PO-CH/NL/0184 PT B

Alex Lawson

PART B

CONFIDENTIAL

(Circulate under cover and notify REGISTRY of movement)

PO -CH /NL/0184

PART B

CHANCELLOR'S 1988 PAPERS ON MERGERS POLICY AND THE MONOPOLIES AND MERGERS COMMISSION (MMC)

Begins: 21/9/88

Ends: 16/11/88

DD: 25 years

6/9/95

PO -CH /NL/0184 PART B

iae3.mn/docs/edna21.9

CONFIDENTIAL

FROM: EDNA YOUNG
DATE: 21 September 1988

1. MR MONCK
2. CHANCELLOR

cc Sir P Middleton
Sir G Littler
Mr Lankester
Mr Burgner
Mr R I G Allen
Mrs Lomax
Mr Burr
Mr Mortimer
Miss Noble
Mr Bent
Mr Kroll
Mr Parkinson
Mr Call

OD(E), 22 SEPTEMBER: EC MERGER CONTROL

1. You are attending OD(E) at 11.00 am on Thursday 22 September. The EC merger control regulation is the only item on the agenda. The regulation was to have been discussed at the Internal Market Council on 14 October, but the Commission now intend to delay Council discussion until November. This is helpful as it leaves time for the further work by the DTI proposed in para 18 below.

OBJECTIVES

2. To make abolition of barriers a condition of our agreement to a regulation. It necessary to reach agreement, to indicate willingness to accept a regulation which came into effect after certain barriers had been removed.

THE PAPERS

3. Lord Young has tabled a paper, OD(E)(88)16. A Cabinet Office note covering a paper by DTI officials on barriers to takeovers has also been circulated (OD(E)(88)17).

4. **The paper by officials** is the study commissioned by OD(E) in June, at your suggestion, of the barriers to takeover activity which existed in other member states and how these might be overcome. It divides barriers into three types:

(a) government imposed, eg. formal merger control systems, golden shares. The paper asserts that the UK has the most extensive formal system of controls (though of course actual use made of it is extremely sparing).

(b) company-imposed, eg. cross-shareholdings, poison pills, poor disclosure rules.

(c) barriers which are part of the corporate environment, eg. small stock markets, family control of companies.

The paper makes clear that we have few barriers under (b) and (c). It thus confirms (although not explicitly) the substantial disparity between the openness of the UK and the relatively closed markets of most other member states. It acknowledges that further work is needed to identify the scope for action to remove those barriers which are susceptible to EC legislative action (principally those imposed at the company level). But this work has still to be done. The paper points out (correctly) that those barriers which are part of the corporate environment cannot be legislated away and are therefore harder to deal with.

5. **Lord Young's** paper argues that, since our market would be more open than others even if all possible action were taken on barriers, and since hostile bids are the minority even in the UK, there is no point in making removal of barriers a precondition of agreement to a regulation. Other Ministers are likely to support him in resisting a link. But this argument does not answer the question as to what the UK, or UK companies would gain in return for ceding some control over bids to Brussels. Company-level barriers, which the paper by officials concludes are susceptible to action, are there precisely to ward off threats of hostile takeovers.

Lord Young's recommendations

6. Lord Young now accepts that we should flag our concerns over barriers in Brussels (but not link them to the merger control regulation). Consideration will need to be given to the precise timing. The next Internal Market Council in November will be too late.

7. On scope Lord Young proposes seeking to raise the threshold in the regulation to at least 7 billion ccu, seven times as high as the current Commission draft. But this is a figure for **worldwide** turnover. Lord Young makes no proposal on the threshold for **Community** turnover, which the draft regulation puts at only 100 mecu. This could give the Commission jurisdiction over a large number of takeovers of UK companies by non-EC companies. The threshold for Community turnover therefore needs at least to be raised in proportion to the worldwide turnover (i.e. from 100 mecu to 700 mecu), and preferably higher.

Double jeopardy

8. The views of British companies have not emerged clearly so far. In particular they seem not to have given much serious thought to the different levels of barriers which exist in the Community (though the chairman of ICI in a recent speech welcomed the proposed regulation). There is however clear business opposition to double jeopardy. This may be difficult to avoid completely if we are to retain something like our current public interest provision. Moreover exclusive Community jurisdiction above a certain threshold would mean the loss of our ability to intervene if a merger acceptable at Community level had anti-competitive effects in the UK market. But high thresholds would reduce this risk.

Criteria restricted to competition

9. This is easier to state than to achieve. The draft regulation is unsatisfactory in that it would clearly allow anti-competitive mergers which promoted an EC industrial strategy.

No automatic suspension

10. The current Commission proposal is for all mergers falling within its scope to require authorisation before they proceed. Our system of what Lord Young refers to as "intervention power" is more appropriate to a competition-based system, reduces interference in the market process, and puts pressure on the Commission to speed up decisions.

Interface with Articles 85 and 86

11. DTI officials claim that, in return for a regulation, the Commission would be prepared to operate a self-denying ordinance on their use of Articles 85 and 86. But this may not mean much in practice. As Lord Young's paper recognises, the Treaty cannot be disapplied. However, without a regulation there are indications that the Commission will seek to increase their use of Articles 85 and 86.

Timescales

12. The latest Commission proposal would allow a total of 5 months for investigation and decision. The MMC generally have 6 months after consideration by the OFT, and with a 3 month extension at the Secretary of State's discretion. It would clearly be to our advantage to reduce the Commission timescales if we can.

Removal of UK barriers

13. If we were to agree to the principle of a regulation in return for action on certain barriers, we would have to be prepared to give up barriers of our own at the company level. In general, this should cause us no special difficulty since we have far fewer than most other member states. But the retention of **golden shares** could present real problems. Where golden shares are **temporary** (eg. BSC), it may be possible to agree transitional arrangements with the Commission. In the **defence field**, the Commission have already asked for justification for the

arrangements for Rolls Royce, which can be seen as discriminating against other EC nationals. The DTI are seeking an exemption under Article 223 of the Treaty (which recognises member states' vital interests in the defence and security fields). Similar considerations could affect **BAE** in due course.

14. Permanent golden shares in non-defence industries (mainly utilities) could present the biggest difficulties. We might need to seek a special exemption for these. The French have arrangements ("noyaux durs") for some of their privatised companies intended to prevent takeovers, but these take the form of "friendly" shareholdings (e.g. by banks). Some form of mutual support might be possible.

15. The continued existence of the **Industry Act** (which empowers the Government to prevent virtually any foreign takeover) could also provoke criticism. But these powers have never been used.

TACTICS

16. We understand that the Foreign Secretary, as chairman, will be briefed to divide the discussion into three parts:

(a) should the UK seek action to remove barriers?

(b) should this be a precondition for agreement to a regulation?

(c) what are our negotiating objectives for a regulation?

The suggested line to take has therefore been structured in the same way.

17. Lord Young's paper indicates a willingness to maintain our present general reserve, while continuing to negotiate. (This follows the tactical advice given by Sir David Hannay at a recent EQS meeting.) His paper also sets a number of ambitious objectives. All this can be used to advantage if you decide to move to the fallback position of agreeing to a (substantially modified) regulation provided certain barriers are removed (Mr Taylor's minute of 20 September).

LINE TO TAKE

18. **Action on barriers**

(a) (Need for further work)

Paper by officials confirms disparity between barriers in other member states and UK.

Recognise that some are not susceptible to legislative action. But a number are susceptible. Important that we should press for removal of those now.

Need more detailed work rapidly on which barriers could be removed and how.

(b) (If it is claimed that the Fair Trading Act could come under fire)

No substance to such a claim. It is because we have an open market that we need a selective mechanism. But we have always made clear we would use it sparingly. Our practice confirms this - cf. Rowntree.

(c) (Hostile bids few)

Number not relevant. Paper rightly argues value of threat of takeover. But many barriers (especially at company level) intended to prevent this. If these not removed, UK companies will remain at a disadvantage.

19. **Removal of barriers as precondition for agreement to regulation**

(a) - Given confirmation of extent of barriers elsewhere, see no way of agreeing to regulation without abolition of those barriers which can be legislated away. Otherwise, only leave UK companies even more open to overseas predators, with no change in other member states.

- Absurd for Commission to claim (in preamble to regulation) that regulation is essential part of single market.

(b) (lack of leverage because other member states not pressing for regulation - 1st para of p2. of Lord Young's paper).

- UK not demandeur for regulation. It is **Commission** which wants a regulation. And should be in their interests, as well as in logic of their position, to achieve equality of treatment throughout Community. So press **Commission** for action on barriers.

(c) (regulation better than use of Articles 85 and 86)

- Case not proven: since Treaty cannot be disapplied, could end up with worst of all worlds - barriers still in place, regulation, **plus** use of Articles 85 and 86.

- Need for more precision on circumstances in which Commission would deny itself use of 85 and 86.

(d) (action on barriers would mean dismantling UK companies' own defences and loss of golden shares)

- UK companies use such defences (restricted voting rights, poison pill etc) far more rarely than others. So see no reason to resist this.

- **Golden shares** separate issue needing further consideration. French may find their system of "noyaux durs" for privatised companies under fire. May be a possibility of mutual support if they were interested in adopting our system.

(e) **(Fallback if no support for link between regulation and removal of <u>all</u> barriers)**

- Continue to believe this would give us maximum leverage for achieving level playing field. But prepared to agree that we could accept the principle of a regulation, provided it came into effect **after certain barriers** (i.e. those susceptible to legislative action) had been removed. The link would be realistic in scope but would ensure we got something in return for regulation. And we would then be playing a full part in negotiating its content.

(f) (if others resist)

- If we make no link at all, we would have no assurance of achieving anything on barriers,

- this proposal would give Commission incentive to achieve removal,

- presentationally, EC partners which resisted dismantling barriers would then bear responsibility for holding up regulation.

(g) (if others argue this line no difference from your previous formal precondition)

- not true. This proposal recognises that not all barriers can be legislated away, **and** gives more flexibility to negotiating position. Note that Lord Young's paper recommends maintenance of our general reserve.

(h) This way forward would give Commission a role in a number of large politically sensitive mergers. **Details** of EC regime **must be got right.**

20. Negotiating objectives for regulation

(These are set out in the order of Lord Young's paper).

(a) **flagging our concern over barriers**

Should establish ~~mini~~-link between barriers which can be legislated away, and regulation. Important to do this **soon**. November IMC too late. Working Group too low level (though details would have to be discussed there). Suggest raising it **either** at 14 October IMC (even if there were no substantive discussion) **or** early meeting of COREPER. Agree we should also alert **Commission**.

Work by officials (eg. in EQS) to identify precise scope for action must be completed soon. Cabinet Office could commission.

(b) **Scope**

Welcome objective of high threshold for worldwide turnover. But need high threshold for **EC turnover** too, at least in line with proposed threshold for worldwide turnover, or perhaps higher. Otherwise risk EC jurisdiction applying to large number of takeovers of UK companies by non-EC companies.

(c) **Avoiding double jeopardy**

Seems clear that British business wants this. But retention of public interest, provision will need to be carefully negotiated. Do not regard prudential supervision of banking sector, defence and the media as broad enough.

(d) **criteria**

agree that these should be purely competition. But note than all Commission drafts so far could be to further **EC industrial strategy**. No question of accepting this.

(e) **no automatic suspension**

"Intervention power" (where Commission has to prove case against company) clearly better than "authorisation" (where company has to prove case against Commission), which is far too dirigiste.

(f) **interface with Articles 85 and 86**

This needs to be spelled out more clearly. Understand DTI officials believe Commission ready to accept informally that they would not use Articles 85 and 86 for mergers falling within the scope of the regulation and should minimise their use for those outside it. But the Treaty cannot be disapplied by a regulation. So important to get best assurances we can. But we should not delude ourselves that these will mean much.

(g) **timescales**

Agree that we should seek to cut these further, if possible.

(h) **public sector predators** (not mentioned in Lord Young's paper. Mr Channon, who has been invited to OD(E), is interested in this because of the BCal/SAS case).

Public sector predators further area of concern. State owned businesses in other member states could find rich pickings in the UK. Not clear whether Article 90 of the Treaty (equal treatment for publicly and privately owned enterprises) would give us any protection.

Edna Young

EDNA YOUNG

pel.1b/SEP.88/min3l

CONFIDENTIAL: MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 22 SEPTEMBER 1988

PS/CHANCELLOR

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Burgner
Mr Moore
Mr Houston
Mrs Brown
Ms Goodman
Mr Call
Mr Tyrie

Ch.
This supersedes Mr Williams' advice of earlier today that 4/5 October was the likely date.
JF 22/9

NOTED.

MMC REPORT ON GAS

I understand from DTI that it has recently been decided that the MMC report on gas will now not be published until after the Party Conference. 19 October is the likely date.

M L WILLIAMS

Gold Fields

Consolidated Gold Fields PLC
31 Charles II Street
St James's Square
London SW1Y 4AG

23 September, 1988.

PERSONAL & CONFIDENTIAL

The Rt.Hon. Nigel Lawson, MP.
Chancellor of the Exchequer
11 Downing Street
London, S.W.1.

Dear Chancellor,

As you know, a Luxembourg-based shell company called Minorco controlled by South African interests has announced a takeover offer for Consolidated Gold Fields PLC (Gold Fields). This is the latest stage in a long running attempt by them to take control of us following a dawn raid in 1980 which was the culmination of secret stake building over a period of months.

We are resisting this bid strongly and are advising our shareholders to ignore it.

Gold Fields is a major British company. Our subsidiary, ARC, is one of the two leading producers in the United Kingdom of crushed stone products and concrete pipes. These products are vital to the construction industry and we employ some 9,000 people in the United Kingdom.

We are also the free world's second largest producer of gold and a major producer of other essential metals and minerals. We plan to be a major investor in privatised UK coal when that becomes possible, based on our major international coal mining expertise. If the South African bid succeeds, any potential involvement by us in privatised UK coal would almost certainly be ruled out for political and other reasons.

Telephone 01 930 6200 Telex 883071 Giovan G Facsimile 01 930 9677
Registered in England No. 36936 Registered office as above.

We also have direct energy investments in Britain via our 50% owned oil and gas subsidiary, Renown Petroleum Ltd., whose principal area of interest is the UK Continental Shelf. South African ownership will jeopardise these interests and certainly embarrass our partners.

Further information about us is set out in the enclosed profile.

We would welcome any help you can give us to make sure that all the complicated issues that underlie this bid are given proper consideration. Gerry Grimstone and I would like to come and see you privately to discuss this and tell you some of our future plans.

We are vital to Britain's strategic interests and must not fall under South African control.

Yours sincerely

Rudolph Agnew

R I J Agnew

fsec.jf/ln.tls/docs/3.26.9.

PERSONAL

FROM: FINANCIAL SECRETARY
DATE: 27 September 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Cropper
Mr Tyrie
Mr Call

MMC REPORT ON GAS

You will recall that I mentioned to you my concern about the MMC's report on British Gas. I have now had a look at the conclusions of the report.

I can see the force of the Commission's arguments. But in my view they are not indisputable. What is criticised bears a strong resemblance to the pricing policy which the Government (and probably Treasury Ministers) itself actively encouraged BGC to follow when publicly owned. There is also a curious contrast between electricity, where we have tried to encourage the industry to move away from uniform pricing and do more special deals, and gas, where we are seeking to impose greater uniformity. Incidentally, on BR, we seem to be about to urge them to exploit their monopoly power in order to raise commuter rail fares. Perhaps this will be condemned by the MMC when BR is privatised.

I am very concerned that it will be argued that we encouraged BGC to follow these practices; but are now prepared to overthrow them having sold the industry to 3 million shareholders.

I appreciate that officials are only guessing when they say that the BGC price could fall below the issue price. But this could do considerable damage to water and electricity sales. If we are now in a bear market, then the price could end up looking very sick.

fsec.jf/ln.tls/docs/3.26.9.

PERSONAL

I gather that publication of the MMC report has now been delayed until after the Party Conference. Would it be possible to consider implementing its recommendations gradually over a period of time? Perhaps that would be worse for shareholders. But either way, I do think we need to think about this carefully.

NORMAN LAMONT

pel.1b/SEP.88/min45

CONFIDENTIAL - MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 30 SEPTEMBER 1988

SIR PETER MIDDLETON

cc Chancellor
Financial Secretary
Mr Anson
Mr Monck
Mr Byatt
Mr Moore
Mr Houston
Ms Goodman - o/r
Mr Tyrie

MMC REPORT ON GAS

1. Following your meeting, we discussed some aspects of this report, and its handling with DTI.

2. It is clear that DTI officials will be strongly advising Lord Young to resist our proposed excision of the reference to BG's substantial profits, not least because it would be unprecedented to delete an expression of the MMC's views on public interest grounds. We have learnt, however, that any excision would be marked as such in the text with an asterisk, with a footnote referring to the fact that material had been excised and a reference to the section of the Act which allows it. Since an asterisk would draw attention to the Government's decision, which could not in turn be explained, it would, I suggest be undesirable to press DTI further. We would instead leave Lord Young to take his officials' advice.

