown of a previous round of discussions in 1980) and the possibility that greater investment would be required at Bathgate. The more likely outcome is that Leyland would be forced out of engine manufacture in this sector and into purchase of engines from either Cummins or Perkins.

Continued

The Rt.Hon. Patrick Jenkin, MP,
Secretary of State for Industry.

22nd April 1982

3.

The collaboration with Cummins is to be formalised by four separate legal agreements, which are intended to be signed in June after the conclusion of detailed negotiations. A summary of these agreements is attached. They do not contain any cancellation penalty provision, as the positions of the two parties would be evenly balanced in such circumstances. No capital commitments are forecast to be required until the end of 1982, and the only significant payment which the Leyland Group is obliged to make to Cummins prior to that date is an initial £100,000 under the licence agreement.

The BL Board has therefore approved the Family I project in concept and has authorised the signature of the agreement, without prejudice to consideration of the full investment programme later in the year, when we shall be better placed to assess the progress of Leyland Trucks' recovery and thus the viability of such a major capital commitment. The investment programme will also, of course, require Government approval.

We are satisfied that the Cummins collaboration will not act as a significant constraint on Leyland Group's chances of securing broader collaborative arrangements. Indeed the Cummins relationship should make Leyland more attractive to potential partners as well as providing a much-needed boost to general confidence in the business.

Even though we shall not commit to any capital expenditure until later in the year, Leyland Group consider it essential to go ahead with signature and announcement of the Cummins deal now. To bring the project to a halt for several months could well encourage Cummins to look elsewhere for a collaborative partner; not only would they have no legal agreements to underpin their further development work, but they would obviously become highly sceptical of Leyland's commitment to the whole project. In addition, announcement of the deal will contribute to the rebuilding of the confidence of Leyland Trucks' employees, dealers, and customers after the strike, while conversely a delay in the project (which is widely known particularly amongst employees at Bathgate) would be very damaging to morale.

Continued

The Rt.Hon. Patrick Jenkin, MP,
Secretary of State for Industry.

22nd April 1982

4.

For these reasons, I trust that you will be able to give clearance to this collaboration in the next 2-3 weeks. If your Department requires any further information, BL staff stand ready to respond to requests from your officials.

Yours sincerely,
Richard Swaine

FORECAST SALES OF FAMILY 1 ENGINE1. WORLDWIDE

	<u>1986</u>	<u>1988</u>	<u>1990</u>
North America (Cummins/Case)	58,320	81,330	94,710
Cummins Europe	4,096	10,962	17,820
Leyland	22,105	22,584	21,744
	<u> </u>	<u> </u>	<u> </u>
----- TOTAL -----	<u>84,521</u>	<u>114,876</u>	<u>134,274</u>

2. BATHGATE-SOURCED ENGINES

Approximate split for -----	<u>1990</u>
Leyland - trucks (MT207, MT211, T68)	15,000
- Bus (211-based chassis)	3,000
- sales to Marshall tractors	4,000
	<u> </u>
Total Leyland	22,000
	<u> </u>
Cummins - UK	9,000
of which - construction equipment	7,000
- rest of Europe	9,000
of which construction equipment	7,000
- marine sales	1,500
- less 3-cylinder volume*	(1,500)
	<u> </u>
Total Cummins	18,000

*Derivative not required by Leyland and therefore to be sourced from Cummins.

SENSITIVITY TO RISKS AND OPPORTUNITIES

A 50% shortfall in European demand from Cummins would reduce average return on assets from 26% to 16%. Recapture by Leyland of the JCB engine business lost in the recent strike would increase the average return on assets to 30%.

FORECAST TRADE PATTERN FOR FAMILY 1 ENGINE IN UK

<u>£m</u>	<u>1990</u>
Imports of cylinder blocks and heads from USA	(8)
Exports of Bathgate components to USA	2
Export of engines for sales by Cummins in Europe	11
	—
Favourable trade balance	5

LEGAL AGREEMENTS

There are four separate legal agreements, which were initialled by both parties on 24 February 1982, covering the following aspects of the Leyland/Cummins collaboration :

- (a) Licence Agreement, which is non-exclusive and gives Leyland the right to manufacture and sell components and complete engines for use in Leyland products anywhere in the world, including replacement parts and engines. Leyland will also be able to grant sub-licenses in certain territories (the most important being Australia, India and Nigeria) including export of vehicles fitted with Family 1 engines from those territories and will be able to sell loose engines to Marshall and Sons Limited only. Payments will be £100,000 p.a. from date of agreement to commencement of production and £38 per engine (excluding those sold to Cummins) thereafter subject to a minimum payment based on 12,000 units (456,000 p.a.).
- (b) Supply Agreement for supply by Cummins of blocks and heads, which covers 100% of Leyland volume requirements (with Leyland guaranteed continuity of supply at the same proportion of total production as in the previous six months in the event of any production shortfall) and sets base prices, which are subject to adjustment at six monthly intervals for inflation, exchange rate and design changes.
- (c) Supply Agreement for supply by Leyland of 20% of the Rocky Mount plant requirements of crankshafts and camshafts, other terms and conditions being essentially similar to (b) above.
- (d) Engine Purchase agreement for engines to be supplied by Leyland to Cummins for 100% of their European requirements up to 20,000 units per annum, again with other terms and conditions being similar to (b) above.

The major outstanding point for negotiation between the parties is matter of warranties to be included in the three supply agreements license agreement specifically excluding any warranty by Cummins, than the commitment for Cummins to use their best endeavours to achieve the Leyland performance criteria.

The clearance of the EEC Commission will be required for these agreements, the legality of which under US anti-trust legislation has been confirmed by Cummins.



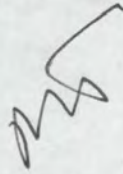
Prime Minister (4)

JdPd

MS 10/6

Treasury Chambers, Parliament Street, SW1P 3AG

N Lamont Esq MP
 Minister of State for Industry
 Ashdown House
 123 Victoria Street
 LONDON
 SW1E 6RB


 9 June 1982

Dear Minister of State

LEYLAND GROUP/CUMMINS COLLABORATION

Leon Brittan has asked me to reply to your letter of 28 May.

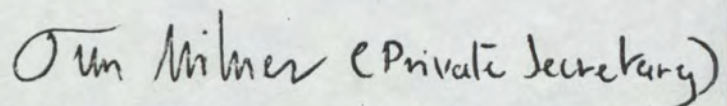
I agree that you can give the clearance that Sir Michael Edwardes seeks to sign an agreement with Cummins but, as you say, this does not mean that we have given approval for the investment. Before we do that we will need to see the investment appraisal and satisfy ourselves that the expenditure makes sense in financial terms.

At that stage I shall be particularly interested to see the basis on which a 21 per cent internal rate of return for the project, compared with the alternative of outsourcing, is claimed. At first sight this seems a rather high figure.

I am informed that between now and the end of the year BL will spend only £100,000 on the project and will be able to pull out without being liable for any compensation payments. I regard this as particularly important given the uncertainty over changing the future of Leyland Group. I hope that by the time we have to take a decision about the investment, the outlook for Leyland Group will be clearer.

I am copying this letter to the recipients of your's.

Yours sincerely



for JOHN WAKEHAM

(Approved by the Minister and
 signed in his absence)