SECRET

PART TWO

MT

(REPORTS AND ACCOUNTS FOR 1986/1987 IN ATTACHED FOLDER)

Confidential Filing.

Short Brothers plc : Corporate Plan and privatisation prospects.

[attached folder Report: "Initial Review of Strategy" June 1988.]

INDUSTRIAL POLICY

Part 1: Nov. 1980

Part 2: June 1986

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~12.6.86~~							
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22.3.89							

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PREM 19/2741

PART 2 ends:-

PM to NIO 23/3/89

PART 3 begins:-

SS/NIO to CST 8/4/89

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ccBG SW

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 23 March 1989

SHORTS BROTHERS plc

The Prime Minister has seen your Secretary of State's letter of 21 March to the Chief Secretary and the Chief Secretary's reply of 22 March. She has noted the proposals on the negotiating brief for discussions with prospective purchasers of Shorts, and is content for your Secretary of State and the Chief Secretary to sort out the details along the lines suggested.

I am copying this letter to Carys Evans (Chief Secretary's Office).

(PAUL GRAY)

Stephen Leach, Esq.,
Northern Ireland Office.

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KK

cst.ps/13jm22.3/drfts

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cc: George Lowe

Treasury Chambers, Parliament Street, SWIP 3AG

The Rt Hon Tom King MP
Secretary of State for Northern Ireland
Northern Ireland Office
Whitehall
London
SW1A 3AZ

22 March 1989

Dear Secretary of State

SHORT BROTHERS PLC

You sent me under cover of your letter of 21 March the outline negotiating brief which you and our officials should be guided by in the next, exploratory stages of negotiation with Bombardier and with Fokker/GEC.

As you recognise, there can be no question at this stage of presenting a detailed package of quantified assistance to either of the prospective purchasers.

Any such package can only be developed in response to their detailed proposals for the future of the business. But the signals you will be giving them over the next few weeks will clearly influence their thinking. As you say, it will be necessary to have opening and fall back positions on a number of key issues - although I would only expect you to move to fall back positions as their proposals begin to gel.

The brief appears to cover most of the main issues satisfactorily, subject to my comments below, and you will consult on further specific issues as they emerge after Easter. One such issue is likely to be the position on the company's main pension scheme on which I attach a line to take which has been discussed between officials.

As agreed at E(A) you will be seeking to constrain the cost of any final package within £600m, but there will be further consultation between us before you put any such package forward.

Turning to the text of the negotiating brief, I have no difficulty on objectives, or on the approach you intend on sales proceeds.

On capital expenditure, I do not think that the fall back under (iii) should be deployed in this exploratory phase - it is very much the sort of point we can only consider in the final stages of closing an otherwise satisfactory outcome.

On new products I am content with what you prepare and welcome the move away from "launch aid" that you are clearly signalling.

On redundancies I do not think that you should go as far as you suggest, at least until firm business plans are put to you. I suggest the opening position should be to offer to cover redundancies in a six month period after completion, although you could indicate that you would be prepared to consider a significantly longer period if eg the purchaser wished to discontinue production of the 360, but was prepared to phase that so as to limit Government liabilities in respect of existing 360s.

I accept the approach that you intend to take on future losses, with those losses arising from past uneconomic contracts being met by provisions in the completion accounts. On losses that may be unavoidable as the business is turned round, but which do not have such a clear root, I agree your opening position but again feel that the fallback should be withheld until we are closing a deal with the successful bidder. I see no need to display it in the next exploratory stage.

I am content with the position you propose on tax losses.

On sales financing the objective is clearly to contain, or if possible eliminate, the future risk to Government. You should try hard to see if, for a price, the new owners will assume these liabilities. We can then consider whether that price is acceptable or whether we need to fall back, as you suggest, to seeking to minimise the costs that may arise by agreeing a managed rundown of 360 production, with continuing spares support, and the new owner managing the leases with Government guarantees remaining in place but protected by counter indemnity.

On Parliamentary Assurances the objective is clearly to withdraw these for future business once we have sold the company and to ensure that in respect of the past the new owners full resources stand between Government and any claim under the assurances, so that, as at present, a claim could only arise on receivership or liquidation.

I agree the approach proposed on Warranties and indemnities.

On training I am content with the opening position, but again feel the fall back should be reserved for the final stages of negotiation.

On employee/management shareholdings while we should indicate that we are fully supportive of such properly structured schemes, we should also make it clear that it would be a matter for the new owners to promote the necessary prospectus, in which the Government could have no role. It may well be that the new owner will wish to get some financial commitment from you. I suggest that a direct contribution is best avoided, although you could indicate that the costs the new owner would face could be recognised in some way in determining the price to be paid to Government for Shorts assets.

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I am content that the commitments you propose to seek from the purchaser are along the right lines, but we will clearly need to consider how well the proposals we receive measure up to them and our prime objective of early privatisation.

Clearly our officials will need to be in close and continuing touch as discussions go forward and, as was the case for Harlands, I am content that Alun White here should form part of your negotiating team.

I am copying this letter to this Prime Minister.

Yours sincerely
Carys Evans

JOHN MAJOR
(Approved by the Chief Secretary and signed in his absence)

Pension Scheme

The Company's principal pension scheme was valued at 5 April 1988. At that date it had an actuarial surplus on a discontinuance basis. On the back of reducing that surplus the company is enjoying a two year contribution holiday, ending 5 April 1989.

The fund will need to be re-valued at completion on a continuing basis. Assuming that there will be significant redundancies associated with disposal this should show a surplus. Our objective should be:

a. If the surplus is modest (ie would not justify more than a further two year holiday) we should leave it in place but seek to get value for it in the sale terms;

b. If the surpluses is more substantial seek to extract any surplus over £5m by way of a payment from the new owners to Government.