(Correction made by Mr Williams)

3. It is also extremely unlikely that any attention will be drawn to the offending passage either in Lord Young's acceptance of the recommendations or in the related request to the OFT to put them into effect. The passage itself is in the middle of a very long concluding chapter; it does not appear near the report's recommendations; it is not in any way crucial to them; and no mention need be made of it in any comment or elaboration of the Government's acceptance. In these circumstances we conclude that the best way forward is to prepare defensive briefing for use when

the passage is subsequently discovered by the keen reader. We will cover this point in the wider briefing on the report that we will be putting in hand with other departments.

4. The Chancellor has asked for a note on two further points and for an annotated agenda for a meeting next week. I hope to submit these shortly.

M L WILLIAMS

cst.pas/mc/1.30

PERSONAL

FROM: MARK CALL
DATE: 30 SEPTEMBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Cropper
Mr Tyrie

MMC REPORT ON GAS

I saw Mike Williams' note of 16 September and, like the Financial Secretary, have misgivings about the MMC's argument. It's one thing to say that BGC must have transparency of pricing, and must avoid undue discrimination between customers. It's quite another thing to say they must derive a cost-related tariff. Most companies segment the market in order to serve optimally the range of customers they have, and to extract the maximum economic rent. In theory that's OK so long as its based on perceived product or service differences. In practice, the line between monopoly or oligopoly rent and 'fair' economic rent is difficult to draw, and a company's profit margin varies widely by product and customer. An assessment of the value to the customer of the service, and his ability to pay all in practice have some effect on pricing. Nobody gets too excited by the fact that retail or industrial customers with large purchasing power, eg Sainsbury's, get better terms. That is not only due to economies of scale, but the fact that they can beat down the suppliers' margin. Of course, in that case, there is some competition. But arguably there is some competition for BGC too, eg from imports.

2. For the MMC to combine their somewhat myopic view of gas pricing with the charge that a 5.3% return on CCA assets is 'very substantial' is disappointing to say the least.

3. Unless we can find a more robust regulatory framework for the forthcoming privatisations, utilities may become a hard sell.

MARK CALL

pel/lb/SEP.88/min48

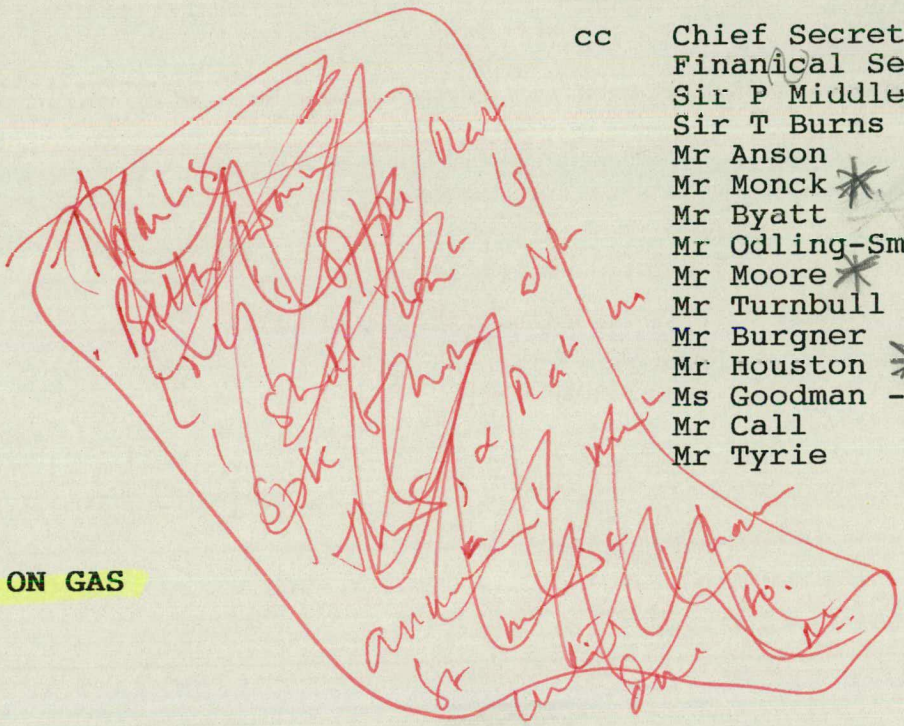
CONFIDENTIAL: MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 30 SEPTEMBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Odling-Smee
Mr Moore
Mr Turnbull
Mr Burgner
Mr Houston
Ms Goodman - o/r
Mr Call
Mr Tyrie



MMC REPORT ON GAS

I attach:

i. An annotated agenda for your forthcoming meeting on this report.

ii. A note by Mr Houston on the points made by the MMC about the rate of return (Mr Taylor's minute of 20 September).

M L WILLIAMS

pel.lb/SEP.88/min47

CONFIDENTIAL: MARKET SENSITIVE

MMC REPORT ON GAS

Annotated Agenda

1. Impact on share price

Likely criticisms

- Possible fall below issue price of 135p (price on 30.9.88 = 172; 12 month range 219-157) [NB: Price fall may be moderated if apparent that recommendations will be implemented over a period].

- "Betrayal" of Sid

- Implications for marketing of water and electricity

Possible defence

- BG will still be able to earn proper return for shareholders (as said in report). More competitive environment will improve efficiency. No need for Sid to sell.

- Must not assume large sustained sale in price inevitable. Market may have discounted MMC outcome to some extent. (Analysts (eg. Hoare Govett) marking the shares as undervalued for other reasons; if so, this is a counter to any further effects from MMC report).

- Shareholders in all regulated industries take risk eg, regulators' decisions on share price (notably in RPI-x revisions) and in all companies they take take risk of effects of competition policy.

2. BG privatised as a monopoly

Likely criticisms

- Government only interested in proceeds, not competition

- These discriminatory practices known about before privatisation (and discriminatory powers enshrined in legislation)

- BG's monopoly position protected its inefficiency (as evidenced by its modest overall rate of profit, despite monopoly profits in contract market)

Possible defence

- Clear in prospectus that contract gas market was subject to normal competition regime

- Indeed, MMC report vindication of competition regime put in place

- In electricity introducing competitive regime from outset (break up of CEGB, competition in generation, separation of grid)

- For water, same problems do not arise; monopoly businesses (water supply, sewage) regulated; other activities (leisure) in competitive environment.

3. Rate of Return

Impact of MMC's remarks about BG's "very substantial" profits

- Any reference in Lord Young's statement highly unlikely: not crucial to argument or implementation of recommendations

- Defensive briefing only (to effect that sentence is unsubstantiated, unclear precisely to what it applies, and no grounds for taking it as a considered view of general applicability)

Wider implications

- BAA case

- Nationalised industries pricing

- Rate of return on privatisation and of privatised industries

- Current work on required rate of return in the public sector.

peau.pp/gacdh/22/9/M(1)

CONFIDENTIAL - MARKET SENSITIVE

MMC REPORT ON GAS: RATES OF RETURN

This note responds to the Chancellor's request for further advice on the points made about rates of return in the MMC report, in particular on the read-across to the present position in other industries and what was currently proposed on the discount rate.

The MMC Comments

2. On the basis of BG estimates, MMC gave the 1987-88 current cost rate of return as 5.2% in the regulated tariff market, 7.2% in the firm contract (or 10.4% if all the profits and assets in the interruptible are ascribed to the firm contracts), making 6.1% overall.

3. Without any discussion of the cost of capital or appropriate returns to the shareholders, these profits were described as "very substantial for a company in its position". The MMC do not challenge BG's estimate that their recommendations would eliminate all £300m profits in the contract market, though they were dubious about the cost allocation between markets. This implies an overall return of 4.4% CCA. The Report says HC profits would fall "only to some 15%; such a return, although below the average for the UK, would not be out of line with that achieved by a substantial number of companies". The exclusive use of HCA figures when the MMC comments on the resulting profit levels is another aspect of the poor quality of this section of the report. BG have maintained CC main accounts and OFTEL are trying to shift BT to CC main accounts as being the appropriate basis for regulating monopolies.

4. The resulting loss of profits or final rate of return are not crucial to the MMC recommendation that BGs discriminatory pricing practices should be stopped. BG have not suggested they will withdraw from the contract market, ie the price schedules should provide adequate incentive to invest. The return to shareholders on new investment in the tariff market will be

regulated; the return on their existing capital depends on what they paid for the shares, not the current replacement cost of existing assets.

Other Industries

5. The immediate concern is for the precedent this level of analysis might set for other industries where MMC is the ultimate regulatory body: these are the first MMC pronouncements on appropriate profit levels in relation to a privatised utility.

a) **Privatised utilities**

- BAA profits in 87/88 were 9.4% CCA (10.3% at Heathrow). This is at the centre of the dispute with the US Government.

- BT CCA return was 8.5%. OFTEL recently agreed a toughening of the RPI-X formula, without specifically judging the appropriate return, but an earlier OFTEL study put BT's cost of capital at some 19% in nominal terms.

b) **Nationlised utilities**

- ESI CCA return 1987/88 was 2.4%, planned to rise to possibly 6% in 1990/91.

- Water CCA return 1987/88 was 2.3%, planned to rise to around 3% in 1990/91

- Letter Post return 1987/88 was 7.6%, with planned 11% in 1990/91

6. The main relevance of agreement on an appropriate return on capital for privatised utilities during the privatisation process is as a factor in determining the appropriate value of X in RPI-X formulae given limits on price rises before privatisation. Outside advice has not yet focused well on the cost of capital,

though an earlier figure was put forward of 7.5% real costs of equity for water, and 10% has been used for (conventional) electricity generation. (An 8% figure is being put forward by DEn as a minimal cost of capital for nuclear power in the Hinkley Inquiry).

The Public Sector Discount Rates

7. The current proposal is that trading bodies in the public sector should earn a real return on new investment of 8%. With appropriate asset valuation, this implies a target CCA profit rate of the same amount. This figure was based largely on a conservative estimate of future returns earned in private sector industry (the current actuals are over 10%).

8. It is proposed that even non-trading bodies should use a low risk cost of capital of 6%, combined with risk analysis: riskier projects would be expected to demonstrate a higher return.

9. The "allowed" return of 4.4% in the BG case is thus below the lowest figure being contemplated as the cost of capital in the public sector (and even below the current 5% rate). BG can hardly be described as risk free, and 4.4% is below even the estimated real cost of Government borrowing in current circumstances.

Personal

TELEPHONE: [redacted] 382 6000

120 CHEAPSIDE,
LONDON, EC2V 6DS

3 October 1988

Dear Chancellor

Congratulations on water! I have told the Electricity chairmen to lie low on their structure for the time being and let time take its course.

Quite separately, I am leading the Goldfields defence against Minorco. There are some unusual aspects of the bid in relation to the degree of insider trading that went on and its likely effect on the outcome of the bid, the market position it gives the Anglo empire in certain minerals, and the South African aspects. The attached note sets some of this out.

Without wanting to embarass you
or lobby you too directly, could
I come and see you privately
by myself for a few minutes
to talk about some of this?

Best wishes

Sonny Grinton

THE DEFENCE OF CONSOLIDATED GOLD FIELDS

This document summarises the non-financial arguments of our defence. The financial arguments will be covered in the official defence document.

I. THE BID RAISES CRITICAL AND COMPLEX ISSUES :

- The bid raises issues of both competition and the national interest.
- Minorco SA is South African controlled and part of the Anglo American/De Beers empire.
- The issues raised by control of Gold Fields moving to Anglo are complex and have wide-ranging international implications.
- Therefore, the issues deserve open discussion and independent, expert examination, for which time is needed.

II. THE MARKET IN GOLD FIELDS SHARES IS DISTORTED :

- The Anglo Group is well known for its secrecy and the creation of cartels.
- The Anglo Group first bought its major strategic holding in Gold Fields, now amounting to 29%, in 1980 by circumventing fair market practice and then existing Company Law. As a result, the law was changed.
- Minorco's current bid was preceded by a massive leak and an opportunity for insider dealing on a large scale. This leak can, by definition, only have come, however innocently, from the Minorco camp or its advisers.
- Given its existing 29% holding, Minorco became the major beneficiary of the subsequent market destabilisation through the flow of shares into the hands of speculative holders.
- The victims will be our long term and small shareholders.
- Minorco is located in Luxembourg, presumably for reasons of secrecy and tax avoidance; it is impossible for Gold Fields to establish the precise ownership of the company.
- Companies Act provisions have not been sufficient to enable Gold Fields to ascertain the underlying ownership of all its shares (including options) following the leaks.

III. DAMAGE TO GOLD FIELDS BUSINESSES :

- **South African control will have easily predictable adverse consequences for Gold Fields :**
  - ~ It will become harder to find business partners and sales will be damaged.
  - ~ The South African stigma will impede recruitment.
  - ~ The Company's competitive edge will be blunted.
  - ~ Thus, overall competition will be reduced through Gold Fields' inability to perform in the market place on an equal footing.
- **The damage to Gold Fields will be seen :**
  - ~ In the U.K., where South African control of ARC will stifle its commercial opportunities.
  - ~ In the U.S., where the CGF Group's current successes and future potential could be lost.
  - ~ In Australasia, where the involvement in the Porgera project will be compromised by South African control.
- **Minorco necessarily conducts its business under serious constraints :**
  - ~ Given that the major shareholders in Minorco are subject to South African Exchange Control this will constrain funding of expansion and investment through raising new equities.
  - ~ Anglo has successfully exerted control over a large stable of companies, in many cases even where it is only a minority stakeholder. Minorco will continue to be subject to this centralised control.

IV. COMPARATIVE TRACK RECORD OF GOLD FIELDS AND MINORCO :

- Minorco is a financial gypsy. Through a series of corporate restructurings, its effective domicile has moved from Zambia, via Bermuda to Luxembourg presumably for reasons of secrecy and tax avoidance.
- Minorco is a passive investment vehicle, not a natural resources operating company.
- A largely unsuccessful investment holding company is now attempting to emulate Gold Fields in moving away from passive minority investments to active ownership of operating subsidiaries.

- Gold Fields' success is the result of a dedicated strategy which has transformed the Company from a mining finance house to a focussed low-cost producer of selected natural resources.

- Minorco's management team lacks depth, and has no expertise in, or record of, finding and developing natural resources.

- The Gold Fields' team, by contrast, has already transformed the Company. Commitment to exploration and capital investment will ensure the continued growth and the development of new projects.

V. CARTELISATION OF WORLD MINERAL SUPPLY :

- **Commodity Cartelisation:**

  There is scope for price manipulation whenever a single dominant producer or a cartel exists. The role of De Beers, an Anglo Group company and a major shareholder in Minorco, in controlling the world diamond market is well documented. Minorco's bid could be a prelude to this in gold, platinum and strategic metals.

- **Gold :**

  - Anglo American and Gold Fields are the western world's two largest gold producers.

  - If the bid were successful, Anglo's share of the western world's gold supply would increase from 20% to 32%. This would raise serious competition issues about the domination of the free world's gold supply.

- **Platinum :**

  - If the bid succeeds, the enlarged Anglo American Group would dominate the western world platinum market with approximately 60% of production capacity.

  - This is of particular concern with regard to auto-catalytic applications for emission control. There are no substitute products.

- **Strategic Metals :**

  - If the bid succeeds, over two-thirds of the western world's zircon production and over half the production of high titanium dioxide feedstocks would be controlled by South African interests.

  - This is of particular concern given the use of zirconium and titanium in strategic, particularly nuclear, defence applications. There are currently no substitute products.

VI. POLITICAL PRINCIPLE AND PRECEDENT :

- If the bid succeeds, a dangerous precedent will have been set. The U.K. will be the only major Western country to allow South African interest to take control of a major company. Those who clamour for sanctions will have been given a major boost by the bid.

- Gold Fields has abided by HMG's request for British companies to refrain from committing new funds to South Africa. For the same Government to allow major inward investment by South Africa into the U.K. would both damage its moral stance, be contrary to the principles upheld by the rest of the western world and give South African companies an artificially protected platform from which to launch hostile bids.

VII. CONCLUSION :

This bid raises the complex and critical issues of fairness, competition, the national interest and greater South African control of U.K. companies and of the world's natural resources. Gold Fields believes in fair market practice and that shareholders should be allowed to take decisions about their ownership of the company on a fully informed basis. HMG must review and settle these issues if it is to retain credibility in its pursuit of fair markets and a level playing field.

These issues are of sufficient magnitude and urgency to warrant an immediate referral to the appropriate Government authorities in the U.K., the U.S. and Australia. Unless these Governments act quickly, the bid will have run its normal course, and control of Gold Fields could pass from the UK to South Africa.

pe1.jo/hcg/minute40

CONFIDENTIAL AND MARKET SENSITIVE

FROM: H C GOODMAN

DATE 7 October 1988

1. MR M L WILLIAMS

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Odling-Smee
Mr Moore
Mr Turnbull
Mr Burgner
Mr Houston
Mr Call
Mr Tyrie

Ch: PE appear to have drawn a distinction between general positive points, + specific Q+A stuff on the rate of return + profitability issues. I read para 3, below, as implying that they intend to press only for the first of these to be used in the announcement. Context with this? (The second bit 'which are flagged' above as "bill points" are I think rather good. But it may be provocative to make too much of them). JF 7/10

MMC REPORT ON GAS

At your meeting on Tuesday afternoon you asked officials for advice on the handling of the issues arising with wider implications for policy, in particular the MMC's criticism of the current BG rate of return and the potential impact on BG's profits of implementing the changes.

