

PRIME MINISTER

30 May 1985

AUSTIN ROVER (ARG) - ENGINES

Draft Letter

Honda could be excused if, when reading the letter in translation, they thought the proposal remains about collaborating on engines. The possibility of supplying engines only merits the second indent at the bottom of the second page of the letter. It could be amended in the following manner.

1. Second paragraph, delete last three lines and replace with "... whether Honda might be willing to supply the new small engine which Austin Rover needs, ~~a~~ view which HM Government endorses".
2. The third paragraph should be modified to require the engine to be available in the summer of 1989, not 1988 as proposed, and pilot build in autumn 1988, not 1987. (ARG had planned to launch the replacement Metro in late 1989 so it is unreasonable to ask Honda to beat that timing).
3. The fourth paragraph is ^{unnecessary} ~~highly misleading~~ and should be deleted. It talks about collaboration and an alternative of ARG taking a Honda design but does not mention a straight supply of engines. A small consequential change to the subsequent paragraph would also be necessary.
4. The attachment on engine characteristics is surprisingly precise given that the car has yet to be designed (and should therefore be able to accommodate any sensibly competitive engine). The stipulation that the economy version of the car should be able to achieve 80 MPG is

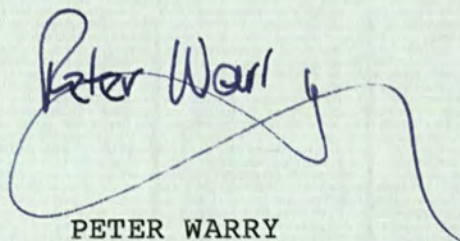
unrealistic, particularly as lean burn will reduce engine economy. Would it not be better to be more general and say "the engine should package in a Metro type car, meet European emission standards through lean burn, and have a fully competitive performance?"

BL and ARG Directors are flying to Japan no doubt to try and persuade Honda to make the response ARG want, under threat of losing the more valuable (to Honda) sub-contract car manufacture. Honda's response will need to be viewed in this light.

The attachment details our understanding of Honda and ARG's engine plans.

Collaboration Announcement

An announcement of the proposed collaboration with Honda seems reasonable, provided that in the underlying Memorandum of Understanding the embargo on ARG buying Honda engines is deleted and the stipulation for the new Maestro/Rover 200 replacement to take both Honda and ARG power trains is softened.

A handwritten signature in blue ink that reads "Peter Warry". The signature is stylized with a large, sweeping flourish that loops under the name and extends to the right.

PETER WARRY

ENGINE PLANS

Although the Metro currently takes 1.0L and 1.3L engines, ARG's revised plans for the new Metro envisage 1.1L and 1.4L K series engines to accommodate the 1.4L division in the emissions legislation. (Both K series engines will be made from the same casting and the design is compromised if there is too wide a difference in engine sizes).

Honda have two separate engines in this sector - the 1.342L currently fitted in the Rover 213 and a 1.2L fitted in the Honda City. They have plans to produce a 1.1L version of this smaller engine and possibly a 1.3L version as well. They would be happy to manufacture the smaller engine at Swindon in addition to the others already planned (they will also be manufacturing the 1.2L in the United States). We are told the engines will be fully competitive on both emissions and performance.

Extract from ARG submission

to DTI 10/5

Attachment 3

Page 1 of 4

SUB CONTRACT MANUFACTURE PROFITABILITY

Under this heading there are three separate questions which have been asked :

- 1 Details of the profitability of the sub contract manufacture to ARG and how this would relate to Honda's profitability.
- 2 Outline details on how "the 80% local content" would be made up.
- 3 Indications on where the Honda capital expenditure related to sub contract manufacture would be spent.

It is essential that we re-emphasise that, to date we have reached the stage of a Draft Memorandum of Understanding with Honda. Following signature of that MOU we will then enter into progressively more detailed discussions/negotiations on the individual contracts which will stem from that MOU. The following information is, therefore, provided from our own knowledge of the profitability of this industry in Europe, coupled with our experience of arrangements which have been made with Honda on previous occasions and, above all, on how, from our past experience of negotiating with Honda, we believe that they will view the situation and therefore what their negotiating position is likely to be.