If, on a continuing basis, the scheme is in deficit the Government will need to accept the responsibility for rectifying the shortfall.

PRIME MINISTER

SHORTS

Following the successful deal on Harland and Wolff, Tom King and John Major are now in discussion about the detailed negotiating brief for discussions with respective purchasers of Shorts - see Tom King's letter at Flag A and John Major's at Flag B.

George Guise has been closely into this and concludes there are **no** points on which you need to intervene. My impression is that the NIO and Treasury are now working closely and effectively on the disposal of these Northern Ireland businesses.

Content simply to note these latest exchanges and to leave Tom King and John Major to sort out the details?

Yes MT

PRG.

Paul Gray

22 March 1989

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A ccf.V

Northern Ireland Office
Stormont Castle
Belfast BT4 3ST

Rt Hon John Major MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

21 March 1989

Dear John,

SHORT BROTHERS PLC

In my recent memorandum to colleagues (E(A)(89) 12) attached I undertook to consult on a detailed negotiating brief to be followed in discussions with prospective purchasers of Shorts.

Although we have identified potential purchasers this is clearly going to be a very difficult privatisation. I will seek to keep the net cost to Government to £600m, even though the estimates from Kleinwort and Touche Ross both suggest the figures will have to be higher.

The packages which we discuss with the potential purchasers will vary substantially depending on their respective plans for Shorts. There are however a number of major points which can reasonably be anticipated to arise in the course of discussions, and we can agree in advance our stance in relation to these.

I therefore attach a detailed negotiating brief which has been agreed between our officials reflecting their consideration of Kleinwort's advice, and I hope you will be able to agree to both the opening and fall-back positions on each point. There will, however,

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SECRETARY OF STATE FOR NORTHERN IRELAND

inevitably be further specific issues which potential acquirers will raise: on these my officials will consult yours and I will then consult you as necessary, but I would not expect to do so until after Easter.

I am keen to ensure that when we privatise Shorts, we put the company in the same position as any other private sector company in Northern Ireland. Consequently I am examining whether to repeal the Aircraft and Shipbuilding Industries (Northern Ireland) Order 1979, which was drawn up to define our powers and responsibilities whilst Shorts and Harland and Wolff were in public ownership.

I am copying this letter and enclosures to the Prime Minister.

Tom

TK

JB/PROB/20990

SHORTS NEGOTIATING STRATEGY

Overall Objectives

The overall objectives in negotiations with purchasers should be to:-

(i) privatise the company, if possible as a single unit, as early as possible;

(ii) secure stable lasting employment at the company based in Northern Ireland;

(iii) achieve sale at least cost consistent with the above objectives and if possible within a net £600m (inclusive of £390m convertible loan already agreed);

(iv) secure linkage of payments of assistance to a purchaser to the achievement of agreed conditions.

I cannot quantify (iii) more precisely until the prospective purchasers come forward with their detailed proposals. Officials will keep Ministers informed of progress but no clear picture is likely to emerge until after Easter.

Policy Issues

Sales Proceeds

After the recently agreed recapitalisation, the company is expected to have net assets of approximately £130m at 31 March 1989. This is on the assumption that 1989/90 losses amount to approximately £80 m and no further major loss provisions are required, but the likelihood is that there will be such provisions to reflect any changes in the commercial strategy which new owners are likely to require eg termination of the SD3 series. Our opening position therefore will be to seek to dispose of the company at the net book value after provisions as shown by the audited accounts at 31 March 1989. This should avoid any debate as to the accuracy or otherwise of the figures as the independent auditors will in effect become responsible for agreeing them. Our fall back position will be to seek a proportion of the net book value as the sale price to reflect the uncertainty regarding future trading.

In arriving at the net assets as a basis for the purchase price, an adjustment should be made to reflect the current market value of property. In disposing of the company, we will seek arrangements to ensure that either the Government shares in any future substantial profit from resale or that such profits are reinvested in the business. Likewise we will seek a share of any substantial profit arising from the subsequent sale of major parts of the existing business.

Capital Expenditure

This falls into four categories:-

(i) Deferred maintenance etc: we should offer to assist in full essential capital expenditure to meet health and safety requirements, existing environmental obligations, essential maintenance not completed etc.

(ii) Expenditure already committed by existing management and therefore unavoidable: Our opening position is that the buyer should meet this expenditure on the basis that it will increase the net assets of the business. Our fall-back position should be to offer some assistance on the basis that they were not in a position to influence the commitment decision.

(iii) Immediate new capital expenditure to rationalise the facilities and improve productivity: Buyers are likely to argue that substantial capital expenditure is needed immediately to make the company competitive. Our opening position should be to grant aid this expenditure up to a rate of 50% so as to provide an incentive to the new owner to proceed whilst leaving risk with him. Our fall-back position, given that this is controllable expenditure which is likely to be acceptable to the Commission, will be to offer grant of up to $66^2/_3$%.

(iv) Longer term expenditure (after the expenditure covered by (iii) above): The company will be eligible for regional aid as with any other NI private sector company. This will not score against the total cost of the package.

New Products

(i) Existing products transferred from buyer to Shorts.

We should offer grant at 25% on tooling and labour learning (equivalent to grants under the Support for Innovation Scheme).

(ii) New Products to be introduced within 18 months.

Opening position as (i) above. Our fall-back position should be grant of 50%. In both cases we would seek provision for all or part to be repayable on a scheduled basis.

Redundancies

The opening position should be to offer to fund the costs of all redundancies under the existing company scheme for a period of up to eighteen months; it is likely to take some time before a new owner can introduce new capital equipment and restructure the business. Since this aid is likely to be acceptable to the EC, our fall-back position should be to cover the costs for a longer period based on an agreed plan which should show clearly the restructuring intentions of the new owner.

