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PRESENTATIONS BY BRITISH AEROSPACE AND ROLLS-ROYCE TO THE PRIME MINISTER AND OTHER MINISTERS: 10 DOWNING STREET: 16 NOVEMBER 1983

Present throughout:

Ministers

Prime Minister
Secretary of State for Trade and Industry
Secretary of State for Employment
Chief Secretary
Mr Hayhoe
Mr Lamont
Mr Pattie
Mr Stradling Thomas

Mr M Alison, MP

No 10 Policy Unit

Dr R B Nicholson (Chief Scientist)
Mr R Young

Officials

Sir Brian Hayes	Department of Trade and Industry
Mr W J Adams	Foreign and Commonwealth Office
Mr A J Pryor	Department of Trade and Industry

Attending for British Aerospace presentation:

Sir Austin Pearce, Chairman
Admiral Sir Raymond Lygo, Managing Director
Mr B E Friend, Director of Finance
Mr I R Yates, Chief Executive, Aircraft Group

Attending for the Rolls-Royce presentation:

Sir William Duncan, Chairman
Mr J A Rigg, Finance Director
Mr R H Robins, Director, Civil Engine Group (CEG)
Mr A Warrington, Company Secretary
Mr D A Marshall, Head of Business Planning, CEG

BRITISH AEROSPACE PRESENTATION

A full record of this presentation is at Annex A. The slides are reproduced at Annex C.

2 Thanking the BAe Chairman for his presentation, the Prime Minister stressed that the UK did not want another Concorde. She personally wished BAe to succeed with the A320. But much of the BAe case seemed to rely on an act of faith rather than an act of calculation. The prospect of vast profits in the future was a theme

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heard from so many businesses. The Prime Minister wondered whether a better assessment could not be done based on launch orders. She asked how long it would be before enough orders were secured conclusively to demonstrate the viability of the project. She agreed that it would be regrettable to leave Boeing with a virtual monopoly in the narrow-bodied market. She also felt the aircraft must have a Rolls-Royce engine and that British Aerospace might aim to do rather more than the wings.

3 In reply, Sir Austin Pearce emphasised that BAe would have to be satisfied with the wing work. The A320 could not be compared with Concorde. The economics of Concorde had been falsified by the massive increase in fuel prices: and the aircraft had in practice been operated by only two airlines. In contrast, Airbus aircraft were designed to meet the needs of a wide international market and Airbus Industrie had secured a very broad customer base. BAe's A320 market assessment had been checked against the assessments made independently by Airbus Industrie and other manufacturers. It was not over-optimistic.

4 Sir Austin Pearce added that BAe had pressed AI to secure more launch orders for A320. But, just like British Airways, a number of airlines were not ready to order a "paper aircraft". Matters were made more difficult by the fact that the current profitability record of airlines was so poor. But BAe were confident that, when the market upturn came, airlines would want the A320. Initially, BAe had sought one large launch order from a US airline and another from a major non-US carrier (besides Air France). Because of the flatness of the market, it had been necessary to relax these conditions and the requirement for a US launch customer had been abandoned. BAe could not yet claim massive launch orders and, though the market projections were based on scientific analysis, they did perhaps represent an act of faith. BAe were nonetheless convinced that, once the programme was launched, numerous orders would be secured (preponderantly in the 1985-86 period). But in order to have an aircraft ready to meet airlines' needs from 1988, the programme had to be launched at the beginning of 1984. The Prime Minister remarked that the opposite danger was that the aircraft could be built and that the orders would then not materialise.

5 Admiral Sir Raymond Lygo stressed that, in addition to the 26% work-share which BAe aimed to secure on A320, British equipment manufacturers could benefit from the programme. Sir Austin Pearce added that one of the conditions upon which BAe had insisted was that 20% of the equipment on A320 should be British (thus corresponding to BAe's 20% partnership share in Airbus Industrie). The Prime Minister asked whether this proportion would be achieved in practice. Sir Austin Pearce was confident that it could - provided the equipment suppliers played their part. The Secretary of State for Trade and Industry noted that the equipment suppliers might also want assistance with their development costs.