It must be understood that Honda do not view financial consequences in the same way that would be understood in the UK. In particular, they regard one-off costs such as tooling manufactured in their own toolrooms, or facility costs, or, indeed, the proposed engine plant at Swindon, as long term strategic investments which they would not necessarily relate in their own evaluation to a specific individual action.

On the other hand, they are very much orientated to the achievement of profits in each part of their business and they will, therefore, expect to more than recover costs on the pack they supply to us and, indeed, in their sales companies. The sensitivity of the information which is being supplied cannot, therefore, be over-emphasised.

1 PROFITABILITY OF CONTRACT BUILD TO ARG

- . Based on Rover 200 pack prices from Honda and our own variable manufacturing costs, the total average variable cost per unit is estimated at £3050 at 1985 economics to ARG.
- . The average available net sales revenue would be £3950 to the Honda sales companies. We would anticipate selling the finished vehicles to Honda at a price of £3450, effectively giving them an average 12% margin in their PDI/sales companies.
- . The economic profit per unit to ARG is, therefore, estimated at around £400 per unit or, on the full volume of 100,000 per annum, £40m per annum.
- . The incremental fixed costs to ARG are £8m on manufacturing, a provision of £3m to cover administration, purchasing etc, and depreciation of £5m per annum.
- . The incremental profit to ARG is, therefore, estimated at £24m per annum on the full volume of 100,000.
- . If ARG were manufacturing such vehicles ourselves, on the anticipated Honda market mix we would expect to achieve an average EP of 27% or £1050 per unit.
- . From the above analysis it can be seen that of this £1050 we would anticipate ARG will actually receive £400. Honda will, therefore, probably achieve an economic profit per unit of £650 assuming that their cost efficiency is comparable to ARG.

- . Honda will incur incremental engineering, administration and manufacturing fixed costs associated with the European versions of the cars which we would estimate at £10-15m per annum. They will also incur selling and marketing costs of around £35m per annum.
- . Thus the total incremental profit available on the sub contract cars is estimated to be £44m (that is EP £105m, less ARG incremental costs £16m, less Honda incremental costs of £45m). On the basis of the estimates above ARG would receive £24m per annum of this profit and Honda c £20m per annum.

2 OUTLINE DETAILS ON HOW "THE 80% LOCAL CONTENT" WOULD BE MADE UP

Obviously ARG has no specific knowledge of how Honda would achieve such a target in detail. However, based on our own knowledge, the level of work to be carried out by ARG, the supply of the engine ex-Swindon, the supply of the fascia ex-Honda in Belgium, plus locally sourced parts such as wheels and tyres, glass, seat and trim materials, exhaust system, fuel tank, battery, radiator etc, would generate a local content of around 72%. The remaining 8% could be achieved in a variety of ways. For example local sourcing of steering and suspension components would generate a content of 7% or, alternatively, a combination of a variety of other bought-out parts could equally be sourced from within Europe.

i.e. body panels will be supplied from Japan.

3 INDICATIONS ON WHERE THE HONDA CAPITAL EXPENDITURE RELATED TO SUB CONTRACT MANUFACTURE WOULD BE SPENT

Answering this question is coming very close to piling estimate upon estimate. It stems, presumably, from the comment made that the tooling costs to be paid for by Honda for the two contract assembly models would probably be, at the very least, double the amount which ARG has estimated it will spend in providing the facilities for the sub contract vehicles.

This comment stems from our own knowledge of the cost of tooling for two such models in terms of both body-in-white tooling and vendor tooling. It does not include the investment which Honda will be making at Swindon although, on reflection, perhaps in this context it should.

However, as an assumption, we would believe that it is almost certain that the body-in-white tooling will be manufactured in Japan, certainly on panels and assemblies, which will have already been tooled for the Japanese and US markets. This would account for some 70% of the total tooling costs to Honda. Of the remainder, it would depend upon the precise sourcing adopted by Honda as to where the tooling costs would be incurred. A very rough guess would imply that 15-20% of the total tooling cost may be incurred in the UK/Europe.

i.e. minimal incremental investment for Honda.

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