Future Losses

With regard to future losses on existing contracts our opening position should be that these have already been provided for in arriving at the net asset position and no further aid is necessary. Further losses may occur however because of previous under-provisions, unrecovered overheads and losses caused by significant changes in production. We would seek to obtain a claw-back in circumstances where the provisions are not required and these are written back. Our opening position should be that these are matters under the control of the new owner and therefore should not be assisted. However in the light of the large losses incurred by the company in the past and the uncertainties about the future, our fall-back position should be to offer support for these future losses against an agreed business plan. This support could be by means of an employment grant related to parts of the business showing clear potential for future viability.

Tax Losses

Our opening position is that existing tax losses should be eliminated.

Our fall-back position should be to ensure tax neutrality ie that the tax effect of grants included in the offer should be equalled by tax losses retained in the company.

Sales Financing

Virtually all sales to the US are under leasing deals where HMG has guaranteed Shorts' obligations to meet leasing commitments. These have resulted in major contingent liabilities inextricably linked to the SD3 series, and early termination of manufacture increases the likelihood that claims could be made under these arrangements. Even if SD3 manufacture is terminated, contractual obligations require spares and logistics support to continue for an appropriate period. In practice purchasers of the company are unlikely to accept past sales financing commitments and indeed the US financial institutions who currently hold the direct guarantees from HMG are unlikely to accept any other guarantees. The size of the contingent liability depends on whether leases are retained, the extent to which aircraft are released and the attitude of the facility banks (who provide an element of risk-sharing) to the privatisation.

HMG is unlikely to be ale to pass on responsibilities to a third party. Our position therefore should be to seek to minimise what could be substantial liabilities until 2004 by:-

(i) agreeing with purchasers a managed run-down of SD3 production over a short period rather than immediate termination (thus helping to avoid a sudden collapse in second-hand market prices resulting in depressed leasing rates);

(ii) agreeing with purchasers the continuation of spares support (to which Shorts is currently obligated);

(iii) Government retaining its guarantees but the new owner managing the leases with a counter indemnity in favour of the Government.

The precise arrangement will inevitably be subject to complex and detailed supplementary discussions including not only the new owner but the US and UK lessors and the facility banks.

Parliamentary Assurances

Our obligation is to meet those liabilities that Shorts owes to persons dealing with the company which the company cannot meet on liquidation. The assurances will be withdrawn in respect of obligations entered into from the date of sale. As regards existing liabilities covered by the assurance we expect the purchaser of the company to assume these. However those presently benefiting from the assurance are unlikely to accept any alternative to their HMG assurance.

Our negotiating position should be that the liabilities should in the first instance be met by Shorts and its new owner. Its new owner should undertake to meet the liabilities of Shorts covered by the assurance and agree to indemnify HMG in respect of them. The aim is that HMG should settle these liabilities only if Shorts and its new owner are in liquidation and unable to meet them.

Warranties and Indemnities

Our objective will be to offer no such warranties but requests may have to be dealt with on a case by case basis eg contingent liabilities such as environmental issues.

Training

Given the industrial relations and skills background of the company, prospective purchasers may seek support for training. Our opening position will be to offer grants of up to 50%, again as an incentive, on an agreed training plan over 18 months. Our fall-back position would be to offer grants of up to $66^2/_3$%.

Employee/Management Shareholding

Given the past history of industrial relations and poor productivity it is likely that purchasers will want to establish a share incentive scheme for employees to help promote a more positive attitude. We should be prepared to consider proposals.

Commitments to be sought from the Purchaser

We will seek commitments from the purchaser relating to such matters as:-

- the continuation of manufacturing in NI;
- continued ownership of shares in the company (except with our agreement);
- intentions regarding the future business of the company including employment levels.

Our aim will be to seek to secure these by way of relating release of the grants to agreed targets and having clawback facilities.

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PRIME MINISTER

HARLAND AND WOLFF PLC, JAMES MACKIE AND SONS LIMITED AND SHORT BROTHERS PLC

E(A)(89) 4, 11 and 12

DECISIONS

1. You may wish to take the progress reports on these three companies in the following order.

i. Harland and Wolff. The only prospect of disposal appears to be a management/employee buyout in partnership with Mr Fred Olsen. Mr King aims to follow the Govan precedent, of keeping the cost of disposal (including any liabilities retained by Government) within the cost of closure. He estimates this figure to be in the region of £275 million. The Chief Secretary is likely to press for a lower figure of £220 million. A decision is needed to enable negotiations to proceed. You may wish to ask Mr King about the prospects for achieving the disposal at either of these figures. You may wish to conclude by inviting Mr King to report progress in two months' time.

12m equity
30m
£88m - ordinary
Intervention

ii. Mackies. Disposal of Mackies to Howdens has been frustrated by the decision of the trustees holding Mackies shares to prefer a revised offer from the American firm of Lummus. Mr King met the trustees on Monday, and may be able to report further at the meeting. You may wish to note the position and invite Mr King to report back again in two months.

iii. Shorts. You may wish to invite the Sub-Committee to note with approval the decision to seek a Spring Supplementary Estimate of £390 million; and to resolve two issues. These are

No first, whether there should be exclusive negotiations with Bombardier until 31 March, as Mr King proposes on Kleinworts' advice; and second, whether negotiations should be conducted within a ceiling for Government support of £600 million (inclusive of the £390 million).

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MAIN ISSUES

HARLAND AND WOLFF

2. At present there appears to be only one serious bidder, the management/employee buy-out in partnership with Mr Fred Olsen. Mr King suggests that Mr Olsen's involvement makes this proposal the best opportunity yet for securing Harland's future. As a precaution, you may wish Mr Younger to confirm that there are no insuperable security implications if Mr Olsen became the part owner of a yard constructing the AOR.