6 The Prime Minister congratulated British Aerospace for their success in winning a contract for 20 146 aircraft to be supplied to Pacific Southwest Airlines of California.

7 In conclusion, Sir Austin Pearce indicated that he would be pressing the Secretary of State for Trade and Industry for a decision on launch aid. The Prime Minister felt that, for his part, Mr Tebbit

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might have some more questions to put to BAe.

8 At this point, the BAe party left the meeting.

Informal discussion among Ministers

9 Ministers briefly considered the BAe presentation. The Secretary of State for Trade and Industry commented that BAe's advantage over companies like British Leyland was that Airbus Industrie had secured a wide overseas customer base. He personally felt that BAe's analysis of the market was correct. Clearly the quality and price of the product must be right - and that to some extent was a question of faith. But it had to be remembered that, from an unlikely start, Airbus Industrie had succeeded with the A300. BAe's problem was quite simply that their profits over the coming years would be inadequate to generate the necessary investment. The Secretary of State for Employment felt that, over the 20 years of the A320 project, the competition would be bound to counter-attack: this could undermine BAe's projections for future profits.

10 The Prime Minister felt that the Government was being driven into the position of saying that BAe would have to be given financial assistance if it were to stay in business at all. At least the Government got a positive product from its investment in military programmes. Mr Pattie pointed to the international environment within which BAe operated, including the substantial "subsidisation" of the US aerospace industry. The Secretary of State for Employment also felt that the UK would not be alone in wishing to avoid a Boeing monopoly in the narrow-bodied market.

11 The Prime Minister commented that what was emerging was a "diplomatic aerospace industry". The Chief Secretary stressed that the exit terms must be right: the UK must be able to withdraw from the project if things went wrong. He also felt that BAe must be tied down on the question of securing a greater proportion of British equipment. The Prime Minister agreed with this latter point and recalled the wider benefits which French industry had derived from the Concorde project.

12 The Prime Minister wondered why Lord King did not want the A320 for British Airways. Mr Lamont explained that British Airways were keeping their options open: they might have a requirement for A320 at a later stage. Mr Pattie noted that the past purchasing record of British Airways (BOAC, BEA) did not suggest that their choice of aircraft guaranteed a wider success for the manufacturers.

13 Reverting to the A320 project, Mr Lamont noted that the financial return postulated by BAe was still marginal. The Prime Minister was reconciled that the fact that Government assistance would be a straight subsidy to maintain technology and to keep people in work. While not dissenting, the Chief Secretary felt that the arrangements for the levy on sales must be fully explored to offer the best chance of a return to the Government. On the basis of a straight financial calculation BAe would, in the short-term, be better off without A320. The Prime Minister countered that, in the longer run, BAe would have no future without the project. She accepted that the aircraft industry would require Government funding.

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She was troubled by the prospect of a loss of intellectual quality in work available in the UK if the US was left with a monopoly. The Secretary of State for Trade and Industry felt that there could be wider benefits from BAe's work in robotics etc. But the Prime Minister had found BAe's accounting methods to be "antique". The practices of one site did not match up with those of another: there was considerable scope for improvement.

14 The Prime Minister further commented that she would not expect the Government to recover its launch aid. The Chief Secretary stressed that the Government must keep up the pressure on BAe. Mr Lamont was sceptical about BAe's need for 100% launch aid. He wished to explore ideas put forward in the City which would mobilise private financing for the development costs on the strength of the Government's shareholding. The Chief Secretary felt that the case could not be as black and white as BAe had presented it. The Prime Minister nonetheless felt that the Government had to be realistic. BAe needed another aircraft to survive (they also needed the ACA). This was a classic British Leyland situation - only more so. In four or five years time, new projects would be needed.