2. Mr Monck will be holding a meeting with Trade and Energy officials on Monday afternoon to co-ordinate the Government's response.

3. I attach briefing which makes positive points designed to divert attention from the awkwardnesses and could be in a Ministerial Statement or more probably for the press; and, also for use with the press, notes dealing with the rate of return and profitability issues and finally defensive Q and A briefing. The standard form of announcement for MMC reports issued by the Secretary of State for Trade and Industry allows some factual background notes. So the positive points might be woven into that. At the official meeting the possibility of using the DTI announcement positively will be raised with Lord Young's officials. We expect other departments will argue that the best

tactic for the Government is to avoid drawing attention to the paragraphs on profitability by volunteering a rejection of the MMC's remarks and to rely on defensive briefing.

4. It would be helpful, if possible, to have any comments on the issues in the attached draft brief before the official meeting with departments.

5. I attach as further background (not for briefing) a note by Mr Houston on the derivation of some of the figures.

H C Goodman.

H C GOODMAN

Positive Points

(1) The main recommendations not to discriminate in pricing; not to supply interruptible gas; and to publish a schedule of prices and information on common carriage terms should lower gas prices overall to the benefit of UK industry, and improve competitivenesss with the rest of the EC.

2. The removal of distortions to the competitive positions of BG's customers and the reduction of uncertainty should improve resource allocation, and the efficiency of the markets for and of gas customers. A notable supply side reform.

3. The measures designed to encourage new entrants will make the gas market more competitive.

4. Acceptance of the MMC's recommendations vindicates the Government's ~~of~~ privatisation and competition policies, making monopolies subject to market forces and maintaining pressure for increased efficiency.

5. Report emphasises that BG will be able to continue to operate its business satisfactorily and provide a reasonable return to shareholders.

[Paragraph references to Report]

1. Do you agree with the MMC's recommendations?

Yes. Accept main recommendations: to publish a price schedule for contract customers and not discriminate in pricing or supply; not to refuse to supply interruptible gas on basis of its use and available alternatives; and to publish further information on common carriage terms.

[On a number of detailed points implementation and 90% contracts for new gas fields have concerns over practical (implementation) but consult DEn for detailed explanation.]

2. Q What are the implications of the proposals likely to be for BG's profit and share price?

A (1) The result will be to bring forward the effect of increasing competition which BG, say would have occurred anyway [para 7.57] ie matter of timing and made the MMC's recommendations unnecessary. BG seem to have preferred these proposals to the alternative of separating transmission (paragraph 7.96)

(2) BG's maximum estimate of short term effect is less than growth in profits in last two years (Appendix 4.4).

(3) BG estimate effect could be to eliminate most of £291 million accounting profit from contract market (paragraph 8.55). Nature of calculation unclear. BG likely to have ways to minimize this figure in practice (paragraph 8.60) without exploitation of its monopolies. Costs can be reduced and lower prices

will stimulate more sales. The report quotes BG's estimate of the effect on profits, but the MMC does not give any estimate for the effect on profits after BG has responded to its recommendations.

(4) No suggestion that contract market will not continue to be profitable. Minimum cost-based prices (3.28) include normal profit on capital employed (eg 3.33). Contract sector busienss will not be jeopardised (8.59). Allocation of accounting costs between sectors is dubious and under study by OFGAS (8.25).

(a) true effect on profits ∝ (b)

(5) Fall in share price uncertain: depends on extent to which changes anticipated by market. As explained above no reason to expect permanent fall.

3. **Are BG's profits at 6% CC return on capital "very substantial" [paragraph 8.27]?**

Rates of Return

	All ICCs	Non-North Sea ICCs
1977	7.5	6.8
1978	7.9	7.1
1979	7.4	5.7)
1980	6.4	3.9)
1981	6.2	3.0)
1982	7.5	3.8)
1983	9.1	4.8)
1984	10.7	5.6)
1985	11.5	7.2
1986	10.0	8.9
1987	11.3	10.2

Source: British Business DTI

ch? CCA?

(a) **Privatised utilities**

- BAA profits in 87/88 were 9.1% CAA (10.3% at Heathrow).

- BT CAA return was 8.5%. OFTEL recently agreed a toughening of the RPI-X formula, without specifically judging the appropriate return, but an earlier OFTEL study put BT's cost of capital at some 19% in nominal terms.

(b) **Nationalised utilities**

- ESI CCA return 1987/88 was 2.4%, planned to rise to possibly 6% in 1990/91

- Water CCA return 1987/88 was 2.3%, planned to rise to around 3% in 1990/91

- Letter Post return 1987/88 was 7.6%, with planned 11% in 1990/91/.

(c) **MMC Report on Manchester Airport (earlier this year)**

Return expected in agreeing RPI - regime 15% over next few years. (MHCA effectively CCA).

1 Only if pressed on Government Rates of Return - Present required rate of return for nationalised industries is 5%. This was set in 1978 by comparison with private sector. Since then private sector returns have risen to over 10% Government aims explicit for RRR in Nationalised Industries.

2 BGs overall profit level (including tariff sector) was not subject of terms of reference. No analysis was put forward on appropriate criteria for rates of return. The report's focusing on BG's policy of price discrimination and its recommendations, are all directed at removing discrimination and promoting competition.

3. Overall profit levels mentioned only because of inadequacy of cost allocation and hence profit figures for contract market [paragraph 8.25].

4. Reference of remark that BGs profits are "very substantial for a company in its position" (paragraph 8.27) is unclear. The argument on monopoly profits in the contract market (the only one being reviewed) is given in the following paragraph) MMC checked that recommendation on price discrimination do not reduce profits so as to endanger viability.

5. It was not relevant to form a view on what rate of return is appropriate in the contract market since objective was to determine prices competitively. No view was given.

6. The allowable rate of return in the regulated tariff sector will be a matter to be considered when the RPI-2 regime is reviewed. No position is taken here.

7. A 6% CC return on a new capital is below the cost of capital for BG. OFGAS have not addressed this issue yet, nor has MMc report. OFTEL methods suggest around 10% for BT. Return on British industry is over 10%.

pe1.jo/hcg/minute36

8. Return to BG share holders depends on share price not on CC return however.

9. No conclusions can therefore be drawn from report on adequacy of profit rates in utilities generally.

pe1.jo/hcg/minute41

Defensive Q and A

1. **Is this a betrayal of Sid?**

Of course not

(a) As MMC say "price discrimination not ... necessary to generate enough profit to make the business viable" [paragraph 8.36] and "there is scope for implementation without prejudicing BG's ability to continue to provide a reasonable return to shareholders" [paragraph 8.28].

(b) An increase in profitable business volume in the contract market can be expected as prices fall. Competition should mean lower costs (eg on storage) and raise efficiency in the gas market overall, to the benefit of BG's profits.

(c) No reason why Gas should be an exception to competition law. Report demonstrates efficacy of Fair Trading regime. Prospectus specifically referred to contract sector being subject to general competition law [paragraph 8.17,. Prospectus p 32].

(d) Shareholders in all companies affected by competition policy and in regulated industries by decisions of regulators (notably in RPI - x revisions). [Make clear difference between buying shares and national savings.]

(e) Recommendations will merely bring forward in time changes which would have occurred anyway. "The expectation of the development of competition from other suppliers of gas was an important element of the regime established by the 1986 Gas Act. "[Paragraph 8.16] BG already reviewing policy when reference made [paragraph 8.16]. BG already reviewing policy when reference made [paragraph 8.19] and in course of

investigation BG made proposals which would have brought some benefits [paragraph 8.42 to 8.48].

(f) Ultimately the interests of shareholders and customers do not conflict. Shareholder best served by increased satisfaction and competitiveness of customer which can be expected to follow from these changes.

(g) Necessary to modify BG's Authorisation under Section 27 of the Gas Act because [redacted] work of OFGAS subject to MMC's authority.(DEn to supply detail)

2. **Why weren't these changes made before privatisation?**

[DEn to supply detail]

CBI agreed arrangements on privatisation

3. **What will be the effect of these recommendations on future privatisations especially water and electricity**

(1) Similar issues not likely to arise in these cases, where industries, natural monopoly elements apart, will be in more competitive environment at outset.

(2) For electricity: Competition will be introduced into generation with CEGB being split up and 12 separate distributors being sold; also expect competition to develop in electricity supply.

(3) For water: 10 separate water supply companies being sold: monopoly businesses to be regulated and other activities in competitive environment. Licences for industrial users for taking and discharging water will be available direct from the NRA. [Currently, twice as much water is taken under licences and these will no longer be administered by the W.As after privatisation.].

4. Do not regard MMC's comments on rates of return (see note above) as having any relevance to the appropriate rate of return in the water and electricity industry.

peau.pp/gacdh/7.10.M(1)

CONFIDENTIAL - MARKET SENSITIVE

MMC REPORT: LOSS OF PROFITS

This note gives further background on the calculations on the possible effect on BG's profit from the introduction of a schedule for firm contract prices and open access to interruptible gas.

DEn Estimates

2. The presumption is that the schedule will force BG to simulate the effect of competition and quote close to long run cost (including normal profit) in the medium term, though the state of the market will allow some fluctuation.

3. The report contains some estimates of onshore cost (Table 3.6), though none for offshore gas cost. The onshore gas costs are known to contain a normal profit (unofficially around 8%, but one can't quote). They are, however, odd, because they show storage costs of 5p therm as a deduction from interruptible costs, instead of an addition to firm costs. One effect of this is to imply that BG made large monopoly profits in the interruptible sector (about £100m): BG consistently deny this, and it is implausible given the HFO competition. If the 5p storage costs are added to the firm costs, this gives onshore firm costs of about 10.3p.th. Combined with 16p for offshore gas costs and compared with an average firm selling price about 31p, this yields the lower DEn estimate of £150m for excess profits (4½p.th.).

4. However, the offshore gas costs are very uncertain, and a current new gas cost could be nearer 13p.th. The 5p storage costs also seem rather high (they are based on Rough Storage field). On these grounds the overpricing is more likely to be doubled at some £300m.

BG Estimates

5. BG do not give details of their estimate of the effect of the proposals, the "virtual elimination" of the £291m contract sector profits. The calculation of the financial effects would be "complex" (7.78). It appears to assume some withdrawal from the firm market, costing around £150m (7.69), as well as higher prices and smaller sales in the interruptible market, costing around £150m (7.17). A decrease in offtake of cheaper take-and-pay gas was envisaged raising average gas costs, including to the tariff market (7.69). MMC comment that these costs would be reduced in later years.

Longer Term

6. Lower prices for firm gas (-30%?) should lead to higher sales and some recovery in profits, but this might take some years. BG suggestion of loss of firm sales seems paradoxical. Some withdrawal from the interruptible market may be economic, even at present. Quantification of the effect on profits is not possible.

arguments are not correct, and that the requirement to introduce a price schedule for contract customers would be consistent with the provisions and intention of the Gas Act.

8.65 We therefore recommend that BG be required to publish a schedule of prices for firm and interruptible gas at which it is prepared to enter into special agreements with contract customers. This schedule would relate prices to characteristics affecting the supply of gas, such as volume or rate of consumption, load factor and extent of interruptibility and could also incorporate different charges according to the contract terms agreed - for example, for contracts of different duration, or with arrangements for indexation - provided that similar terms were available to all other contract customers. However, the schedule would not relate prices to factors characterising individual customers' willingness to pay, such as [purpose of use or] ability to use alternative fuels (with the exception discussed in paragraph 8.72). The level and structure of prices incorporated within the schedule would be a matter for BG to decide in the light of market conditions. BG could change the schedule as and when it deemed this appropriate, subject to notifying the Director General in advance. The Director General however should ensure that frequent changes were not used to circumvent the purpose of the schedule in order, for example, to secure a particular company's business. We recommend that such a schedule should be introduced by the beginning of BG's next financial year.

chex.nh/aa/41 **RESTRICTED**

FROM: A C S ALLAN
DATE: 7 October 1988

NOTE FOR THE RECORD

cc Sir P Middleton
Mr Monck

CONSOLIDATED GOLD FIELDS/MINORCO

Mr Rudolph Agnew and Gerry Grimstone called on the Chancellor at 6 pm on Thursday 7 October.

2. Mr Agnew explained the history of Minorco's earlier purchases of Consolidated Gold Fields shares; those shares had led to an Inspector's report which had said that Minorco had gone out of its way to circumvent the Takeover Panel rules. Agnew was now very concerned about the insider trading that had taken place before the recent bid was announced: there had been a large build-up in options starting in mid August which had led to perhaps 5 per cent of the company's stock being shaken loose: that was a significant amount when Minorco needed only a further 21 per cent to obtain control.

3. Mr Grimstone said that Consolidated Gold Fields were pressing hard for an MMC reference, and for Inspectors to be appointed. Speculative holdings were being encouraged by rumours from Johannesburg that Minorco would increase its offer by £2; if the appointment of Inspectors was announced that would shake loose some of these holdings. Even though they would then be in the market, that was preferable to them being held by arbitrageurs.

4. Mr Grimstone said that Consolidated Gold Fields had put in a strong paper to the OFT, concentrating on the dominant position the merged company would have in the gold market, and particularly in strategic minerals such as titanium and zirconium; Anglo had a long history of involvement in cartels. Consolidated Gold Fields would also be putting in a strong financial defence next week. He thought that if the bid were referred to the MMC,

Minorco would sell, since the Oppenheimer interests would not be keen on an investigation.

5. The issue was urgent, and Consolidated Gold Fields were concerned that DTI did not understand the market dimensions. As soon as Minorco were allowed to under the takeover code, they would be in the market buying Consolidated Gold Fields shares: since they only needed another 20 per cent, that might be achieved on the first day. Consolidated Gold Fields were trying all the usual routes, including talking to DTI, the Stock Exchange and the Takeover Panel and considering whether there were any likely and suitable white knights.

6. The Chancellor said he had listened to what Mr Agnew and Mr Grimstone had said. It was not his responsibility, and he had not discussed this with Lord Young, but he was sure Lord Young would understand the market dimensions, and the case for an early decision on whether or not to refer the bid to the MMC.

ACSA

A C S ALLAN

22/96 PS/Chancellor cc Sir P Middleton Mr Moore Mr Williams Mr Matthews Mr O'Brien Smee Mrs Brown

This has just arrived. On privatisability para 16 is significantly weaker than Mr Lieser, in agreement with me, tried to get but it is better than nothing.

DTI have now given you CONFIDENTIAL the briefing together, which we agreed the broad line on Monday and I attach (top only) the Treasury contribution on privatisability. Publication may slip because of the new point in para 14. MM 14 Oct.

SECRETARY OF STATE

It has slipped (Mr Williams note in your personal folder)

JR 14/10

NOTE!

MONOPOLIES AND MERGERS COMMISSION REPORT ON THE SUPPLY OF GAS THROUGH PIPELINES TO NON-TARIFF CUSTOMERS

INTRODUCTION

In this submission I advise you under Section 86 of the Fair Trading Act, in the absence of the Director General of Fair Trading (DGFT), on this report on a monopoly reference to the Monopolies and Mergers Commission (MMC). This submission has been agreed with the Office of Gas Supply (OFGAS) and its recommendations are endorsed by the Director General of Gas Supply.

2. Under the Gas Act 1986, British Gas (BG) must supply customers consuming less than 25,000 therms of gas per annum (tariff customers) at prices set by a published tariff, but it is free to supply larger consumers (contract customers) at negotiated prices subject only to a published maximum. The MMC report relates only to supply to contract customers, of whom there are 21,000 and who are largely industrial or commercial users (but who also include for example schools and hospitals).

3. The Commission have found adverse effects, which operate against the public interest, of BG's actions in relation to its contract customers; these exploit or maintain the monopoly situation BG enjoys as the only "public gas supplier" at present authorised under the Gas Act 1986. They make recommendations to remedy these adverse effects.

4. I recommend that you should accept the MMC's findings and recommendations, subject to the qualifications explained in paragraphs 12-16 below.

BACKGROUND TO THE REFERENCE

5. The DGFT's reference to the MMC was made following strong and widespread complaints from BG's industrial and other contract customers about its pricing and supply policies, some of which were also taken to the EC Commission. These complaints are summarised in the Annex.

...

THE COMMISSION'S REPORT

6. The report confirms the strong dissatisfaction of BG's business customers. It shows that gas, almost all of it supplied by BG, now accounts for 46% of all energy consumed in the UK, and 35% of that consumed by industry. Of BG'S supply to contract customers, about half is "interruptible": that is it can be cut off at times of peak demand. The

DFSAAJ

remainder is "firm": continuity is guaranteed and the price is higher.

7. The report shows that interruptible gas is priced to compete with heavy fuel oil (the cheapest oil product) but is available only on restrictive conditions (see paragraph 11(b) below). Firm gas is priced on what BG describe as a "market related" basis. What this comforting phrase means however is that firm customers, having chosen gas as a fuel, and having equipped themselves accordingly, are categorised according to the difficulty they would have in switching to alternative fuels: and the less choice they are thought to have, the more they pay.

8. This striking policy, which BG has followed under both public and private ownership, amounts to exploiting its monopoly to the utmost extent that the varying circumstances of each of its contract customers will permit.