Cost of closure

3. Mr King estimates the overall closure costs to be £275 million, on the basis of Touche Ross's figures: paragraph 10 and Annex B of his paper. This compares with his preliminary estimate of £240 million last July. The Treasury are sceptical for two reasons. First, the estimate has been prepared (understandably) on the basis of detailed costings from Harlands themselves. The management of Harlands have a clear interest in inflating such costings, since this will provide more headroom for their buy-out bid. Second, the estimate includes £55 million for contingencies, comprising £25 million of the £105 million cost of completing existing contracts (which is described as an estimate of the direct consequence of reduced productivity following a closure announcement) plus the £30 million contingency to take account of possible industrial unrest and disruption, wilful negligence and the risks of criminal damage. The Chief Secretary is expected to argue that this £55 million should be deducted from the estimate of £275 million for the purposes of negotiating with potential bidders: that is, that the current ceiling in negotiations should be £220 million. You will wish to consider whether the Chief Secretary's figure would be a better basis for negotiation in the circumstances.

Timetable for decisions

4. An early end to negotiations on Harlands is highly desirable. Whilst the uncertainty persists, management at the yard continues to leave. Limited progress appears to be being made with the two current orders. In December Mr King estimated that SWOPS would be delivered in June 1989 and the AOR in December 1990. His latest

estimates are November 1989 for SWOPS and February 1991 for the AOR. You may wish to ask Mr King about his intended timetable to the conclusion of negotiations.

MACKIES

5. Negotiations on a package of Government assistance for Howdens to take over Mackies were nearly complete when the Trustees holding Mackies current shares came forward with a revised proposal from the American firm Lummus. The Trustees have accepted Lummus' offer in principle, subject to Government support being available for Lummus' business plan. Lummus had been involved at an earlier stage, but it had been understood that they were no longer interested.

6. The proposals under discussion with Howdens had involved no immediate payment for the shares but the prospect of a share in future success should that occur. The proposals from Lummus are understood to be more generous to the Mackies Trustees, who act on behalf of current and former employees of the company. Mr King met the Trustees on Monday to explain his attitude towards the Lummus proposal and to press them to resolve the future of Mackies as soon as possible. You may wish to ask Mr King to report on these latest developments and simply note the position. No immediate decisions appear to be required.

SHORTS

Capital Reconstruction

7. When E(A) met on 1 December it concluded that a once and for all capital reconstruction of Shorts would be preferable to an interim reconstruction. Mr King may therefore wish to explain briefly the reasons for deciding on a financial injection equivalent to Shorts existing debt in this financial year.

Exclusive Negotiating Rights

8. Mr King regards Bombardier's bid as the most attractive. Its proposal to buy Shorts is considerably more advanced than the others which were received. Bombardier has said that it needs to know where it stands with Shorts by the end of March, because its plans for a regional jet are far advanced and arrangements urgently need to be

made with sub-contractors. We understand that Mr King made considerable efforts to extend his deadline when he met Bombardier's chairman on Monday, but without success. Mr King therefore proposes, on Kleinworts advice, to negotiate on an exclusive basis with Bombardier until 31 March.

9. We understand that the Chief Secretary agrees with Mr King that Bombardier's bid should be pursued. The main alternative to giving Bombardier exclusive negotiating rights would need to persuade at least one of the other bidders to pursue its bid on the same timescale. You will wish to decide whether Bombardier should be given exclusive negotiating rights until 31 March. If this period is granted and no deal is finalised, you would probably wish all remaining bids to be given time to reach the same stage of knowledge as Bombardier before any competition continued.

Ceiling for Government support

10. Mr King proposes to conduct negotiations at this stage with a ceiling of Government support of £600 million. This compares to the range of £700-850 million which the Select Committee on Trade and Industry recently suggested would be necessary, and is also below the ranges produced by Kleinworts and Touche Ross. We understand that the Chief Secretary may be prepared to allow negotiations to proceed on the basis Mr King proposes. You will wish to decide if you are also content.

11. You may wish to note that Mr King proposes that some of the Government support for Shorts could be in the form of launch aid for the development of whole or part new aircraft. He also proposes to tell bidders that there will be no objection to Shorts bidding for Ministry of Defence contracts once in the private sector. You may wish to check that the Chief Secretary, Mr Younger and Lord Young are content.

Next Steps

12. You may also wish to ask Mr King to report back to E(A) in a month's time, if an exclusive period for Bombardier is agreed until 31 March. You may also ~~wish Mr King~~ to consult the Foreign Secretary and Lord Young on the handling of any further negotiations with the European Commission.

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HANDLING

13. You may wish to ask the Secretary of State for Northern Ireland to introduce the discussion on each company in turn. The Chief Secretary, Treasury will wish to respond first. The Secretary of State for Defence may wish to comment on the implications for his Department of the prospects for Harland and Shorts. The Foreign and Commonwealth Secretary and the Trade and Industry Secretary may wish to comment on the handling of discussions with the European Commission on the provision of financial support for the three companies. Other Ministers may wish to contribute to the discussion.

RJW.

R T J WILSON
Cabinet Office
1 March 1989

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PRIME MINISTER   1 March 1989

NORTHERN IRELAND INDUSTRY

The main subject is Shorts where Tom King's paper proposes dealing exclusively with one potential purchaser throughout March. Prospective suitors for the other two businesses, Harland and Mackies, continue to appear and disappear although the joint Olsen/MEBO proposal for Harland is the most positive yet.

HARLAND AND WOLFF

The Olsen initiative should be encouraged under the absolute constraint that the Government's financial outcome must under no circumstances be worse than closure. A total cost limit of £275 million should therefore be set at E(A). This figure already appears to be heavily padded with contingencies and maximum estimates included at every stage of the calculation. Nevertheless, in order to achieve a settlement, it makes a realistic working limit. Fred Olsen has a respected reputation and has put his name to a serious letter of intent. This is far more encouraging than last year's 'make believe' proposals from Ravi Tikoo.