15 The Secretary of State for Trade and Industry commented that the Government also had the option of raising finance by simply selling part of its existing shareholding. The Prime Minister felt that this might have the effect of undermining confidence in the company. The Secretary of State for Employment wondered how one could genuinely "privatise" a company which was dependent upon Government.

16 At this point, the Rolls-Royce representatives joined the meeting.

The Rolls-Royce Presentation

17 The presentation as given by Sir William Duncan and Mr Robins is at Annex B. Copies of the slides used to accompany the presentation are in Annex D.

18 In questions after the presentation, Mr Pattie queried Rolls-Royce's projection of market penetration for the V2500 engine. The presentation had appeared to imply that Rolls would secure greater penetration if A320 did not proceed. Mr Robins explained that Rolls-Royce were assuming a 60% market penetration for the 150-seat aircraft class as a whole, including A320. This implied engine sales of 3000 units out of a total market of 5000 units. If the A320 did not proceed, the total market would be smaller: Rolls-Royce would nonetheless expect 2200 sales of the V2500. Sir William Duncan stressed that Rolls-Royce wanted the A320 project to proceed. Beside the direct benefits to R-R, the project might stimulate Boeing and McDonnell Douglas to develop new products rather more quickly than would otherwise be the case.

19 The Prime Minister queried the Chairman's statement that all Rolls-Royce borrowing required a Government guarantee. Sir William Duncan commented that some of the US financial institutions were

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uneasy about the prospective return of Rolls-Royce to the private sector. R-R's longer term loans might have to be re-negotiated nearer the time of privatisation.

20 The Secretary of State for Employment asked about the various joint ventures. How would marketing be handled? Did GE and/or Pratt & Whitney have Federal funding for development on the civil side and was HMG financial support a pre-condition for the acceptance of collaboration? What employment would arise from the joint ventures?

21 On marketing, Sir William Duncan and Mr Robins explained that the V2500 engine would be handled by staff working for the joint company: it had to be remembered that Pratt & Whitney and Rolls-Royce would remain competitors in other sectors. As for the big engines, Rolls-Royce and GE would initially respect "spheres of influence". Over the next 5 to 6 years, Rolls-Royce were bound to promote the RB211-535E4 and the RB211-524D4A against US competition. GE would simultaneously be promoting the CF6-80C. But collaboration with GE was essentially seen as a means of meeting the needs of the 1990s. It was hoped that GE and R-R would gradually evolve a pattern of cross-selling which would be the prelude to full collaboration.

22 The Prime Minister asked why collaboration with GE was envisaged. Was there not a risk that GE would use collaboration as a means of squeezing Rolls-Royce out? Sir William Duncan commented that collaboration offered both R-R and GE the chance to reduce costs - and to compete more effectively with the Pratt & Whitney 4000.

23 As regards employment, Sir William Duncan observed that some 3000 jobs in Rolls-Royce were directly affected by participation in the V2500. In addition, some 4000 jobs would be similarly affected outside Rolls-Royce. Mr Rigg stressed that the project would be sustaining jobs rather than creating new ones.

24 Mr Young asked why Rolls-Royce were pursuing collaboration on the larger engines with GE rather than Pratt & Whitney. Sir William Duncan replied that Pratt & Whitney had a dominant share: there were thus anti-trust implications. Unlike Pratt & Whitney, GE were not competing directly with the RB211-535: R-R saw some chance of a deal which could be genuinely reciprocal. Such a deal would be unattainable with Pratt & Whitney. The Chief Secretary, noting the previously-expressed view that privatisation of R-R as a whole would not be feasible in the near future, wondered whether it would still be possible to privatise the industrial marine division. Sir William Duncan replied that R-R engines were designed for aerospace applications. It would make no sense to hive-off the marine division which would continue to rely on aerospace technology. R-R wished to be able to develop collaboration with GEC on the basis of the breadth of its experience.