9. The Commission explain that the Oil and Gas Enterprise Act 1982 and the Gas Act 1986 sought to stimulate competition by providing for the carriage by BG of gas on behalf of third parties, as a "common carrier". But they show that these enabling provisions have remained almost entirely a dead letter, notwithstanding a provision for the Director General of Gas Supply to arbitrate disputes on the terms of common carriage.

THE COMMISSION'S FINDINGS AND RECOMMENDATIONS

10. The Commission consider that the only entirely effective means of remedying the adverse effects of the present monopoly situation is the development of direct competition in gas supply. Some of their recommendations are designed to encourage this. But they recognise that it will be a slow job, and also make recommendations to restrain BG's discriminatory policy in pricing and supply in the meantime. They explain that this restraint on discrimination is necessary to permit the emergence of a competitive market.

11. I summarise below and comment upon the seven particular facts found by the Commission to operate against the public interest: and the remedies they propose. The legal position on these is that if you accept an adverse finding by the Commission you are free to take any action within the scope of the Fair Trading Act to remedy that adverse effect. You are not bound to follow the Commission's recommendations:-

(a) BG's policy of extensive discrimination in the pricing of firm gas. To remedy this BG should be required to publish by the beginning of their next

financial year a schedule of prices for both firm and interruptible gas; and should be required not to discriminate in pricing or supply.

Comment: in the short term, this is the heart of the matter, and I recommend you to accept the Commission's proposal. It should greatly reduce BG's ability to price selectively in order to quell the emergence of competition. There must be some doubt whether such a schedule could always prevent BG from granting selective discounts when they thought this necessary in order to smother incipient competition. But OFGAS believe they could ensure that the published schedule was generally observed. (For the role of OFGAS in implementing these recommendations see paragraphs 18-19 below).

(b) BG's practice of refusing to supply interruptible gas to most firm users. To remedy this BG should be required not to refuse to supply interruptible gas to any user on the basis of the use made of the gas, or of the alternative fuel available.

Comment: I endorse this recommendation. It is inherent in the requirement not to discriminate. It should be for the customer to decide whether to accept the risk of interruption in exchange for a lower price.

(c) BG's special pricing policy for gas in Combined Heat and Power (CHP) schemes. To remedy this BG should be required to supply interruptible gas for such schemes on the same basis as to any other user.

Comment: I endorse this recommendation. It appears that gas-fired CHP schemes will become of increasing importance after the privatisation of the Electricity Supply Industry.

(d) BG's insistence on contract conditions which do not aggregate the quantities of gas supplied to users with several premises: which specify the use to which gas is to be put: and which require users of interruptible gas to have facilities for using alternative fuels. The remedy in each case is that BG should be required to abandon these contract conditions.

Comment: these are less vital recommendations, but they deserve your support.

(e) BG's failure to provide adequate information on its charges for common carriage (CC). To remedy this they should be required to publish the principles they use in calculating CC terms, in sufficient detail to put a potential customer in a position to make a reasonable estimate of the CC charges he would incur.

Comment: this and the following recommendation are for the longer term. I believe they are essential if a competitive supply is to emerge. They aim to breathe life into the CC concept. BG is already required to provide such guidance, but has done so only in perfunctory terms: and potential CC users are left without sufficient guidance.

(f) BG's ability to use information obtained when negotiating CC terms for its own commercial purposes. The remedy is that BG should be required to guarantee the confidentiality of such information.

Comment: it is hard to know how serious a deterrent this fear may have been, or how effective the remedy would prove. "Chinese walls" do not always command confidence. But I agree that all practicable steps should be taken to remove obstacles to the negotiation of CC contracts.

(g) BG's position as a dominant purchaser of gas. To remedy this BG should be required not initially to contract for more than 90% of deliveries from any new field within the UK Continental Shelf, nor to contract for the balance of such a field within two years of the date of the initial contract.

Comment: this is the crucial recommendation if a competitive market is to develop. See paragraphs 12-16 below.

MAKING COMMON CARRIAGE WORK

12. Strictly, the Commission's adverse finding on point (g) above is outside its terms of reference, which refers to the supply of gas but not the purchase of it. You therefore cannot accept this adverse finding. However this need not affect your acceptance of their recommendation at (g), which is a valid remedy for the adverse effects, which the Commission have properly specified, of BG's monopoly in the supply of gas.

13. And indeed I recommend you accept it, though with one important qualification set out in paragraph 14 below. The

CC provisions in the 1982 and 1986 Acts are purely permissive, and they have not yet worked. This is in some ways surprising, since the oil companies producing gas in the North Sea have long held that they could sell their output more advantageously but for BG's monopoly as a purchaser. The fear must be that, nothwithstanding that the CC provisions in the legislation have now provided them with a means of doing so, each of them has shrunk and may continue to strink from grasping this opportunity, lest they jeopardise their relations with BG and mark themselves out for some form of commercial retaliation. On this point both the Commission in their report, and the Director General of Gas Supply, have made their anxieties very plain. It is eloquent that so few North Sea gas producers were willing to give evidence to the Commission (see paragraph 8.92 of the Report) and that of the five who did,three asked for their anonymity to be protected. I therefore agree with the Commission that, nothwithstanding their recommendations at (e) and (f) above, CC arrangements will probably not become a reality on any scale, and competition in the supply of gas will probably not develop substantially, so long as BG is allowed to purchase all the gas coming forward from all new fields: and further that if 10% of the gas from the new fields had to be transmitted on a CC basis and sold independently of BG, a competitive market would have a chance of developing. The process would be slow: 10% of the gas from new fields would at first be a tiny proportion of the total supply: but in the course of years it would build up.

14. However there is I believe a technical flaw in the Commission's recommendation on this point. I do not believe a competitive market would develop as the Commission intend if the bar on BG's purchasing the whole output of each new field lasted only two years. BG would find that too easy to circumvent. It could, for example, offer contracts under which it would buy 90% of the output of a field immediately and 100% two years forward, or in other ways make it unattractive to the producers to market direct. Thus it seems unlikely that a competitive market will develop in practice unless BG is indefinitely barred from buying 10% of the output of each new field as it comes forward. The 10% would then have to be sold on terms which involved BG as a common carrier but not as a principal.

15. However I do not ask you to decide this firmly at this stage. It would be preferable for the Director General to consult gas suppliers and users, and to advise you further by the end of the year whether the 90% ceiling should be temporary or indefinite, and if temporary, how long it should continue after each new field has come on stream. What I recommend you to decide and announce now is that:-

(a) BG should be precluded as the Commission have recommended from contracting for more than 90% of deliveries from any new field;

(b) How long this bar should last in the case of any new field will be the subject of further advice to you from the Director General by the end of the year;

(c) In the light of his advice you wish to consider whether the 90% ceiling for any given field should last indefinitely.

BG'S PROFITABILITY

16. The Commission express the view (paragraph 8.27 of the Report) that "BG's profits are very substantial for a company in its position". They do not detail their reasons for this view, or specify the criterion on which it is based, and it does not appear among their formal findings. They say BG's current cost rate of return is just over 6% on the whole of their business: but on their contract business almost 10½%. For comparison, the real rate of return earned in British manufacturing industry in 1987 was 9%. The Commission recognise (paragraph 1.7) that their recommendations will probably reduce BG'S profitability, "to the extent that its profits on contract gas have relied on discrimination". They give no estimate of the extent of this reduction. However they make clear that the reduction of profits is not the purpose of their recommendations but a probable consquence of them.

17. I agree with the Commission that the removal of discrimination, and hence the removal of that element of present profit that is dependent on discrimination, is essential to pave the way for the emergence of a more competitive market.

IMPLEMENTATION

18. The Commission's recommendations (a) to (f) in paragraph 11 above can all be implemented through an amendment to BG's Authorisation under Section 27 of the Gas Act 1986. It would then be the responsibility of the Director General of Gas Supply to monitor and enforce the amended Authorisation.

19. BG's Authorisation can be modified either:-

(a) by agreement between BG and the Director General of Gas Supply, or

(b) failing that, by Order, which it would be for you to make, under Section 56 of the Fair Trading Act.

I recommend that the Director General of Gas Supply should in the first instance be invited to seek BG's agreement to the necessary modifications to the Authorisation. It would be well if your announcement made it clear that Order-making powers are available for the purpose if agreement is not forthcoming.

20. The Commission's recommendation at (g) in paragraph 11 above, concerning a 90% ceiling on purchasing of gas from new fields, cannot be implemented by a change in BG's authorisation. It would require either an undertaking from BG, or failing that an Order under Section 56 of the Fair Trading Act. I recommend you to request the Director General of Fair Trading to consult and advise you further by the end of the year, as in paragraph 15 above. In the light of his further advice you would then request him to obtain an undertaking from BG, the extact terms of which you would decide at the time.

SUMMARY OF RECOMMENDATIONS

22. I therefore recommend you:-

(i) to accept the Commission's findings (a) to (f) in paragraph 11 above, but not finding (g);

(ii) to accept all the Commission's recommendations subjec to (iv) below;

(iii) to invite the Director General of Gas Supply to seek BG's agreement to modifications to its Authorisation, in the sense indicated in paragraph 11 above;

(iv) to request the Director General of Fair Trading to advise you further by the end of the year, as in paragraph 15 above, on whether a 90% ceiling on BG's purchasing of gas from any new field should be subject to a time-limit, and if so what time-limit;

(v) if you accept these recommendations, to announce your decision in terms that make clear that Order-making powers will be used failing agreement; and that your acceptance of the 90% ceiling is a firm decision, and that only its duration is subject to further consultation.

A J Lane
Deputy Director General of Fair Trading

14.10.88

DFSAAJ

ANNEX A

BACKGROUND TO REFERENCE

1. The DGFT referred BG's monopoly to the MMC in November 1987 for investigation in the light of heavy complaint from BG's contract customers about its pricing and supply policies. These complaints were about the terms on which BG supplies both "firm gas" (ie guaranteed continuous supply) and "interruptible gas" (ie supply, at lower prices than firm gas, which can be temporarily cut off at times of peak demand on up to 63 days per annum). The DGFT was particularly concerned at:

a The difficulty to customers of estimating future costs because there was no clear basis for individual gas prices, and no clear relationship with the prices of alternative fuels;

b Wide differences in prices paid by customers with similar requirements and levels of consumption;

c The shortness of contractual periods (typically three months or less) which exacerbated the uncertainty about costs resulting from lack of price transparency;

d BG's unwillingness to quote prices for interruptible gas supply unless the customer had installed dual firing capacity, which both made it difficult for the customer to assess whether the cost of dual firing plant would be worthwhile and denied him the option of closing down, when gas supply was interrupted, rather than switching to an alternative fuel.

2. At the same time as the reference was made, two complainants (Sheffield Forgemasters Group and the Energy Intensive Users Group) also complained to the European Commission (DGIV) that BG's excessive prices, lack of price transparency, and restricted access to interruptible gas were abuses of dominant position under Article 86 of the Treaty of Rome. DGIV officials decided to proceed slowly with their own enquiries pending the conclusion of the MMC's investigation. They have a particular interest in the outcome because of similar complaints from Germany and France. However, DGIV may be reluctant to pursue any of them because of the difficulty of proving that the practices complained of have an appreciable effect on trade between Member States. Provided that the two UK complainants are satisfied with action taken to implement the MMC's recommendations, further action by DGIV seems unlikely.

DISTRIBUTION LIST:

PS/Secretary of State for Energy

PS/Parliamentary Under Secretary of State for Corporate Affairs

PS/Sir Brian Hayes, Permanent Secretary, DTI

Mr H Liesner, Chief Economic Adviser, DTI

Mr R E Allen, CP1/DTI

Ms A Scrope, CP1c/DTI

Mr N Monck, Treasury

Mr D R Davis, D En

Director General of Gas Supply

Deputy Director General, OFGAS

PS/Director General of Fair Trading

Dr M Howe, CP/OFT

Mr R Woolman, Legal/OFT

Mr D W Lightfoot, CP2/OFT

Dr A Marshall, CP1/OFT

Mr D Elliott, Econ/OFT

Mr H Emden, CP2 International/OFT

Mr P Cahill, CP2a/OFT

ARE BG's PROFITS AT 6% CURRENT COST RETURN ON CAPITAL "VERY SUBSTANTIAL" [PARAGRAPH 8.27]?

Line to take

Relevance of report's remarks unclear. The report was about BG's contract market, no conclusion can be drawn on appropriate rate of return for a regulated activity or for utilities generally.

Factual: comparable rates of return

(a) Industrial and Commercial Companies

	All ICCs	Non-North Sea ICCs	
1977	7.5	6.8	
1978	7.9	7.1	
1979	7.4	5.7	)
1980	6.4	3.9	)
1981	6.2	3.0	) *
1982	7.5	3.8	)
1983	9.1	4.8	)
1984	10.7	5.6	)
1985	11.5	7.2	
1986	10.0	8.9	
1987	11.3	10.2	

* NB less than 6%; use only if pressed

Source: British Business DTI

(b) Privatised Utilities

- BAA CCA return in 1987-88: 9.1% (10.3% at Heathrow)

- BT CCA return in 1987-88: 8.5%

(c) Nationalised Utilities

- ESI CCA return 1987-88: 2.4%; will rise to 4.75% in 1989-90

- Water CCA return 1987-88: 2.3%; similar return expected for 1988-89

- Post Office (excluding Girobank) CCA return 1987-88: 4.9% [in 1988-89 affected by strike]

(d) MMC Report on Manchester Airport (November 1987)

Return expected by MMC in agreeing the RPI-X regime now applied to the Airport: 15% over next few years (MHCA effectively CCA).

Defensive

1. Only if pressed on public sector rates of return - present required rate of return for nationalised industries is 5%. This was set in 1978 by comparison with private sector. Since then private sector returns have risen to over 10%. Government reviewing implications of this rise for RRR in Nationalised Industries

2. BG overall profit level (including tariff sector) was not subject of terms of reference. No analysis was put forward on appropriate criteria for rates of return. The report focuses on price discrimination by BG in contract market and its recommendations are all directed at removing discrimination and promoting competition

3. Overall profit levels mentioned only because estimates of profit figures for contract market alone depends on uncertain allocation of costs (paragraph 8.25). Cost allocation methods currently being considered jointly by BG and OFGAS

4. Relevance of remark that BGs profits are "very substantial for a company in its position" (paragraph 8.27) is unclear. The argument on monopoly profits in the contract market (the only one being reviewed) is given in the following paragraph (8.28). Back check by MMC on recommendation on price discrimination to ensure that profits not so reduced as to endanger viability

5. Prices in the contract market are, under the MMC's recommendations, to be determined competitively. That will allow normal rate of return; but not relevant to form a view on what that rate of return should be, and no view was given

6. MMC did not consider regulated tariff sector. The rate of return there will be one of the issues to be considered when the RPI-2 regime is reviewed by OFGAS in 1992.

7. A 6% CCA return on new capital is below the cost of capital for BG. OFGAS have not addressed this issue yet, nor has MMC report. OFTEL methods suggest around 10% for BT. Return of British industry is over 10%.

IMPACT ON OTHER PRIVATISATIONS

(1) General

Similar issues not likely to arise in these cases. Where industries have monopoly element that will be fully regulated (as for gas tariff market). Otherwise they will be in a competitive environment at the outset.

(2) Electricity [DEn to complete]

(3) Water

(i) 10 separate companies being sold. Their water supply and sewerage activities will be regulated; other activities (eg, leisure) in what is already a competitive environment.

(ii) Industrial users will have option whether to take and discharge water from rivers themselves under licence by the National Rivers Authority (ie the public sector body that will be retaining current water authorities' responsibilities other than supply and sewerage) or to deal through water supply company. (Industrial use under licence currently accounts for about two thirds of water use).

(4) Steel [DTI to complete]

pel.lb/OCT.88/min33

CONFIDENTIAL- MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 14 OCTOBER 1988

MR MONCK

cc PS/Chancellor
PS/Secretary (Financial)
Sir P Middleton
Mr Anson
Mr Byatt
Mr Moore
Mr Turnbull
Mr Burgner
Mr Gieve
Mr Houston
Ms Goodman
Mr Call
Mr Tyrie

MMC REPORT ON GAS

I have just heard that DTI have come to the conclusion that they will not be ready to publish the MMC report on 19 October. They need more time to assimilate the advice of OFT (in particular in respect of implementation of the report's recommendations).

2. The expected publication date is now 26 October.

M L WILLIAMS

pel.lb/OCT.88/min38

CONFIDENTIAL - MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 17 OCTOBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Odling-Smee
Mr Moore
Mr Houston
Mr Gieve
Ms Goodman
Mr Call
Mr Tyrie

Ted

Chx
Content with PQ?

(Incidentally 'X', Hayes, did not appear in the earlier version of the briefing which you approved).

17/10

MMC REPORT ON GAS

It now looks likely that this report will be published this Wednesday, 19 October.

2. I attach a copy of Lord Young's proposed PQ reply. This reply has been agreed inter-departmentally, and will be put to Lord Young this evening. DTI officials have agreed to meld some of the positive briefing points into the body of Lord Young's statement; see in particular the top of page 3, and the final paragraph. In the press announcement, which is arguably more important from the presentational point of view, the third page of the reply will be brought forward, and follow a brief introductory paragraph.