It is nevertheless important to make the cautionary point that to 'be seen to explore all the privatisation possibilities' must not be interpreted as a licence to keep Harlands bleeding for evermore on the back of the tax payer. If the Olsen/MEBO deal disappears then the yard must be closed. Whatever the short-term popularity consequences, it can do no good to the Province or to the Government to let this drift on much longer. Harlands is one of the highest cost and most incompetently run shipyards in the world. The hard prospect of closure may incline the workforce to reduce activity to a crawl but this could be counteracted by incentive payments linked to deadlines. Such additional costs would be part of the overall closure decision and should be so treated.

Hopefully we shall not get to this position but in pursuing the Olsen deal, the reality of the closure alternative must be recognised and, if necessary, quickly implemented. It is no solution to enter a vicious circle of procrastination so the yard runs out of work before a decision is made. That would leave a longer and blacker political mark than planned closure with adequate planning.

MACKIES

The suitors for Mackies change every time the subject comes up. In December we were told that the only alternative to a Howdens sale was 'complete closure of the company'. Now Lummus has reappeared but where this will lead is pure speculation. However, it would do no harm to remind the meeting that the number we were talking about for Government support for a Mackies sale was a maximum of £20 million.

Indeed, you initially suggested that might be tranched with an initial payment of say £10 million and the remainder dependent upon performance. If either the Lummus or Howden initiatives mature into a real purchase, then it would be better to let the £20 million go in one lump and be shot of Mackies. I understand that Lummus is a competant firm which should have the capability of turning Mackies around although not as strong as Howdens.

It might be appropriate to remind Tom King of his own words on Mackies - 'I am determined that the situation will not be allowed to drift'.

SHORTS

I have seen the various proposals for purchasing Shorts. Only that from Bombardier reads like a coherent strategic plan - see Annex A. Even that is qualitative without proper numerical analysis. The strength of the Bombardier proposal is that their own business plans make it essential to reach a decision on Shorts very soon. It is appropriate to use this to our advantage but not at the cost of ending up with no sale through sending potential purchasers away too soon.

Only the joint GEC-Fokker, and possibly the MBB proposal, seem worth pursuing with any urgency. It is improbable that either of these could be finalised by the end of March, although it could be possible to push Fokker within a two month deadline. I have suggested that Kleinworts tell Fokker that they have a potential rival capable of completion by the end of March. If Fokker could make the same commitment, they could examine the company simultaneously. This might be administratively awkward but one possibility might be to allow both suitors more time. I understand that Tom King is also now moving in this direction. No individual purchaser would be seen to be on some 'inside track' and, if Bombardier fell away, it would leave at least one other active contender.

If however Bombardier is given a de facto exclusive, there must be an absolute deadline at the end of March which should not be extended to resolve detailed matters. As with

BAe/Rover, an overall sum of say £600 million could be set as the broad framework for the detailed deal. It is difficult to be adamant about the size of this sum in advance but last week's Select Committee mentioned a figure of up to £850 million which Kleinworts have privately indicated will probably cost the government an extra £100 million! It might therefore be appropriate to start Tom King with a limit of £600 million with the requirement that he return to E(A) if he needs to go higher.

don't reveal you know this! PRG.

The Government could defend itself against allegations of not achieving the best price by reaching a settlement within the figure recommended by the Select Committee and also pointing out that Bombardier was the only company that actually made an offer for the entire business. The GEC/Fokker deal separates the missile division straight away and the same sounds true of the MBB proposal (see Annex B). In any case MBB can only be tentative because of the necessity of prior resolution of a merged business strategy with Daimler-Benz. MBB therefore seems a limp fallback and very much the third contender.

The realistic alternative to Bombardier is Fokker/GEC but this would mean breaking up the company in opposition to the views of management, Northern Ireland politicians and the Select Committee. This should be a strong defence if a Bombardier deal is concluded.

CONCLUSIONS AND RECOMMENDATIONS

1 On Harlands, set an absolute limit to the Olsen deal of £275 million failing which closure must automatically follow.

2 Take note of the new situation at Mackies reminding King of the £20 million limit.

3 On Shorts reiterate your insistence that the actual transfer of the £390 million is dependent on both the appointment of the Finance Director and the rearranged capital structure which effectively limits their further borrowing headroom to £10 million. (This has the same effect as reducing their borrowing limit from £400 million to £10 million because the Government funding is also a loan which itself uses up £390 million of Shorts borrowing limit leaving only £10 million left).

4 Propose that an exclusive be given to Bombardier only if Fokker/GEC would be unable also to reach a quick decision. Emphasise that if an exclusive is given to Bombardier, the end March deadline is absolute. 16

5 Support a parallel investigation by both Bombardier and Fokker (over say two months) if King offers this alternative.

GEORGE GUISE

Annex A - Extract from Bombardier's proposal.

Annex B - Extract from MBB's letter.

Logistic Equipment Division

This division was established in 1981 to manufacture vehicles for the transportation of troops and materials. Products in this division include a 2.5 ton truck licensed from AM General, the four-wheel drive all-terrain ILTIS jeep (with technology acquired from Volkswagen), as well as the parts for these vehicles. The overall strategy in this division is to cover the full range of vehicle sizes through joint ventures and licensing agreements.

Vehicles have been delivered to the Canadian, Belgian and West German Armed Forces, and we intend to exploit these bases to further develop domestic and international markets.

6. Bombardier's plans for the future

Bombardier Inc. intends to continue its strategy of building on the strengths we have established in the transportation field, and to remain a financially strong company with good profitability.