25 The Prime Minister was somewhat disturbed to find that there was no possibility of privatising R-R for five years. Sir William Duncan explained that the next two years would be difficult. Up to 1986/87, R-R would have a poor record of profitability. There must be doubt as to whether the company could then achieve a balance sheet which would be credible against the requirements of privatisation. But he

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did not totally discount the prospect of privatisation within five years. The Prime Minister noted that R-R would remain dependent on Government both directly for orders and for funding of the research needed for new engines. Sir William Duncan confirmed that the military side of the business would need continued Government support for orders and on the research side. The Chief Secretary wondered what would need to be done to the R-R balance sheet after two years to make privatisation possible. Sir William Duncan commented that years of good profits would be needed - not manipulation of the balance sheet.

26 The Secretary of State for Trade and Industry recalled that one of R-R's great successes since the War had been the turbo-prop Dart engine: this had had no major competitor to erode its margins or enforce costly interim developments. The position of the V2500 might be not dissimilar. It ought to be able to see off the CFM56-4 engine and achieve long-term dominance with the market. He felt that Rolls-Royce were very wise to change policy and to pursue a policy of collaboration on the big engines. The Secretary of State for Employment wondered whether the collaborative engines would have the R-R label - or whether R-R would be aligned with GE and Pratt & Whitney. Sir William Duncan commented that, in the case of the V2500, R-R would be aligned with its partners in a consortium. The R-R name would certainly be preserved on a marketing level. The Secretary of State for Employment wondered whether R-R engineers would not start to look upon the product as foreign engines. Would they need re-training on this account? Sir William Duncan recognised that the CF6-80C would be a GE engine. But, in the long-term, R-R could be identified technically with it and its successors. Mr Robins made the point that R-R were not simply a demandeur: GE wanted some of R-R's technology. The important thing for R-R was to spread the R&D base. Sir William Duncan stressed his view that the civil aero-engine market would not support three direct competitors.

27 Mr Robins also stressed that the whole of the compressor system on the V2500 engine would be provided by R-R. R-R would not lose control of this technology and would be able to use the compressor in other projects, eg to drive a prop fan in the 1990s. The advantage of the V2500 would be to keep R-R in the front line of the business. Something similar had to be worked out with GE for the bigger engines: and R-R were confident they had the technology to do this. Sir William Duncan noted that the alternative to collaboration with GE would be to stick with the RB211-524D4A until such time as R-R were pushed out of the 50,000 lbs plus market altogether. Mr Pattie confirmed that the withdrawal of R-R from "own name" participation in the bigger engines would have no military affect. MOD had certain decisions to take, but collaboration was already firmly established on the military side.

28 Sir William Duncan emphasised that R-R would not enter into collaboration with GE unless it was clear that this course would be more profitable than staying independent or getting out of the large engine market altogether.

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29 The Secretary of State for Employment recalled that he had asked whether an agreement with GE would be conditional upon HMG launch aid for further development of the CF6-80C. Sir William Duncan replied that this was not the case. The Prime Minister recalled, nonetheless, that all R-R's borrowing was subject to a Government guarantee. Was this not Government support? Mr Rigg agreed that banks would continue to rely on the comfort letters. But R-R were confident of their ability to repay - and predicted the necessary cash surpluses.

30 The Secretary of State for Trade and Industry felt that the Government should avoid displaying any lack of confidence in R-R's ability to participate, in their own right, in the large engine market. We needed to let GE think that R-R could go it alone as a means of securing the best collaborative deal.

31 At this point the Rolls-Royce party left the meeting.

Informal discussion among Ministers

32 The Prime Minister felt that R-R had sung the same song as BAe: perfect days were always in the future. Mr Lamont nonetheless commended R-R for moving towards collaboration. The Prime Minister wondered whether there was a real future for Rolls-Royce, even when they had done everything right. She felt the Government must expect to prop up the company in order to keep the technology going.