3. There was some doubt as to whether we could publish on Wednesday because of disagreement between OFT and DEn about the implementation of the MMC's recommendation that BG should not initially contract for more than 90% of deliveries from any new field within two years of the date of the initial contract. The OFT believe that there should be no two years limit if this recommendation is to be made effective. DEn (and Mr Parkinson), on the other hand, are concerned that new fields would be put at

risk if the implementation of the recommendation was burdensome for the oil companies. It is generally agreed that it would be difficult to come to a firm conclusion until the oil companies had at least been consulted; but at the same time we do not want to give BG any comfort that we are backsliding on this recommendation. The trick was to agree a form of words that is positive on the principle, but leaves open the details. The penultimate draft of the attached reply is the result.

4. In view of the limited time now available, Lord Young will not be able to consult colleagues; although he will probably write round for information. If you do have any outstanding points of concern, it would be helpful to have them on Tuesday morning, so that I can relay them to DTI. Unless they hear anything to the contrary, the report will be released to British Gas at noon on Tuesday, to give them a clear 24 hours before Lord Young's statement.

5. I attach a copy of the latest version of the draft brief. This takes account of our concerns expressed at the meeting that Mr Monck held. But it is still subject to minor amendment.

M L WILLIAMS

dti

the department for Enterprise

CONFIDENTIAL AND MARKET SENSITIVE

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

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

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

CH/EXCHEQUER
REC. 18 OCT 1988 18/10.
ACTION MR M L WILLIAMS
COPIES TO CST, FST, EST, SIR P MIDDLETON SIR T BURNS, MR ANSON MR MONCK, MR BYATT MR ODLING-SMEE MR MOORE, MR HOUSTON MR G. EVE MS GOODMAN, MR CALL MR TYRIE

Direct line 215 5422
Our ref PS6AOT
Your ref
Date 18 October 1988

Ch.
Ans. Mr is as you said in draft (including changes suggested by Mr Williams).
18/10

Dear Nigel,

MMC REPORT ON GAS

I intend to announce by arranged question in both Houses on Wednesday, 19 October the publication of the Monopolies and Mergers Commission report on the supplying of gas through pipes to persons other than tarrif customers. I enclose a copy of the draft answer.

You will note that I have accepted the Director General of Fair Trading's advice that I accept the MMC recommendation on pricing and contract terms and on the provision of information on common carriage terms. I have also accepted the Director General's advice that the remedies be implemented by agreement. I will use my order-making powers only if necessary.

The most controversial of the MMC's findings is that British Gas' position as the dominant purchaser of gas may be expected to operate against the public interest by deterring entry by new suppliers of gas. As this is outside the MMC's terms of reference, I may not accept this finding. Nevertheless I intend to act upon the consequential recommendation as it is fundamental to remedying the MMC's other adverse findings - others cannot compete with British Gas in this market unless they too can get supplies. The MMC recommended that British Gas should be required not initially to contract for more that

dti

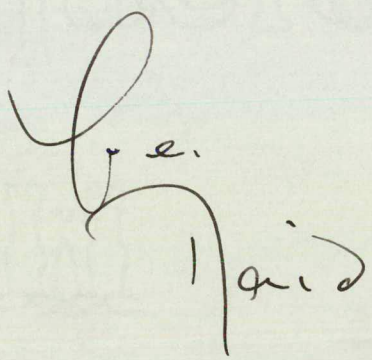
the department for Enterprise

CONFIDENTIAL AND MARKET SENSITIVE

90 per cent of deliveries from any new field within the UK continental shelf nor to contract for the balance within two years. However, the Director General of Fair Trading considers that the bar should run indefinitely. I know that this causes Cecil concern. For my part, I am most anxious that the remedy should encourage others to enter into competition with British Gas. Therefore I intend to ask the Director General of Fair Trading to consult interested parties with a view to advising me by end-January on a scheme that should succeed in meeting the objective of effective competition in gas supply.

I expect press comment to be favourable for the most part although there may be questions as to whether "Sid has been betrayed". I think it unlikely that attention will focus immediately on the MMC's unfortunate comments about British Gas' profitability. However we must, of course, be prepared. Our officials have therefore collaborated in preparing defensive briefing.

I am copying this letter to the Prime Minister, the Secretary of State for Energy, the Director General of Fair Trading and Director General of Gas Supply.



the Enterprise initiative

HOUSE OF LORDS

ANNEX A

CONFIDENTIAL AND MARKET SENSITIVE UNTIL 3.30 PM ON WEDNESDAY 19 OCTOBER 1988

DRAFT ARRANGED PARLIAMENTARY QUESTION

Q. To ask the Secretary of State for Trade and Industry when the report of the Monopolies and Mergers Commission on the supply of gas to non-tariff customers is to be published, and if he will make a statement.

A. The report is published today, following a reference to the Commission by the Director General of Fair Trading in November 1987. In its unanimous report, the Commission found extensive discrimination by British Gas in the pricing and supply of gas to contract customers. They concluded that this practice operated against the public interest. The Commission made four main recommendations which it felt would encourage competition in the supply of gas, and restrain BG's discriminatory policy on pricing and supply of gas. The recommendations were that BG should be required:

[This bit is spread out over two sentences as proposed in the earlier draft]

- to publish a price schedule at which it is prepared to supply firms and interruptible gas to contract customers, and not to discriminate in pricing or supply;

- not to refuse to supply interruptible gas on the basis of the use made of the gas, or the alternative fuel available;

SLOABU

- to publish further information on common carriage terms;

- to contract initially for no more than 90 per cent of any new gas fields.

One of the main findings was that BG's policy of price discrimination imposed higher costs on customers less well placed to use alternative fuels, or to obtain them on favourable terms, thus placing an arbitrary cost disadvantage on these customers. In addition, BG's policy of relating prices to those of the alternatives available to each customer placed it in a position to undercut potential gas suppliers, which may be expected to deter new entrants and inhibit the development of competition in the market. Its refusal to supply interruptible gas to some customers also imposed additional costs on those users.

The Commission also concluded that BG's failure to provide adequate information on the costs of common carriage, its ability to identify potential customers of competing suppliers and the potential source of gas, and its position as a dominant purchaser of gas may all be expected to deter entry into the market.

SLOABU

I welcome this report. The MMC's recommendations offer a sound basis for encouraging the development of effective competition in the supply of gas to contract customers. I am asking the Director General of Gas Supply to seek agreement with British Gas to modifications to British Gas' authorisation so as to effect remedies relating to British Gas's pricing and contract policies in the supply of gas to large users, and also relating to the provision of information on its common carriage terms for transmission of gas. If satisfactory arrangements cannot be made by agreement, I have powers to remedy the adverse effects by order under the Fair Trading Act.

In order to encourage the emergence of other suppliers of gas to industrial users, I consider that it is essential that a reasonable percentage of the output of new gas fields should be available to suppliers other than British Gas. I have asked the Director General of Fair Trading to consult interested parties on the basis of the MMC's recommendations, with a view to proposing by 31 January 1989 a scheme which will make it easier for others to buy gas from developers of gas fields. In particular, I have asked him to advise me whether the requirements under such a scheme should be subject to a time limit, and if so what the limit should be. I will then consider the position further.

SLOABU

I believe that these measures will remove distortions in the gas market with consequential improvements to resource allocation and efficiency. The remedies are designed to encourage new entrants into the industrial gas market thereby accelerating the development of competition.

SLOABU

pel.lb/OCT.88/min40

CONFIDENTIAL - MARKET SENSITIVE

FROM: M L WILLIAMS

DATE: 17 OCTOBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Odling-Smee
Mr Moore
Mr Houston
Mr Gieve
Ms Goodman
Mr Call
Mr Tyrie

Ch. Content to write? With sq. bracketed sentence?

MMC REPORT ON GAS

Lord Young has now written with his proposed statement on the MMC report, which will be published at 3.30pm on Wednesday.

2. The text is the same as I circulated last night, subject to some minor amendments (marked on your copy only). It is therefore acceptable.

I have marked these on top copy, behind.

3. In his letter, Lord Young notes the concerns of both DGFT and Mr Parkinson about the implementation of the recommendation concerning purchases of new gas supplies. He also acknowledges your concerns, which we have emphasised to DTI officials, about some of the issues to which briefing should be addressed.

4. I attach a brief draft reply: the last paragraph is optional.

M L WILLIAMS

pel.lb/OCT.88/min41

CONFIDENTIAL - MARKET SENSITIVE

DRAFT LETTER FROM CHANCELLOR TO SECRETARY OF STATE FOR TRADE AND INDUSTRY

MMC REPORT ON GAS

Thank you for your letter of 18 October.

2. I am content with your proposed statement. I am sure that it is right to emphasise our welcome for the report, and the encouragement that it will give to the development of effective competition in the supply of gas to contract customers. Indeed I understand that, in your press notice, you intend to bring forward the last three paragraphs of your Parliamentary answer.

3. There are, as you know, good answers to the unfavourable questions that might be asked; and I agree that they should be covered in the briefing being prepared.

4. I am copying this letter to the Prime Minister, the Secretary of State for Energy, the Director General of Fair Trading and the Director General of gas supply.

iae.st/Yo/030 **CONFIDENTIAL - MARKET SENSITIVE**

Ch/ content with proposed line?

FROM: EDNA YOUNG
DATE: 18 October 1988

1. **MR BURR** Seen in draft
2. **CHANCELLOR**

cc Mr Monck
Mr Burgner
Mr N P Williams

MERGERS PANEL, 19 OCTOBER: PROPOSED ACQUISITIONS OF CONSOLIDATED GOLDFIELDS (CGF) BY MINORCO AND OF IRISH DISTILLERS BY GRAND METROPOLITAN (GRAND MET)

The Office of Fair Trading has called a meeting of the Mergers Panel for the morning of 19 October to discuss whether or not to refer the MMC the proposed acquisitions of CGF by Minorco and of Irish Distillers by Grand Met.

2. On CGF/Minorco, we would propose to allow other Departments to take the lead, but to say that, unless other Panel members (notably the Bank) saw a risk for the London bullion market, we saw no grounds for a reference. On Irish Distillers/Grand Met we would also propose to say that we saw no grounds for a reference. The background is set out below. If you have any comments, it would be helpful if your office could pass them to me by 0930 on Wednesday 19 October.

CGF/Minorco

3. Minorco announced on 21 September that it would be making an offer for the 71% per cent of the share capital of CGF which it does not already own. Minorco is a publicly traded holding company which owns, directly and indirectly, shares in companies primarily engaged in natural resources and related activities worldwide. 39% of its shares are held by the Anglo-American Corporation and a further 21% by De Beers. CGF is a major British natural resources company with worldwide operations and investments in the mining of gold, crushed stone, coal, titanium and zircon sands, tin, iron ore and other metals and minerals. It has a 38 per cent holding in Gold Fields of South Africa Ltd (GFSA), a major gold mining company in South Africa. The merger would qualify on both the market share and assets tests.

4. In its submission to the OFT, CGF adduces a number of issues which it claims justify a reference:

(a) Gold CGF claim that the enlarged Anglo-American grouping would be well placed to attempt to manipulate the market in the short term, as the producer of 32 per cent of Western world output (65 per cent of South African output, and 22 per cent of total world supply), in addition to having substantial influence in gold refining worldwide (Anglo- American has holdings in both the UK major refiners, Johnson Matthey and Engelhard).

(b) Platinum. Here CGF argue that the merger would have an impact on future competition since CGF itself has a controlling interest in a South African platinum company which has a new mine due to open in 1992.

(c) Titanium and zircon. CGF claims that the merger would result in Anglo- American and Gencor (another South African company) controlling 67 per cent and 54 per cent respectively of Western supplies of titanium minerals and zircon sand, giving ample opportunity for restricting supplies and manipulating prices.

(d) Implications of South African control. CGF claim that the merger would lead to their being perceived as a South African controlled company which would damage its own interests and the UK public interest. CGF claim that there could be discrimination against their subsidiaries in the US, Australia and Papua New Guinea which would affect the CGF contribution to the UK balance of payments through invisible earnings. CGF also suggest that since the government has asked UK companies to observe a voluntary ban on new investment in South Africa, the acquisition by South African interests of a major UK company might also raise public interest concerns.

5. CGF overstate their case on all these issues. On gold, our understanding is that the enlarged group would be responsible for about 25 per cent of total Western world output, rather than the

32 per cent which CGF claim. More importantly, under South African law all domestic gold production has to be sold to the South African Reserve Bank at the prevailing London spot market price. Producers in South Africa therefore have no influence over conditions in the world gold market. Moreover the Chairman of the South African competition board has told our ambassador in Pretoria that they will almost certainly require Minorco to sell their holdings in GFSA if their bid for CGF is successful. That would leave the Anglo-American share of gold output unchanged. On platinum, CGF has no production at present; and although it plans to open a (South African) mine in 1992, that will produce only 6 per cent of Western output compared with the 54 per cent Anglo-American already produces.

6. There are differing views on the effect of the merger. The MOD view is that none of the materials affected is strategically vital, that other Western sources of supply would still be available, and that the merger does not give rise to issues which merit a reference to the MMC. The DTI take a similar view. Moreover in time of crisis it is likely to be location rather than ownership which would be the major determining factor affecting security of supply. Users of the materials produced by CGF vary in their views: Rolls Royce is concerned at the implication of over 50 per cent of titanium feedstocks coming from sources under South African ownership; Vauxhall Motors believe the merger may lead to the creation of a virtual monopoly in the supply of platinum into Europe; and a number of building material producers are concerned at the impact of the merger on competition in the supply of aggregates (sand, gravel and crushed stone) resulting from possible discrimination by local authorities against the CGF subsidiary ARC (one of the two main UK producers of aggregate). On the other hand, BAe do not believe that the merger would lead their titanium suppliers to raise their prices, while on platinum BAe suppliers are more concerned about finding an alternative catalytic process for vehicle exhausts.

7. As regards the implications of South African control, we understand from the FCO that the Australian Prime Minister has written to the Prime Minister to lobby against the merger. The Prime Minister of Papua New Guinea has issued a statement expressing strong opposition to the Minorco bid. CGF are also seeking to instigate an investigation by the US authorities, and intend to lodge a complaint

against the merger with the European Commission (but we do not yet know on what grounds). As regards local authorities, the Local Government Act 1988 prohibits them from taking account of non-commercial matters when placing contracts.

8. In the DTI's view the merger is unlikely to have an adverse affect on the UK's wider commercial and economic interests. In their view, more wide-ranging measures taken against South Africa by a new US administration, for example, would not necessarily affect CGF: previous such measures have exempted markets or activities of major importance to the US (eg platinum imports). Moreover Anglo-American already operates in a number of other countries including Australia, and it should not therefore be assumed that a "South African takeover" of CGF would affect its operations in those countries (setting aside the relatively minor operations in Papua New Guinea). Moreover the CGF claim on reciprocal investment (para 4(d) above) is inaccurate. The voluntary ban on new investment in South Africa was part of an EC package of measures which we went along with as a political signal to the South African government. There was no suggestion of any parallel ban on South African investment in the EC.

9. The markets in gold and the other metals and minerals in which CGF and Minorco are involved are already heavily dominated by a small number of producers and, more importantly, a small number of governments. The competition grounds for a reference are not strong. Our recommendation is, therefore, to allow other Departments to take the lead in the discussion, but to indicate a preference for the case not to be referred.

Irish Distillers/Grand Met

10. Grand Met, the international drinks and leisure industry group, is seeking to acquire Irish Distillers group, the sole suppliers of Irish whiskey. A competing bid has been made by Pernod Ricard. Irish Distillers has an insignificant share of the spirits markets in the UK as a whole. In Northern Ireland on the other hand, there is some overlap: Grand Met has 69 per cent of the vodka market (but only 0.3 per cent of the whiskey market), while Irish Distillers have 54 per cent of the whiskey market (but only 1 per cent of the vodka market). It would seem appropriate to take the view (as the OFT have

done in earlier cases) that differences between different spirits in terms of taste, method of production and consumer preference justifying seeing each as a separate market. There is therefore no cause for concern on competition grounds in respect of sales since other suppliers already have a significant presence in the market (Guiness has 11 per cent of the whiskey and 14 per cent of the vodka market, while Allied Lyons has 17 per cent of the whiskey market).

11. The question of distribution at first sight gives cause for more concern. Since each brand in Northern Ireland is handled by an exclusive distributor, the merged company would be the distributor for both the leading whiskey and the leading vodka brands. Nevertheless, if Grand Met were to seek to exploit this position, it would not be difficult for distributors and wholesalers in Great Britain to come into the market. Moreover the large wholesalers and retailers in Northern Ireland should be able to exert buyer power. Our recommendation in this case therefore is to argue against a reference.

Edna Young

EDNA YOUNG

BY APPOINTMENT
TO HER MAJESTY THE QUEEN
BREWERS

Scottish & Newcastle Breweries plc

Abbey Brewery
Holyrood Road
Edinburgh
EH8 8YS

Telephone 031-556 2591
Telex 72356

AMR/SOH/LSJ

21st October, 1988.

Sir Gordon Borrie, Q.C.,
Office of Fair Trading,
Field House,
15-25 Breams Buildings,
London, EC4A 1PR.