We will continue to strengthen our standing in major markets in Europe, North America and Asia. We intend to pursue product diversification in the transportation industry, seeking a counter-cyclical mix of products for the consumer, industrial and defence markets. Expansion will be achieved through internal development, joint ventures and acquisitions.

7. Bombardier's interest in acquiring Shorts

Bombardier believes there could be an excellent strategic fit between our company and Short Brothers. There is complementarity between our three main areas of business and our principal geographical market bases. We can immediately project that both companies could benefit from the significant synergies to be gained in the areas of engineering, research and development, production, and marketing.

We see the potential, with the proper investment and private sector leadership, to set Shorts on the path of growth and profitability that would be to the mutual benefit of Bombardier, the British Government and the community of Northern Ireland.

In the context of Europe 1992, free trade between Canada and the United States, and increasing global competition in the defence and aerospace industries, the joining of strengths between two medium-sized but strong players will provide mutual advantages and open up opportunities which may otherwise not be available.

Bombardier is not a financial holding company which buys and resells assets to increase its worth. We are committed in the long-term to the transportation equipment sector including the aerospace and defence industries, and the acquisition of Shorts would be a long-term investment which would complement our current manufacturing and corporate global strategy.

8. Bombardier's assurances regarding Shorts

From our current assessment of the situation of Short Brothers, we would be prepared to consider the following commitments.

A separate entity based in Northern Ireland

Bombardier's intention would be that Short Brothers continue to operate as a separate whole entity under its present name and that it be developed with a long term perspective similar to what we have pursued with Rotax in Austria, and with B.N. in Belgium. Headquarters, as well as manufacturing and R&D facilities would remain in Northern Ireland.

Retention of Shorts Shares

It is our intention to acquire Shorts as a long-term investment and we would be prepared to give assurances that we would retain a shareholding for a minimum of three years. May not sound long but is quite a committment

As part of our strategy in an increasingly complex competitive environment where projects and corresponding business risks are growing in scale, we see great potential for complementarity and specialization between Canadair and Shorts in a manner which will increase the viability and competitive advantages of both organizations.

Bombardier is committed to the aerospace sector, and we have demonstrated our capacity to stand behind our products and businesses through good and bad times. Our finances are solid and we have access to capital markets in North America and in Europe. We are prepared to make the appropriate long-term managerial and financial commitments for the future development of the company.

Future Strategy

Bombardier sees considerable advantages in maintaining Short Brothers as a complete entity, and in strengthening the individual divisions that currently exist. A decentralized structure is one of our well served management principles, and we believe that responsibility and accountability should be pushed down to where the action takes place. We encourage our managers to look for new business opportunities and to seek innovative solutions to problems. We strive to recognize, support and reward such initiatives.

Our experience with the privatisation of Canadair has further proven the benefits of our management philosophy. Since its acquisition by Bombardier, Canadair has achieved profitability after a long history of significant losses. This profitability was achieved in the first two years of our ownership. Since then, we have made significant investments to expand its technological base, upgrade product lines and develop new markets, including a C$ 15 M study on opportunities in the regional aircraft market.

Used much Canadian govt money but it did make it profitable.

It would be our intention to pursue a similar strategy for Short Brothers. Based on the information at hand, we have identified clear preliminary strategies for each of the three main divisions of the company.

Aircraft

We see good market potential for Shorts total systems capabilities in the aircraft sector in the long term. We also feel that Shorts technology and the experience gained in the SD3 series, the Tucano and the Sherpa could be supported and further exploited. The commitment to product support for Shorts aircraft would also be continued.

In the past months Bombardier has invested considerable time and effort in order to become familiar with Short Brothers. In particular, advanced discussions between senior managements have been held to explore potential areas of collaboration and synergies on the Regional Jet project.

In the short term, we believe we should go ahead with our Regional Jet which we have developed based on proven Challenger technology. In spite of some advantages which could be provided by Shorts proposed FJX, our Regional Jet project will minimize the technical and financial risks, and will allow a timelier response to immediate market demand. In doing this, we could directly share the program with Shorts and utilize its capabilities by engaging its personnel in specific engineering, tooling and manufacturing requirements.

We would also intend to have Shorts share in the responsibility for the development of a second generation commuter jet.

As part of our strategy, Bombardier anticipates good potential synergies between Shorts and our own military aircraft in the North American and European markets. In particular we foresee significant opportunities in the further development of the Tucano trainer for the Canadian Armed Forces and other markets.

Aerostructures

Given the current state and evolution of the aircraft industry, the aerostructures market clearly has great potential for future growth. Short Brothers and Canadair are recognized for their expertise in the design and production of aerostructures and we see promising avenues for complementarity and synergy in this area. It should be noted that both Canadair and Shorts have major subcontracting arrangements with Boeing.

For instance, the mandate for composites manufacturing and technology development in our aerospace sector could be given to Short Brothers for its Queens Island and Dunmurry sites.

Furthermore, Canadair and Short Brothers should share costs and market information in order to strengthen the profitability of each organization.

Missiles

Shorts has demonstrated its ability to excel in the development of state of the art missile systems. It would be Bombardier's intention to support the company's strategy for continued growth in these markets through internal development and joint ventures. Furthermore the Canadian Armed Forces has recognized a need for the type of missile developed by Shorts.

We also believe there is considerable potential for an integrated approach to the European and North American missiles and surveillance markets. We would intend to pursue significant expansion of this business through alliances with other European and American partners.

In order to capitalize on defence procurement opportunities, with the collaboration of the Canadian and British Governments, Bombardier would consider a joint venture on the technology and development of our surveillance systems with Shorts. This could be done in conjunction with a review of the requirements of HM Ministry of Defence.

Employment levels

Bombardier recognizes the impact of Shorts on Northern Ireland's economy. As outlined in our mission statement, Bombardier is committed to ensuring our employees quality of life, job security and training. As previously mentioned, since Canadair was acquired from the Canadian government, approximately 700 new jobs have been created.