33 The Secretary of State for Trade and Industry felt that the position on launch aid and levies had been somewhat less black than might have been feared. The Secretary of State for Employment nonetheless feared that the next recovery would inevitably be followed by further slippage, making continued HMG support inevitable. The Prime Minister noted that the US industry received considerable support in the form of Defence contracts.

34 Mr Lamont felt that the Government should keep up the pressure on the company about privatisation. He was sure that Sir William Duncan wished to privatise the company and to do without further Government support. The Prime Minister felt that the Government should not lose too much sleep if it was unable to privatise R-R. The purpose of Government support to the company was to preserve a necessary technology, partly because of a political commitment and partly because of the employment implications. We had to keep R-R alive because we would otherwise lose contact with the appropriate technology base.

35 Dr Nicholson, asked by the Prime Minister for his views, observed that both BAe and R-R were operating in the area of leading edge technology with potential spin-off benefits. He personally had been impressed by Rolls-Royce's R&D effort at Derby. R-R had stated in their presentation that they were reducing their R&D spend by 25%: but they were significantly increasing their productivity. He had not had the opportunity to visit BAe. But his impression was that BAe were less competitive vis-a-vis Boeing than Rolls-Royce were vis-a-vis Pratt & Whitney. BAe seemed to be lagging behind in manufacturing and metals technology. Boeing were now saying that they could build an aircraft with only 11% by weight in aluminium - the rest would be new materials. He doubted whether BAe could achieve the same.

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36 The Prime Minister asked about the next steps in the consideration of launch aid. The Secretary of State for Trade and Industry felt that, since the Prime Minister appeared to be sympathetic towards the concept of launch aid, he would now wish to talk to British Aerospace in an attempt to reduce their bid (both as an absolute amount and as a proportion of the development costs). The Prime Minister observed that BAe's current bid appeared to be little more than a guesstimate. The Chief Secretary also felt it would be important to follow up Mr Lamont's ideas for innovative mechanisms to mobilise private sector financing.

Department of Trade and Industry
22 November 1983



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21 November 1983

David Barclay Esq
 10 Downing Street
 LONDON SW1

Dear David

*die RB (FW)
 order and
 copies to those on the
 attached list.
 Annexes C & D of the
 report are available
 for DTE*

I enclose my record of the BAe and Rolls-Royce presentations at No 10 on 16 November, including the question and answer sessions and the informal discussions among Ministers. I have done this in a standard Private Office format, attributing remarks to individuals: I did not think the discussion lent itself to the traditional Cabinet Office type of report.

2 In order to keep the report within manageable proportions, I would suggest that you circulate it without Annexes C and D. These are the brochures including copies of the slides used by BAe and R-R. One copy of each is attached for your own records. But I would suggest that any recipient of my note interested in seeing these Annexes should simply be referred to me. We will keep a number of spares which can be sent out on demand.

*Yours sincerely
 Andrew Brown*

A J PRYOR



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10 DOWNING STREET

From the Private Secretary

22 November 1983

Dear Roger,

Although in the event the Foreign Secretary was unable to attend the presentations by British Aerospace and Rolls Royce on 16 November, you may like to have the enclosed copy of the DTI record of this.

I am sending copies of this letter and of the meeting record to those on the attached list. Annexes C and D to the record are available on request from Mr. A.J. Pryor of Air Division 2 at the Department of Trade and Industry.

*Yours ever,
David*

David Barclay

R.B. Bone, Esq.,
Foreign and Commonwealth Office.

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Prime Minister
Secretary of State for Trade and Industry*
Secretary of State for Employment
Secretary of State for Wales
Chief Secretary
Mr. Hayhoe
Mr. Lamont*
Mr. Pattie
Mr. Stradling Thomas*

Sir Brian Hayes (DTI)*
Dr. R.B. Nicholson (Chief Scientist, Cabinet
Office)
Mr. R. Young (No.10 Policy Unit)
Mr. W.J. Adams (FCO)*
Mr. A.J. Pryor (DTI)*

* Without enclosure