Dear Sir Gordon,

You will read of the Offer announced on Monday 17th October by Elders IXL Limited through its Courage subsidiary to acquire Scottish & Newcastle.

This Company is strongly resisting the Offer which is totally unwelcome and unacceptable.

We consider that the merger would be wholly contrary to the public interest and we request that it be referred to the Monopolies and Mergers Commission without delay. I enclose our detailed submission setting out the grounds for such reference. By the date of the Offer Elders held 9.6% of the company, and it is reported today that Elders have made further market purchases. These and any further purchases are facilitated by the adverse effect on the Company's share price caused by market apprehension that the bid will be referred.

In these circumstances I would particularly draw your attention to paragraph 1.4 of the enclosed submission which underlines the urgency of reference and the damage to the Company and to the public interest of any further stake building in the Company during the period of uncertainty before a decision on reference is made. We consider that a block on further acquisition should be in place at the earliest possible moment. Your Office's knowledge of the industry and the grounds for reference is such that your recommendation to the Secretary of State under the Fair Trading Act need not be delayed.

We are also very concerned about the competition effects and pressures on the merged group of certain serious financial issues concerning the Offer which we intend to cover in a further submission to you in the next few days.

Cont./.....

My office will be in touch with yours to seek an urgent meeting with you, which if possible we should like to arrange for Tuesday morning, 25th October. I am sending copies of this letter and the enclosed submission to the addressees listed below.

Yours sincerely,

A. M. RANKIN
Group Chief Executive

c.c. The Office of Fair Trading
(Deputy Director-General A. J. Lane, Esq.)

Ministry of Agriculture and Fisheries and Food
(Secretary of State and Permanent Secretary)

Department of Employment
(Secretary of State and Permanent Secretary)

The Scottish Office
(Secretary of State and Permanent Under-Secretary)

The Department of Trade and Industry
(Secretary of State, Parliamentary Under-Secretary of State for Corporate Affairs, Permanent Secretary and Chief Economic Adviser)

H.M. Treasury
(Chancellor of the Exchequer and Permanent Secretary to the Treasury)

The Bank of England
(The Governor)

iae.st/Yo/032 CONFIDENTIAL - MARKET SENSITIVE

FROM: EDNA YOUNG
DATE: 21 October 1988

NOTE FOR THE RECORD

cc PS/Chancellor
Mr Monck
Mr Burgner
Mr Burr
Mr N P Williams

MERGERS PANEL, 19 OCTOBER: PROPOSED ACQUISITIONS OF CONSOLIDATED GOLD FIELDS (CGF) BY MINORCO AND OF IRISH DISTILLERS BY GRAND METROPOLITAN (GRAND MET)

As foreshadowed in my submission of 18 October, on 19 October the Mergers Panel discussion these two proposed acquisitions. The Panel was chaired by the Deputy Director-General of Fair Trading (DDGFT) in the Director-General's absence on leave.

CGF/Minorco

2. In their introduction the OFT stressed that they were still in the process of collecting information. They nevertheless had to put the merger to the Panel at this stage as the first closing date for the Minorco offer was 25 October, and there was a fair chance that the merger would succeed on or shortly after that date.

3. DTI recalled that the Secretary of State was likely to consider the case mainly on competition grounds. Their preliminary view was that, although the merger would lead to South African control of CGF, they saw no grounds for a reference to the MMC. The gold market was unlikely to be much affected, given the South African government's existing control of all gold mined in South Africa, and the large reserves of gold held throughout the world; the platinum market was already under the control of a very small number of companies, and the possibility of collusion already existed; as regards titanium and zirconium, the Australians should be in a position to act against any monopolistic tendencies of the merged group. Nor did the DTI think there were non-competition issues which gave rise to concern.

Contrary to CGF's claims, neither they nor Minorco were involved in the production or marketing of any of the metals or minerals included in the DTI's strategic stockpile list (materials of which stocks need to be kept for industrial purposes in case of civil disorder in producing countries). Nor do any of the materials produced by CGF or Minorco figure on the MOD's strategic stockpile. The FCO said that there was no direct foreign policy interest in this case. But they wondered whether the absence of a reference might lead to adverse comparisons being drawn publicly with the KIO case. The Bank confirmed its view that neither gold market considerations nor the financing aspects of the bid gave grounds for a reference.

4. As instructed, I said that we saw no grounds for a reference on competition grounds (the insider dealing aspect is dealt with in para 6 below). The MMC agreed with the DTI that the decision whether to refer should be made on competition grounds, and agreed with me that the competition case was not strong. They agreed that there could be presentational difficulties if comparisons were made with the KIO case but pointed out that in substance the two cases were quite different: KIO was an agent of the Kuwait government, not a private company.

5. Professor Griffiths (No 10 policy unit), stressing that he was speaking in a personal capacity, expressed concern about the Anglo-American Group's generally monopolistic strategy. De Beers' domination of the world diamond market was an extreme example of the harm it could do. He was concerned about the effect on the gold market, and saw a prima facie case on the platinum market which might merit further investigation. But he was clearly not well briefed on the existing powers under the Fair Trading Act.

Insider dealing

6. I raised the question of the allegations of improper dealings in options for CGF shares the DTI reported that CGF had asked for a DTI investigation under section 442 of the Companies Act (to establish the beneficial owners of shares) and section 177 of the Financial Services Act (insider dealing). The Secretary of State

would now have to decide whether or not to set up an investigation before the bid became final (and it has now been announced that an investigation is to be held). It was possible that such an investigation would reveal evidence of possible criminal activities. If the merger succeeded, it could be that criminal activity had contributed to the merger going ahead. If such information came to light after the normal 6 month deadline had passed for a reference to the MMC, there would be grounds for saying that the Secretary of State's powers to refer the case had been revived. Nevertheless, this could not in itself be used as grounds for a reference to the MMC now, since the MMC had no remit to investigate these issues. The DTI recognised, however, that the merger would be very difficult to unscramble.

Conclusions

7. Members of the panel were in general agreement that the effects on competition for most of the products concerned seemed likely to be small: as regards gold, the South African government already had direct control over the 44 per cent of "free world" output produced in South Africa and the extra 3 per cent of the market which Anglo - American would gain from the merger was likely to make little difference; South Africa already had a monopoly (93 per cent) of Western production of platinum, and the merger was unlikely to make much difference; for titanium and zirconium there were a number of other Western suppliers. Nevertheless, in view of the political sensitivities of the case, the DDGFT indicated that he would wait for the Director General's return on 24 October before a submission went forward to the Secretary of State. This would probably mean that no announcement of the Secretary of State's decision would not be announced before the first closing date for the bid of 25 October.

Irish Distillers/Grand Met

8. All members of the panel agreed that there was no case for a reference of this bid. The OFT reported that the Irish Fair Trade Commission were expected to report shortly on the effects of the bid on the Irish market.

Edna Young

EDNA YOUNG

Jonathan.

FLETCHER SCOTT LTD

8A SYMONS STREET
SLOANE SQUARE
LONDON SW3 2TJ
TELEPHONE. (01) 823 5567
FAX: (01) 730 0612

Ch - Another routine sick from me might be best, here - agree? df 24/10

Our Ref: AMF/kma/L

23 October 1988

PRIVATE

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

yr -

Dear Nigel,

You will recollect our discussions in the aftermath of the Guinness affair. As you know, Scottish interests were frustrated by the outcome of the Guinness bid for Distillers, and as my company is advising Elders IXL in its bid for Scottish & Newcastle, I would like to make you aware of the strength of the commitments Elders are making to Scotland, as well as the commercial logic of this proposed merger and its benefits to the British economy.

The enclosed extract from the offer documents makes specific commitments to Scotland. These include plans to float Elders international brewing group, the world's sixth largest brewer, on the London Stock Exchange, and locate the international head-quarters in Edinburgh. Elders Brewing Group will be a significant multi-national company and its presence here will stimulate other economic activity, particularly professional services and associated commercial facilities in Scotland.

These commitments have not just been made in Edinburgh, to please Scottish interests. The plan to headquarter Elders Brewing Group outside Australia has been publicly supported by the Australian Prime Minister and the Treasurer. Moreover, their inclusion in the offer documents should imply that any transgression of commitments made in this way, would be severly penalised by DTI and the new regulatory authorities under the powers available in the FSA and company legislation.

This proposed merger would also create a new force in the UK brewing industry, one capable of competing on a national basis with Bass. The new enlarged group would be strong enough to help defend the industry against European in-roads into the UK beer market, and of course Elders is committed to expand into the European market from its UK base.

Yours ever,

Alex.

SIR ALEX FLETCHER

Encs

9 SOUTH CHARLOTTE STREET, EDINBURGH EH2 4AS. TELEPHONE: (031) 226 5709. FAX: (031) 220 1940.

REGD. IN SCOTLAND NO. 108117

Elders' commitment to S & N and Scotland

Elders is approaching the merger from a position of financial strength. We have become one of the major brewers in the world. Our aim now is to strengthen the foundations of our brewing business in Europe. To achieve this, we are making substantial and far-reaching commitments to S & N's future and to Scotland. Our financial arrangements do not require us to sell any of S & N's assets and will not affect S & N's capital expenditure or development programmes.

S & N and Courage are a near-perfect fit, both geographically and commercially. The combination will create a business with the scale, depth of resource and range of products:

* to recapture the lead S & N has lost in the Scottish market
* to develop national brands and to enhance the performance of local products in their regional markets
* to use S & N's excess capacity to brew Foster's and other brands for export to Europe as new markets open up in the 1990s.

"Within the Scottish beer market Tennent Caledonian Breweries continues to lead the field, particularly in market share and in the quality of its advertising."
Bass 1987 Annual Report and Accounts

Our plans for S & N's brewing operations are based on a platform of growth. In line with this, we are able to offer very specific undertakings for S & N's future and for Scotland:

* the management of Elders' UK and European brewing interests will be headquartered in Edinburgh. In due course, when the intended listing in the United Kingdom is achieved, the central management of the whole Elders Brewing Group will also be based in Scotland
* there will be no reduction in jobs in Scotland as a result of the merger. Indeed, with the merger, S & N's employees will become part of a vigorous international organisation and will enjoy enhanced career opportunities. In particular, Elders is confident that there will be a greater long term certainty for jobs than S & N provides as an independent company
* we assure all S & N employees that their rights (including pension rights) will be fully safeguarded
* as with Courage, the utmost importance will be placed on safeguarding the heritage and identity of S & N, its regional companies and its brands.

"No obvious reasons for Elders bid to go before Monopolies Commission."
Headline, Glasgow Herald, 19th October, 1988

Elders and Courage

Elders Brewing Group is one of the world's largest brewers, already producing more than three times as much beer as S & N:

* our products are sold in over 80 countries
* Foster's, our flagship brand, is among the fastest growing major export beers in the world, with worldwide sales increasing by 20 per cent. in the year to June 1988
* in the United States, the world's largest beer market, sales of Foster's rose during the calendar year 1987 by 60 per cent., to put it in 9th place among beers imported into that market
* much of our growth has been through acquisition and the revitalisation of long-established brewers.

24 October 1988
AMR/MH/S&NB

1. Moira
2. MCC

BY APPOINTMENT
TO HER MAJESTY THE QUEEN
BREWERS

Scottish & Newcastle Breweries plc

Abbey Brewery
Holyrood Road
Edinburgh
EH8 8YS

Telephone 031-556 2591
Telex 72356

The Rt Hon Nigel Lawson MP
The Chancellor of the Exchequer
H M Treasury
Parliament STreet
LONDON SW1P 3AG

Ch/ At most, a routine acknowledgement from me – but perhaps best if no acknowledgement at all.
JF 25/10

Dear Chancellor.

You will, perhaps, be aware that on Monday, 17 October Elders IXL Ltd announced, through its British Courage subsidiary, an offer to acquire Scottish & Newcastle Breweries plc.

I am enclosing a copy of the submission which we have sent to Sir Gordon Borrie at the Office of Fair Trading on 22 October, together with a copy of the accompanying letter.

Rouse ack. pse. MC

The offer is entirely unwelcome and unacceptable and we consider wholly contrary to the public interest on the various competition and other grounds clearly detailed in the submission.

In addition, we intend to make a further submission to the Office of Fair Trading very shortly in relation to various financial matters which we are sure will be considered highly relevant to this bid proposal.

Yours sincerely

Archie Norman

cc Sir Peter Middleton KCB
Permanent Secretary to the Treasury

Andrew for Paul
info.
Jonathan has already got a copy.

dti
the department for Enterprise

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

Alex Allen Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CH/EXCHEQUER
REC. 27 OCT 1988 27/10
ACTION FST
COPIES TO

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 PS4BJP
Your ref
Date 27 October 1988

Dear Alex,

MERGER POLICY

... You might like to see the attached copy of a speech my Secretary of State is giving this afternoon to the International Stock Exchange Conference for Industry. Recent decisions on reference or non-reference of mergers to the Monopolies and Mergers Commission have given rise to a good deal of interest and some comment that the Government's merger policy has either changed, or become inconsistent. There have been calls - for example from Sir Trevor Holdsworth of the CBI - for a clear restatement of the Government's policy, notwithstanding the Blue Paper.

The attached speech is therefore being widely distributed to major companies, as well as to MPs and the Press.

I am sending copies of this letter to Paul Gray, to Private Secretaries to Members of the Cabinet, and to Trevor Woolley.

Yours sincerely,

pp NEIL THORNTON
Private Secretary

the enterprise initiative

MERGER POLICY

The title of this conference prompted me to look for a subject close to the hearts and minds of both the Stock Exchange and industry. The choice was not difficult. The Government's mergers policy fits the bill on all counts.

Six months ago my Department published a Blue Paper after a thorough review of our mergers policy. Since that Paper was published claims have been made that the rules were being rewritten; or even that there were no rules. I want this evening to set the decisions that I have made over the last six months in the context of our policy.

Any mergers policy must provide industry and commerce with a clear and predictable framework within which to conduct the merger and takeover activity that is an important part of the operation of the market. Our policy, far from being the thing of shreds and patches its detractors would claim, does show a remarkable degree of consistency.

The presumption underpinning all we do is that the market should be allowed to "get on with it". Government interference is justified only when there is a clear expectation that the outcome will not be in the best interests of the economy as a whole. This is not a blind belief in market forces, but rather the empirical judgment that in general market forces will be more likely to be "right" than the deliberations of committees

of politicians or bureaucrats. Indeed, as valuable as the MMC is, I am sure they would not wish to take over from the market the decision on the many mergers that take place month after month.

Competition is the Key

The Blue Paper concluded that the basic policy which we have been following for a number of years is correct: that the main consideration in evaluating a merger for a reference to the Monopolies and Mergers Commission should be the potential effect on competition in the UK.

I want to take a minute to explain what that outwardly rather bland statement actually means. My responsibilities are for the UK, not Europe nor the wider world. I look at mergers from the standpoint of the UK customer. It is competition policy which is the great shield of the consumer.

In many cases that consumer is, of course, a business. My concern can therefore be restated as ensuring that UK industry has sufficient choice to be able to buy the materials and components it needs at the lowest possible prices and on the best possible terms.

Let me elaborate on what we do not do. We do not look at mergers from the viewpoint of the companies concerned or of investors. The interests of these parties are promoted by other

means. So mergers policy is not in the business of "saving" companies from predators, or indeed from foreign takeovers. I do accept that the threat of takeover adds to the problems faced by those running companies. I am equally certain that removing that threat by adopting a more interventionist stance would not be in the best interests of UK industry. The best defence is, surely, getting your company into such good shape that a predator realises that he can't make a better use of the assets and has no incentive to offer a winning price. This approach is also in the best interests of the economy as a whole.

Whilst competition will be the main consideration in my decision whether to refer I still retain the power to make a reference on public interest grounds. Such cases are exceptional. Public interest is often claimed as the effect of a merger on employment or R&D. These are matters where the parties themselves may be left to take a view. What is good for the firms in the long run will be good for the economy.

<u>The Reference Procedure</u>

What does a reference of a merger to the MMC actually mean? It certainly does not mean that I have anything against the companies concerned. It means only that there are issues which merit further investigation. It is, if you like, the equivalent of a Magistrates hearing, when they are deciding whether there is a case to answer. It is not the full trial and it certainly

does not mean the bid will be blocked - that can only be done if and when the MMC find it against the public interest.

Of course, it is not as simple as that, and the delay and uncertainty of a reference can sometimes lead to bids being abandoned. I have asked the MMC to reduce the delay and they have halved the time they take. A decision to refer is not taken lightly. Of around 240 cases considered this year, only 7 have been referred to the MMC for further investigation. The average year produces about eight cases and the highest is 13 in 1986.

There seems to be a belief that references are sometimes used as a kind of political bolt-hole, and that decisions on whether or not to refer can be influenced by extensive - and expensive - campaigns involving lobbying and advertising. I have even known cases where parties to a bid have published open letters addressed to me in full page advertisements in the national press, although, heaven knows, if they did want to write postage would be cheaper. This is not how the system works.