Within the framework of the objectives we have expressed for Short Brothers, Bombardier would do everything in its power to enhance employment opportunities in Northern Ireland and the current growth in commercial aircraft orders should help this.

As previously mentioned, the Regional Jet project could have a significant impact on employment opportunities in the near future through the creation of approximately 500-600 jobs which should endure over 10 years for Shorts employees, plus the additional work provided in composites manufacturing. We can also foresee new employment opportunities emanating from the surveillance systems and other projects. In addition, we are prepared to collaborate with HM Government's employment objectives for Northern Ireland, and will work with the Government in meeting these objectives.

We also recognize the importance of economic spin-offs and indirect employment provided by Short Brothers in Northern Ireland, and would strive to maintain and improve them where possible.

Existing Obligations

Bombardier's intention would be to continue to respect the commitments of Short Brothers towards its customers, subject to a review of these obligations.

? This may be a hint of wanting HMG to continue some of the present assurances

Further Assurances

Bombardier would consider making the following other commitments to ensure the future success of Short Brothers in Northern Ireland:

- It is our intention to continue working with present management

- We believe in fostering the entrepreneurial spirit of our people. In this perspective, we would explore with Shorts management ways which would allow them to participate in equity ownership.
- The Board of Directors of Short Brothers would retain substantial representation from Northern Ireland and the United Kingdom.

9. Bombardier's interest in the proposed FJX Program

The senior management of Bombardier and Short Brothers have been involved in extensive discussions regarding collaboration on the FJX and RJ Aircraft Programs. As mentioned previously, after careful review, Bombardier feels its Regional Jet project presents the best opportunity for a timely market penetration with a limited investment and acceptable level of risk.

It would be our intention however to have Shorts share in the R.J. program by involving its engineers in the design and development work, and in the development of a second generation regional jet, thus helping to maintain integrated capability in the aircraft sector.

For the immediate future, Bombardier would consider the following as a practical means of ensuring a high level of activity for Shorts Aircraft division:

- Transferring to Shorts a substantial amount of work on the RJ program, aiming for a level equivalent to that which would have been generated by the FJX. This includes approximately the 500-600 jobs mentioned previously within which is included a significant engineering task. This is based on a program of 400 RJ aircraft sold, and the manufacturing of parts which are common to the RJ and to the CL-601 executive jets. (Detailed list of work which could be transferred in Appendix C).
- Transferring all composite manufacturing for the RJ to Shorts. jobs?
- Developing with Shorts a coordinated sales and customer support network for the commuter market.

Bombardier feels that this long term approach, designed to build on the respective strengths of both companies, is an appropriate way to attain a strong competitive position in this market segment of the commuter sector.

10. Bombardier's requirements pursuant to this proposal

Bombardier's previous experience with the privatization of Canadair has given us valuable experience in managing the issues related to such an acquisition. Following its selection for the next stage of the sale process, we will be prepared to move quickly, but would require the following:

- The opportunity to visit Short Brothers facilities with a Bombardier team in the near future
- A complete review of due diligence information directly available from the company. A comprehensive list to be provided at the next stage of the process.
- Early discussions with HM Government regarding their intentions for restructuring the balance sheet of the company and funding for its future development.
- Joint discussions between Shorts and Bombardier management of Shorts business plan and five year pro-forma demonstrating its view of the future and its intended strategy.
- An indication of the level of Government support to be provided for work which Bombardier could immediately transfer to Shorts.
- We also believe it would be useful to meet with labour representatives in order to obtain a clear understanding of their objectives.

11. Other information in support of this proposal

Bombardier has invested two years and $15 million in the development of its Regional Jet project, but has only recently engaged in serious discussions on potential collaboration with Short Brothers. We strongly believe, as does Shorts management, in the future of the regional jet and in the potential of our two companies to jointly establish a strong foothold in this market.

Timing

Timing is of the essence if we are to maximize market penetration of this new aircraft, and Bombardier intends to announce the launch of its Regional Jet before the Spring of 1989. Given the significance of our potential collaboration with Shorts on this project and for Shorts to obtain the greatest possible benefits from the potential acquisition and its subsequent role in engineering, tooling and manufacturing of the Regional Jet, it is critical that Bombardier obtain a clear indication of HM Government's intentions with respect to the sale of the company by the end of February 1989. now March 31

Bombardier's original December 1988 launch date was already delayed due to the Canadian Federal Election. Institutional and government financing for the project is nearing completion and must be finalized; Shorts participation and HM Government's support would need to be finalized beforehand. Furthermore, our negotiated quotes from suppliers expire at the end of March and would need to be re-negotiated after that time. Shorts role in the project could have a significant impact on the nature and volume of external supplier contracts.

The Board of Directors of Bombardier will meet in March 1989 to approve the launch of the Regional Jet Project. If no clear indication of HM Government's intentions is received by this time, this employment opportunity for Short Brothers will pass.

We must turn this pressure back on them by a March 31 deadline for exclusivity.

In conclusion, we would like to reiterate our sincere interest in Shorts and in the important synergies and strategic advantages for both companies, as well as the significant employment opportunities which could be created by allowing Canadair and Short Brothers to collaborate together under the leadership of Bombardier.

Yours sincerely,

RE Brown
for

Laurent Beaudoin
Chairman of the Board
Bombardier Inc.

Kleinwort Benson Limited

17.2.89

MBB

Annex B

Extract from very vague MBB letter.

...s the leading German aerospace and defence contractor. It ...nvolved in many prestigious European aerospace and defence ...grammes. Within MBB's aerospace division there are a number ... developments, processes and products which are complementary ...o those of Shorts. Both MBB and Shorts have an established ...istory of successful co-operation. This would augur well for the development of the two businesses following the acquisition in the context of the evolving European aerospace industry. MBB is hopeful that the acquisition of Shorts by MBB would generate substantial benefits for both businesses.