The first step in the process is for the Director General of Fair Trading to analyse the implications of the bid. He discusses the issues with the parties, their customers and competitors. This assessment, which covers the effect on competition, and any other public interest issues, forms the basis for the Director General of Fair Trading's advice to me whether or not to refer the bid to the MMC. The decision is

mine : but I would need very strong reasons to reject the Director General's advice. On only 9 occasions, out of a total of about 2,000 cases since 1979, has that advice not been followed by the Secretary of State of the day. So the message to companies involved in controversial takeovers who want to influence referral is - don't advertise, don't talk to me, talk to Sir Gordon Borrie.

Confidential guidance

Another service available to prospective bidders is the "confidential guidance" available from the OFT. In appropriate cases the Office can give a confidential indication after consulting me of whether I would be likely or not to refer a particular merger. Such guidance does not tie my hands in making a substantive decision and is based on the limited evidence available at a time when the proposal is not public knowledge. Approximately 30 requests for Confidential Guidance have been dealt with so far this year.

Markets differ

How do some of the more controversial recent reference decisions fit into this framework? I believe with rather more consistency than that adopted by some of the critics. Let me examine some recent cases in more detail.

A competition-based mergers policy is about the economics of evaluating markets and market shares in terms of the competitive structure. In competition terms, market sizes vary greatly.

... a local market

Some markets are confined to a part of the UK. For example recently, in the Badgerline case, I referred a merger between two companies running bus services in Bristol and Avon. Bus services are a market where competition is highly localised; to consider local bus services in the context of the overall UK market for bus services throughout the UK would not make a lot of sense!

... the UK market

Other products and services do have a national, UK-wide market, where competition for the consumer is essentially between UK companies and where, for whatever reason, imports or international sources play only a very minor part. Take package holidays as an example; competition in the market for foreign inclusive tours by air, which is one of the markets in which Thomson and Horizon operate, is mainly between UK companies. Together they have a large market share. There appeared to be no mitigating factors such as competition from overseas operators; and so the bid raised questions of competition and the bid was referred. How valid the questions are, the MMC will consider.

Let's now take a controversial non-reference decision - Rowntree. Here we looked at the effect on competition in our chocolate confectionery market. Continental chocolates do not sell well in the UK, and thus the markets were different.

There were no competition issues: Nestle and Suchard had only 3% and 2% respectively of the UK chocolate confectionery market.

Arguments were put forward that Rowntree should be referred on public interest grounds. The particular issue was reciprocity. Now reciprocity is a tricky concept - especially in the mergers market. It turned out that Swiss companies like Nestle are virtually immune from hostile bids even from other Swiss companies; that some British companies are in the same position. Indeed I was given a list of over 60 British companies that had, often with the consent of their shareholders, protected themselves against unwelcome bids. There are no Swiss Government rules against mergers involving foreign companies. It goes without saying that there are no UK rules either!

To have referred Nestle's bid simply because Nestle was effectively bid-proof would have sent a dangerously misleading signal to other countries about our attitude to inward investment - and invited retaliation against UK investments abroad.

... **Europe**

For other products competition comes from Europe, or even further afield. That means that the UK consumer can purchase from a very wide range of sources and is not limited to UK producers. The creation of UK companies with large shares of the UK output of such products is entirely consistent with our

concern to encourage effective competition within open markets.

In only a few weeks British Steel is coming to the market, as a single entity. It still has over 60% of the domestic market for finished steel products, yet in the UK it is still faced by competition from other European producers.

Another recent example: at the end of September I announced my decision not to refer the acquisition by Volvo Bus Corporation of Leyland Bus Group. Although Volvo and Leyland Bus together accounted for over 50% of bus and coach deliveries in the UK in 1987, I took into account the competition from European manufacturers, as assessed by the OFT.

... the World

The Minorco bid for Consolidated Gold Fields was referred on competition grounds. The Director General of Fair Trading in the usual way assessed the implications of the bid for the world-wide supply and prices of certain metals and minerals. I accepted his advice. I considered that there was a case to answer - the merger raised competition issues which justified detailed investigation by the MMC.

Incidentally, I have heard it argued that the bid should not have been referred, because titanium and zircon would account for only a minute part of the new group's activities. This is not the test. What must concern me is not the interests of either of the companies involved, or of the new group, but the effect of the new arrangements on the consumer in the UK. The

Director General considered - and I agreed - that the effect of the bid could be to reduce competition. We shall see. I am not prejudging the outcome of the MMC's enquiry. They have hardly begun.

The appointment of inspectors under the Financial Services and Companies Acts had no bearing on the reference, nor was the nationality of the bidder in itself a factor.

The Customer is King

So markets vary. It is too simplistic to say merely that Europe ought to be the market against which competition is judged. For some products or services the market may be a single county - for others it may be the UK. There are circumstances where the whole of Europe is the market and as I have shown on occasion we might have to take the whole world into account.

But in each and every case it is the market that is judged and the effect on the customer is the test. If a merger is likely to lead to loss of choice and higher prices for the UK customer, it will probably be referred. But the corollary follows - where the UK customer has adequate choice as the result of effective competition from elsewhere in Europe or the world, apparently high shares of the UK market created by a merger will not necessarily lead to reference.

What this means is that reference decisions cannot be reduced to some simple arithmetical formula based on market shares. There

is of course a market share test of 25% (together with an assets test for the acquired company of £30 million) in the Fair Trading Act : but these are no more than trigger levels for determining whether the merger qualifies for investigation. The assessment of the competition implications requires a more sophisticated analysis to determine the effect on the consumer.

The Single Market in Europe

As the Single European Market develops, and 1992 approaches, the remaining barriers to trade among the Community countries will gradually be removed. This will increase the scope for competition from Europe, and increase the importance of that factor in our consideration of mergers.

Our policy of taking account of competition from overseas is often confused with a separate issue - that of international competitiveness of UK firms. It is often argued that we should give more weight to international competitiveness. What people mean by this is that a reduction in competition in the UK should be accepted in order to enable large UK groups to be formed to compete more effectively in world markets. We certainly consider claims that a merger will increase efficiency and international competitiveness : but I have to say that all too often in the past the claims have not been borne out by results, and the track record of post-merger performance does not justify our simply taking such claims on trust. In general, therefore, if a merger poses a threat to competition in the UK, we regard the MMC as the appropriate body to balance the prospective

benefits against the detriment to competition.

EC Merger Regulation

I would not want to talk about mergers policy without mentioning the EC proposals for a merger control regulation. Some of the critics of our mergers policy who argue that it is too parochial have gone on to say that implementation of merger control at the European level will provide the ideal solution. I have already made it clear that mergers policy takes the European and international dimension into account, and that there is no need for an EC merger control regulation on this account. In any event, some degree of merger control at the European level already exists in the form of Articles 85 and 86 of the Treaty, which cover competition. It is an entirely separate question as to whether the regulation would provide a better regime for controlling mergers at Community level than the existing regime of Articles 85 and 86. As is well known the UK has reserved its position on the principle of the Regulation, while continuing to participate constructively in Council working group discussions.

Leveraged Bids

An issue which has caused a lot of concern is highly geared, or leveraged bids. The Blue Paper looked carefully at this question, in the light of the MMC's report on the first major case of this kind in the UK - Elders' bid for Allied Lyons. The conclusion was that I will not normally regard leveraging on its own as a ground for reference : but there may be a case for

referral if high leveraging combined with some other feature of the bid may have undesirable effects. This is how our policy has operated.

Some highly leveraged bids have not been referred (such as Barker and Dobson's bid for Dee Corporation) : but the most recent example of a reference involving a leveraged bid - Goodman Fielder Wattie's bid for Ranks Hovis MacDougall - also reflected competition worries. One of the markets affected by the proposed merger was the bread market, which in the UK is both important and unusual. There are only two dominant producers, and this in itself can imply significant barriers to large scale entry. The weakening of one of the producers could have a potentially serious effect on competition. While the high leveraging of the bid would not normally, in itself, have been grounds for reference the knock-on effect this could have had on competition was of sufficient concern to justify a reference. In the end the withdrawal of the bid prevented us from putting this to the test.

Public Interest

The reference of the Kuwait Investment Office shareholding in BP was an example of a reference made on wider grounds than traditional competition concerns. Such cases are very rare and this was truly an exceptional one. The implications of BP coming under the influence or control of a Government which has substantial oil interests, and which is a member of the OPEC

cartel, raised issues of public interest which warranted investigation by the MMC. But even here there were issues of competition in the widest sense.

Protectionism

Some mergers involve foreign bids for UK companies. Where these have been referred, some observers have claimed there has been a shift of policy towards protectionism. Where they have not been referred, others have accused us of operating too open a system. The fact that both criticisms can be made speaks for itself. Mergers policy is not pro-Swiss, nor is it anti Kuwaiti, anti Australian or anti South African. The nationality of the bidder is not in itself a factor in mergers policy. Nor are we adopting a "fortress UK" posture.

During this decade nearly 500 bids by foreign companies have been cleared, including bids for household names such as Courage beer, Rowntree and Leyland Bus. The Government's general approach to investment from overseas in the UK economy is to welcome it, and to encourage the free flow of investment both inward and outward. Today the UK is the great overseas investor. The value of UK direct investment overseas has risen three-fold since the beginning of the decade to stand at over £90 billion. Since 1986, UK companies have spent on acquisitions overseas £20.6 billion in the United States, £3.1 billion in Western Europe and £0.7 billion in Australia.

Merger policy

So to look at a number of reference decisions and draw the conclusion that we are, for example, against bids from a particular country, or a particular type of bid is, if I may say so, so much arrant nonsense. Each merger is different and is considered individually on its merits: we start with a clean slate each time and look at every merger, but within the framework of our stated policy. My aim is to achieve open markets. That is why the main criterion in deciding whether to refer a merger to the MMC is the effect on competition in the UK.

dti

the department for Enterprise

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

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and Commonwealth
Affairs
Foreign and Commonwealth Office
Downing Street
LONDON SW1

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

CH/EXCHEQUER
REC. 11 NOV 1988
ACTION FST
COPIES TO

Direct line 215 5422
Our ref DW4ATC
Your ref
Date 11 November 1988

Dear Secretary of State

MERGER CONTROL/BARRIERS TO TAKEOVERS

At OD(E) on 22 September we discussed a study by officials on barriers to takeovers throughout the EC. We decided that further work was required to clarify targets for removal before deciding whether to link action on barriers with agreement to a merger control regulation. The result of this follow-up work has been circulated separately. However, I thought it would be useful to set out here how Francis Maude should raise the barriers issue at the Internal Market Council on 18 November, and how we see the Merger Control negotiations going over the rest of the year. If the general approach I suggest here is acceptable, I do not think we need a detailed debate at OD(E) on 17 November.

Barriers to Takeovers

The new official paper confirms that many barriers to takeovers are embedded in the corporate culture of other member states. Removing them will be a long term process, which will require changes in thinking as much as legislative action. Nevertheless, the paper also shows that there are strong reasons for pursuing the subject now, and suggests a number of possible lines of action which I hope we can endorse.

In pursuing the barriers issue within the Community, we have several tactical problems to surmount. First, if we want the Commission to take us seriously, we must avoid creating the impression that this is just a transparent negotiating ploy in relation to the Mergers Control Regulation. Second, I think we have to accept that action on barriers will generally take

place in a much longer timescale than the negotiations on the Regulation, though we should look for a clear early commitment by the Commission and the Council to effective action. Third, the most promising avenues for action are the Fifth Company Law Directive and the Takeovers Directive. But we still have major problems of principle with both these Directives and will need to make sure that we do not undermine our general negotiating position on them. Finally, we will need to seek allies. Our first contacts with the Commission were promising. They are likely to regard an initiative on barriers as a timely step. Recent informal contacts with the French suggest that they too may be interested. We will probably need to follow-up the IMC discussion with a wider lobbying exercise.

With these tactical questions in mind, I propose that we should take the following line at the November IMC. We should make a statement pointing out that the Regulation will not result in level playing fields for takeovers in the Community. Without listing specific actions at this stage, we would raise our general concern stemming from both consideration of the Mergers Regulation and the responses to our consultation exercise on the European Company Statute (also on the IMC agenda). We would give a broad indication of the barriers which remain to be tackled giving a few examples (such as poison pills, restricted voting rights and the way proxy voting can be used to achieve a blocking vote). But (partly because of our problems with the relevant directives, mentioned above) we would not at this stage make specific suggestions on how to tackle them. Instead, we will seek agreement that work should be put in hand by the Commission ~~with a view to the Council being able to take the idea further at its December meeting on the basis of a Commission~~ with a view to the Council being able to take the idea further at its December meeting on the basis of a Commission paper. I think this is the essential point for this IMC meeting. If we can get a firm commitment to further work, we can then work behind the scenes before the December meeting to ensure that the Commission come up with the goods.

I think it would be unwise, for the reasons given above, to make an explicit link with progress on the Merger Control Regulation. A link will of course be implicit in the way we raise it under the merger control item. How we develop that link in December and beyond will depend on what the Commission comes up with, and how discussions on the Regulation progress.

Merger Control Regulation

It is not yet clear what form the discussion at the 18 November IMC will take. The Presidency have so far failed even to obtain agreement on the questions to be posed and this will be considered in COREPER later this week. There is, in any case, no question of the Presidency trying to achieve agreement on the Regulation this month, and all the signs are that negotiations will have to continue into next year.

It is clear that there are points of major disagreement between member states. The Germans are fundamentally opposed to the Commission proposals on exclusivity; and the French are equivocal about them. The UK, France and Italy oppose the Commission's proposals on suspension. The UK and Germany are insisting on competition as the decision criterion for assessment; but the French dislike this, and appear to want scope for social and "industrial strategy" considerations to be taken into account.

The effect of this is that the UK is no longer singled out as obstructionist, despite our continuing general reservation. Indeed, our general reservation makes it easier for us to contribute constructively to the debate, without commitment. Other member states have had to work hard to extricate themselves from positions which the Commission and Presidency claimed they committed themselves to at the previous Council, in the absence of any explicit reservations.

I propose that, at this Council, we should take the following line on the issues likely to come up.

(i) Exclusivity

We should support exclusive Commission jurisdiction for mergers covered by the Regulation provided that other aspects of the Regulation are satisfactory : notably the threshold levels; suspensory effect; the criteria for assessment; and the procedural aspects such as timescales. This would have the advantage of clarity for companies, and avoidance of "doublt jeopardy". The Commission has already accepted that exclusivity will not prejudice member states acting to protect legitimate national interests, although discussions continue on the detailed formulation of this principle. We should make clear that UK support for exclusivity would also be conditional on satisfaction on this point.

(ii) Criteria for assessment

We should support the view taken in the IMC in June that "the decisive criterion for prohibiting a concentration with a Community dimension will be the creation of a position on the European market which impedes effective competition". It is very important that the basic criterion for assessing mergers should be the effect on competition. The Regulation should not be an instrument of achieving social or industrial policy objectives.

(iii) Suspensive effect

We should reject automatic suspensive effect. Mergers make an important contribution to the dynamic process of structural change and economic development within the Community. Automatic suspension would act as a brake on that process. Mergers should be allowed to proceed unless specifically prohibited. The onus should be on the Commission to justify suspension in particular cases. The Commission should however have power to require suspension in the small minority of cases where irreparable damage to competition was likely to occur if a merger went ahead.

On all these issues, we will have some major allies. The French share our view on thresholds and, like us, see this whole set of questions as an inseparable package. On the criteria for assessment, on the other hand, we are very close to the Germans. We will, of course, make it clear in our opening statement that the general UK reservation remains, and that we will want to assess the final shape of the Regulation before considering whether to remove it.

I am copying this to members of OD(E) and to Sir Robin Butler, and Sir David Hannay.

Yours sincerely

Jeremy Godfrey

or Lord Young of Graffham

Approved by the Secretary of State
and signed in his absence

1234/14

CONFIDENTIAL

1. MR MONCK

2. CHANCELLOR

FROM: EDNA YOUNG
DATE: 14 November 1988

cc Mr Burgner
Mrs Lomax
Mr Burr
Mr Mortimer
Ms Symes

EC MERGER CONTROL/BARRIERS TO TAKEOVERS

Lord Young has written to OD(E) colleagues proposing the line that Mr Maude should take on these issues at the Internal Market Council on 18 November. Lord Young also suggests, that if this line is agreed, there should be no discussion at OD(E) on 17 November. This submission sets out the background to Lord Young's proposals, and recommends that you should agree to drop discussion at OD(E) provided Lord Young accepts a number of counter-proposals which are set out in the attached draft reply.

Barriers to takeovers

2. A further paper by DTI officials (OD(E)(88)19), to which Lord Young refers, responds to the remit from OD(E) on 22 September for further work to clarify which barriers to takeovers should be targeted for removal. The paper addresses company-imposed barriers (poison pills, restricted voting rights, proxy voting etc.) and barriers which are part of the corporate environment (disclosure rules, stock exchange regulation, obfuscatory accounting systems, cross-shareholdings etc.). It proposes that we should pursue the removal of barriers in a number of fora, notably within the existing company law harmonisation programme. Lord Young's letter makes clear that he now accepts that action is possible in this area. This represents a considerable move towards your position. Lord Young points out (rightly) that we have substantial difficulties of principle with some of these draft directives. But there are some avenues we could pursue (in

particular the implementation by all member states of directives which have already been agreed) which do not present this problem.

Linkage between barriers and the regulation

3. Lord Young proposes that no explicit link should be made. This is acceptable, provided such a link is not explicitly ruled out either. The draft reply floats the idea (which you had agreed as a fallback for OD(E) on 22 September, but in the event did not use) that we should link the coming into effect of the regulation with the removal of certain barriers (not yet specified).

Merger Control Regulation

4 (i) Exclusivity

The draft reply questions Lord Young's view that we should now support exclusive Commission jurisdiction provided that the content of the regulation is otherwise satisfactory and raises the particular problem of public sector predators, which is of concern to Mr Channon.

(ii) Criteria for assessment

The draft reply endorses Lord Young's view that competition should be the criterion for assessing mergers. In fact, however, we shall probably find in the end that this is too rigid an objective to be achievable. It is not possible to devise sensible competition criteria which entirely exclude economic effects. Nevertheless, insistence now on competition criteria alone as the basis of EC assessment could be of help to us in retaining a broader public interest provision within the competence of member states. The latest Commission draft would allow member states to take "appropriate measures with a view to protecting legitimate interests other than competition .... provided that such interests are clearly defined and

provided for in national law." This should cover banking, defence and the media, but the proviso "clearly defined" seems bound to exclude anything like own public interest under the Fair Trading Act. We could therefore argue that since competition would be the test for preventing mergers, the retention of a national public interest test to prevent mergers which are acceptable on competition grounds would not conflict with EC competition policy. An EC "public interest" test to allow anti-competitive mergers would inevitably include industrial policy criteria (and would be unacceptable).

Turnover thresholds

iii) Lord Young's letter contains no suggestion for acceptable figures for either worldwide or Community turnover. The draft reply therefore seeks an assurance that his objective for worldwide turnover remains 7 billion ecu (as he proposed in his paper for OD(E) on 22 September), and proposes a threshold of 700 million ecu for Community turnover.

5. The letter will need to reach Lord Young quickly if he is to be able to respond in time for the Chancellor to decide whether he is content to forgo OD(E) discussion.

Edna Young

EDNA YOUNG

35/g iae3/ph.1.14.11

CONFIDENTIAL

Pse type final

DRAFT LETTER FROM THE CHANCELLOR TO:

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H OET

EC MERGER CONTROL/BARRIERS TO TAKEOVERS

Thank you for copying to me your letter of 11 November to Geoffrey Howe proposing the line that we should take on these issues at the Internal Market Council on 18 November. I have a number of comments on your proposals.

2. I assume that Francis Maude will start his presentation with a firm restatement of our general reservation of principle on the draft merger control regulation. This will be particularly important given Sutherland's avowed intention (at lunch with COREPER (Deputies) on 9 November) to secure agreement at the Council on exclusivity and thresholds. And, as you say, our reservation has made it easier for us to contribute constructively to the debate on the regulation, but without commitment.

<u>Barriers to takeovers</u>

3. I recognise that the removal of barriers is likely to take place in a much longer timescale than the negotiations on the regulation. But, short of some last ditch attempt by Sutherland to secure agreement on the whole regulation, this Council is not likely to be the meeting at which the content of the draft regulation is settled. We do not therefore need to concede explicitly this

difference in timescales. Similarly, I can accept some ambiguity on the strength and directness of the link between the regulation and action to remove barriers. But I would not wish anything to be said which would exclude our raising at a later stage a modified form of a link. What I have in mind is the possibility of a trigger mechanism which would enable us to say that we wished to see some specific progress (which we do not need to define yet) on barriers before we could accept the entry in force of the Regulation. I do not think that the "clear early commitment ... to effective action" which you mention would be enough, since we could easily find ourselves in a situation where there was no possibility of Council decisions which went far enough to satisfy us on barriers. Getting a commitment that the Commission will produce proposals and that the Council will consider them cannot be the same as a "commitment...to effective action"

Merger Control Regulation

4. (i) Exclusivity. I am not convinced that this is the moment to concede exclusive Commission jurisdiction. In terms of tactics, it seems unwise to leave the Germans publicly isolated on this when we continue to need their support to ensure that the criteria for assessment are restricted to competition. And more substantively, it seems likely that the only way we shall be able to tackle the problem of public sector predators will be through a "derogation" from exclusive Commission jurisdiction. It does not seem to me that the Commission's acceptance of some sort of public interest provision remaining within Member States' competence goes as far as we will need; indeed the new text of Article 21 of the draft Regulation which the Commission circulated last week seems intended to cover

prudential supervision of banks, newspapers and defence, but nothing more.

(ii) Criteria for Assessment. I entirely endorse your view that the criterion in the regulation for assessing mergers should be the effect on competition. This would not be incompatible or inconsistent with the retention of a public interest test at the national level.

(iii) Suspensory Effect. Again, I endorse your view that we should reject this and that mergers should be allowed to proceed unless specifically prohibited. I should be interested to know how you would define the small minority of cases where you believe the Commission should have the power to require suspension.

(iv) Thresholds. You rightly posit the threshold level as one element which must be got right before we can consider accepting exclusive Commission jurisdiction. But you give no indication of what that threshold might be. In your paper for our OD(E) discussion in September, you suggested that the scope of the Regulation should be such as to keep to 10 - 15 the number of UK qualifying mergers which would fall under the Regulation. This, you calculated, would mean a threshold of at least 7 billion ecu for the aggregate worldwide turnover of the parties.

I assume that this still your objective for the worldwide threshold. But we also need to look carefully at the threshold for Community turnover (ie 700 million ecu). This surely needs to be at least in line with our objective for the threshold for worldwide turnover. Otherwise we will risk EC jurisdiction applying to large numbers of takeovers of UK companies by non-EC companies.

5. If you are content to accept the suggestions I have made above, and can let me have some further details on thresholds, suspensory effect, and how to tackle public sector predators, I should be ready to forgo discussion at OD(E) on 17 November.

6. I am copying this letter to members of OD(E), Paul Channon, Sir Robin Butler and Sir David Hannay.

cc Mr Monck
Sir T Burns
Mrs Lomax
Mr Burr
Mr Mortimer
Ms Symes
Ms E Young

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

15 November 1988

Rt Hon Lord Young of Graffham
Secretary of State for Trade
and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

EC MERGER CONTROL/BARRIERS TO TAKEOVERS

Thank you for copying to me your letter of 11 November to Geoffrey Howe proposing the line that we should take on these issues at the Internal Market Council on 18 November. I have a number of comments on your proposals.

I assume that Francis Maude will start his presentation with a firm restatement of our general reservation of principle on the draft merger control regulation. This will be particularly important given Sutherland's avowed intention (at lunch with COREPER (Deputies) on 9 November) to secure agreement at the Council on exclusivity and thresholds. And, as you say, our reservation has made it easier for us to contribute constructively to the debate on the regulation, but without commitment.

Barriers to takeovers

I recognise that the removal of barriers is likely to take place in a much longer timescale than the negotiations on the regulation. But, short of some last ditch attempt by Sutherland to secure agreement on the whole regulation, this Council is not likely to be the meeting at which the content of the draft regulation is settled. We do not therefore need to concede explicitly this difference in timescales. Similarly, I can accept some ambiguity on the strength and directness of the link between the regulation and action to remove barriers. But I would not

wish anything to be said which would exclude our raising at a later stage a modified form of a link. What I have in mind is the possibility of a trigger mechanism which would enable us to say that we wished to see some specific progress (which we do not need to define yet) on barriers before we could accept the entry in force of the Regulation. I do not think that the "clear early commitment ... to effective action" which you mention would be enough, since we could easily find ourselves in a situation where there was no possibility of Council decisions which went far enough to satisfy us on barriers. Getting a commitment that the Commission will produce proposals and that the Council will consider them cannot be the same as a "commitment...to effective action"

Merger Control Regulation

(i) Exclusivity. I am not convinced that this is the moment to concede exclusive Commission jurisdiction. In terms of tactics, it seems unwise to leave the Germans publicly isolated on this when we continue to need their support to ensure that the criteria for assessment are restricted to competition. And more substantively, it seems likely that the only way we shall be able to tackle the problem of public sector predators will be through a "derogation" from exclusive Commission jurisdiction. It does not seem to me that the Commission's acceptance of some sort of public interest provision remaining within Member States' competence goes as far as we will need; indeed the new text of Article 21 of the draft Regulation which the Commission circulated last week seems intended to cover prudential supervision of banks, newspapers and defence, but nothing more.

(ii) Criteria for Assessment. I entirely endorse your view that the criterion in the regulation for assessing mergers should be the effect on competition. This would not be incompatible or inconsistent with the retention of a public interest test at the national level.

(iii) Suspensory Effect. Again, I endorse your view that we should reject this and that mergers should be allowed to proceed unless specifically prohibited. I should be interested to know how you would define the small minority of cases where you believe the Commission should have the power to require suspension.

(iv) Thresholds. You rightly posit the threshold level as one element which must be got right before we can consider accepting exclusive Commission jurisdiction. But you give no indication of what that threshold might be. In your paper for our OD(E) discussion in September, you

suggested that the scope of the Regulation should be such as to keep to 10 - 15 the number of UK qualifying mergers which would fall under the Regulation. This, you calculated, would mean a threshold of at least 7 billion ecu for the aggregate worldwide turnover of the parties. I assume that this still your objective for the worldwide threshold. But we also need to look carefully at the threshold for Community turnover. This surely needs to be at least in line with our objective for the threshold for worldwide turnover, ie around 700 million ecu. Otherwise we will risk EC jurisdiction applying to large numbers of takeovers of UK companies by non-EC companies.

If you are content to accept the suggestions I have made above, and can let me have some further details on thresholds, suspensory effect, and how to tackle public sector predators, I should be ready to forgo discussion at OD(E) on 17 November.

I am copying this letter to members of OD(E), Paul Channon, Sir Robin Butler and Sir David Hannay.

NIGEL LAWSON

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

My ref:

Your ref:

The Rt Hon Lord Young of Graffham
Secretary of State for Trade & Industry
Department of Trade & Industry
1-19 Victoria Street
LONDON
SW1H OET

Dear David.

16 NOV 1988

MERGER CONTROL/BARRIERS TO TAKEOVER

Thank you for the copy of your letter of 11 November to Geoffrey Howe. I have also seen the OD(E) paper on this subject.

I agree in general with the negotiating line you have proposed for Francis Maude at the Internal Market Council on 18 November, and for the subsequent lines of our discussions with the Commission on this proposed Regulation. There is, however, one point of major concern to me which is not yet recognised in the papers, but which I am sure you will agree ought to be covered from the outset. My officials have raised this with yours in the aviation context, although I think it also goes wider.

We need to be certain that in negotiating towards a "level playing field" under the Regulation, we also defend our considerable successes in reducing the public sector in the UK, particularly in aviation. I think it is therefore essential that there is an absolute ban, in whatever is agreed on the Regulation, on cross-border acquisitions of private sector enterprises in one state, by state-owned or state-controlled enterprises in another. Otherwise we face the risk that foreign "public sector predators" could buy into our flourishing private sector airlines with state funds and achieve nationalisation by the back door. I would like to see this point made to the Commission from the outset, as part of the argument about moves towards a level playing field.

My officials have additionally made the point that we also must be able to retain our powers to revoke airline route licences in the event of foreign takeovers, in order to protect our bilateral air services agreements with other countries. This is vital to the aviation sector.

I hope you will agree that these points should be reflected in our negotiating line (the second perhaps at a later stage). Should you see any difficulty, however, perhaps we should discuss further at OD(E).

I am sending copies of this letter to members of OD(E), Sir Robin Butler and Sir David Hannay.

Yours,

Paul

PAUL CHANNON

FCS/88/195

SECRETARY OF STATE FOR TRADE AND INDUSTRY

Merger Control/Barriers to Takeovers

1. Thank you for your letter of 11 November proposing a line to take at the 18 November Internal Market Council.

2. I agree with your proposed approach on barriers to takeovers. As long as we avoid any rigid link, we should be able to gain ground on both barriers and mergers.

3. I agree with the line you propose on exclusivity, criteria and suspensory effect for the merger control regulation. I note that you do not address the question of thresholds directly. We must avoid an excessive number of mergers being caught. But unless the Commission are given some scope for action, we shall not avoid greater Commission use of Articles 85 and 86 of the Treaty.

4. Subject to the Chancellor's views, I too see no need for further substantive discussion at OD(E) on 17 November.

5. I am copying this minute to members of OD(E), to Sir Robin Butler and to Sir David Hannay.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
16 November 1988

Done. N Thornton seemed content. (Tom Edmunds rang).

CHANCELLOR OF THE EXCHEQUER

Ch.

EC Mergers etc

IAE are content with Lord Y's reply, behind, to your letter. It does not give everything we want on exclusivity, but they think we can live with it (particularly as there are, apparently, signs that the Germans are shifting their ground).

2. They would, however, like me to spk. to Lord Y's office to say ('X' on last page) that we should not give a figure for the number of cases we would expect to go to the Commission. This is only c. 13 cases a year go to the MMC, and we shouldn't imply effectively abolishing the MMC before Mrs T discussion. At the Council DTI should just refer to size - e.g. a "ten fold limit" in thresholds.

Content? 16/11

dti

the department for Enterprise

CONFIDENTIAL

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

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

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

CH/EXCHEQUER
REC. 16 NOV 1988
ACTION FST
COPIES TO

Direct line 215 5422
Our ref PS3BPR
Your ref
Date 16 November 1988

Dear Nigel,

EC MERGER CONTROL/BARRIERS TO TAKEOVERS

Thank you for your letter of 15th November about the line to take on these issues at the Internal Market Council on 18 November. I have also seen Geoffrey Howe's minute and Paul Channon's letter of 16 November.

I can confirm that there is no intention of removing our general reservation of principle on the draft merger control regulation; and Francis Maude will make this clear at the outset. I do not believe that discussion on the regulation has reached the point where it would be sensible to contemplate lifting our reservation.

Barriers to takeovers

I agree that we do not need to concede explicitly at this Council our perception of the difference in timescales between the removal of barriers and negotiations on the regulation. I think that the line proposed in my letter to Geoffrey Howe meets your point on this. I also agree that we should say nothing at this Council which rules out the possibility of our making such a link at a later stage, if we decide that this is the right thing to do. At this stage, it will be enough to indicate the nature of our concern on barriers; and the fact that we do so in the context of the regulation will itself be an implicit link.

the enterprise initiative

Merger Control Regulation Exclusivity

I am not suggesting that we should concede exclusive Commission jurisdiction at this point. We have our general reservation, and in addition to this we shall make it clear that our view on exclusivity will be coloured by the way in which other aspects of the regulation are dealt with. Nevertheless, I believe that exclusivity on the right terms is more likely to lead to a satisfactory regulation than an arrangement involving some form of dual control over all mergers. Therefore, while not ruling out the possibility of dual control of a kind which the Germans want, (any more than we are ruling out the possibility of rejecting the whole regulation at the end of the day) I think that it is right at this point to indicate our preference for a form of exclusivity if other aspects of the regulation prove acceptable. There are signs, in any case, that the Germans may move towards our position on this point.

An aspect which will have an important bearing on our attitude towards exclusivity is the nature and extent of the "derogation" allowing Member States to prohibit mergers in protection of their "legitimate national interests". The present text (Article 20) provides that Member States can protect such interests, provided that they are clearly defined and provided for in domestic law, and that the measures are compatible with other provisions of Community law. This certainly covers the cases which you mention; but is not limited to those cases; and the Commission appears favourably disposed to removing the "clearly defined and provided for" criterion in order that we could deal with a BP/KIO type case. However, I propose that we should also raise in this context our wider concern over state-owned predators, which Paul Channon raised.

Suspensory effect

You asked how I would define the small minority of cases where I believe that the Commission should have power to require suspension. As I say in my letter, I believe that the test should be whether there is a high risk of serious or irreparable damage to competition if the merger went ahead. I believe that the onus should be on the Commission to demonstrate in each case the need for suspension. This would be analogous to the Commission's existing power under Articles 85 and 86 to take "interim measures" to stop anti-competitive behaviour; and to my power under the merger control provisions of the Fair Trading Act to take interim action after I have referred a merger to the MMC.

dti

the department for Enterprise

Thresholds

I think that we should maintain our objective of setting thresholds which would catch about 10-15 UK qualifying mergers per year. This could be achieved either by leaving the lower threshold at 100m ECU in terms of aggregate Community-wide turnover, and raising the upper threshold to at least 7,000m ECU in terms of aggregate worldwide turnover; or by keeping the upper threshold at 1,000m ECU, and raising the lower threshold to about 600m ECU. There are a range of intermediate options, involving modifications to both thresholds; for example an upper limit of 2,000m ECU with a lower limit of 500m ECU, or an upper limit of 5,000m ECU and a lower limit of 300m ECU. I do not think that this Council is the occasion to come down firmly in favour of any one of these options. I propose that at the Council we should confine ourselves to saying that if the Commission has exclusive jurisdiction, the number of mergers within the scope of the regulation should be limited to about 10-15 UK cases per year, and we would expect the thresholds to reflect this.

We will need to review the next steps in the light of the TMC discussion, but I think the amplifications of our line that I have suggested here meets your immediate concerns, and that there is no need for an OD(E) discussion at this stage.

I am copying this letter to members of OD(E), Paul Channon, Sir Robin Butler and Sir David Hannay.

David

the enterprise initiative