Outline plans have recently been made public for a series of transactions involving a substantial increase in the share capital of MBB following which MBB will form the major part of a new aerospace division of the Daimler-Benz Group ("Daimler"). After this proposed re-organisation, the new aerospace division will rank as one of the largest in Europe.

In light of its strong financial position, MBB has the capacity to acquire Shorts and support its development. This will be reinforced following the subscription of new capital in MBB by Daimler.

MBB is sensitive to Short's position as a significant supplier to the UK MoD. Based on the limited information about Shorts currently available it is not clear to MBB that 100% ownership of all the operations of Shorts would necessarily be most advantageous for MBB or Shorts. Additionally, 100% ownership by MBB of Shorts's missile division may not result in the most beneficial relationship with MBB's existing missile operations.

At the appropriate stage, therefore, MBB may seek approval from H.M. Government and its advisers to enter into discussions with possible partners in the acquisition of Shorts.

At this early stage it is not feasible for MBB to put forward any detailed financial proposals. However, MBB expects any proposals it may eventually make to include an offer for the shares of Shorts at a price related to the consolidated net asset value of Shorts at completion. The relevant net asset value would be a pro-forma figure reflecting the recapitalisation of Shorts and a full review of the consolidated assets and liabilities, covering, among other matters, the level of provisions, the valuation of work in progress, the off-balance sheet assets and liabilities and the financial implications of long term contracts.

Top filed on MANPOWER: SEYS

File

PRIME MINISTER

MEETING OF E(A): 2 MARCH

There is, I fear, a daunting pile of paper for this meeting. But you do not need to read it all, and I doubt if the meeting need last too long. That means it should be over in good time by 12.30, so that you can then talk further to the Chancellor about the Budget.

I will try in this minute to summarise the issues and the bits of paper you need to refer to.

The papers are organised in two dividers below:

The first includes all those relating to Norman Fowler's proposals on Skill Centres and the Employment Service; the second, the papers on the three Northern Ireland companies - Harland and Wolff, Mackies and Shorts.

Skill Centres and Employment Service

The formal agenda has Skill Centres as the first item and the Employment Service as the second. For reasons explained below, I suggest you reverse this order.

The full list of papers enclosed is:

Flag A - Norman Fowler's paper on the Employment Service
Flag B - His short personal minute on the same subject
Flag C - Minute from the Attorney General on the Employment Service
Flag D - Cabinet Office brief on the Employment Service
Flag E - Norman Fowler's paper on Skill Centres
Flag F - Cabinet Office brief on Skill Centres
Flag G - Policy Unit note on Skill Centres.

When you discussed the Employment Service paper on 8 February you called for further work, particularly on the legislative implications. Norman Fowler's paper (Flag A) reports that this work is underway, and simply provides a progress report on other aspects of the proposal. In his separate minute (Flag B) he invites you simply to note the progress report and to ask him to return to the Committee in May or June when the other work is done, and the dust has settled on other issues.

But the key paper to look at on the Employment Service is the Attorney's minute (Flag C). This confirms that legislation is required:

- for the principle of privatising job centres

- and to cover various aspects of the transfer of the staff to the private sector; covering the transfer of Undetakings Protection and Employment Regulations, the redundancy provisions of the Civil Service Pension Scheme, and the Model Redundancy Agreement.

All this means the discussion of the Employment Service can be brief. You can simply note that:

- there are major legislative implications, which cannot be covered at least until the 1989/90 Session.

- Mr. Fowler will report back in May or June.

- Meantime you may want a brief discussion on some aspects of the points which are covered in Mr. Fowler's paper (see paragraphs 4-6 of the Cabinet Office brief at Flag D).

You can then move on to Skill Centres. You had a brief look over the weekend at Mr. Fowler's paper (Flag E). But I suggest all you need read now are the Cabinet Office and Policy Unit briefs at Flags F and G.

Notwithstanding his proposal to delay action on job centres, Mr. Fowler proposes to press ahead in this Session with the Skill Centres proposal, by means of amendments to the current Employment Bill. You may want to question this. The first issue to settle is how extensive is the need for legislation. It is clear that some at least of the legislative requirements for the job centres are also required for Skill Centres. That being so, would it not be better also to defer Skill Centres until the next Session?

That is the first point to settle. Having done so, however, there would in any event be advantage in having a "Second Reading" debate on other aspects of the Skill Centres proposals. I suggest you use the check list in paragraph 2 of the Cabinet Office brief (Flag F), adding in the point on page 4 of the Policy Unit brief (Flag G) about employment ~~and~~ Rehabilitation Centres.

Harland and Wolff, Mackies and Shorts

The papers are in the second divider. They are:

Flag H - Tom King's paper covering Harland and Wolff and Mackies.
Flag I - Tom King's paper on Shorts.
Flag J - Cabinet Office brief on the two papers
Flag K - George Guise's note covering both papers.

You are already familiar with most aspects of the latest position in these companies, and need only skim Tom King's papers. You should however read George Guise's note (Flag K) and use the Cabinet Office brief (Flag J) to steer the discussion.

The key issues are:

- on Harland and Wolff set a timetable for Tom King to report back on progress in the discussions with the MEBO/Olsen consortium. And settle whether those

Mr Olsen has now written to you. See Flag L.

discussions should be within a financial envelope of £275 million (Tom King's figure) or £220 million (John Major's figure).

- on Mackies: invite a report back in two months, reminding Tom King of the £20 million financial limit.

- on Shorts:

  - Note the position on the capital injection of £390 million.

  - Settle whether negotiations should be on an exclusive basis with Bombardier, or in competition between Bombardier and Fokker/GEC.

  - Whether the negotiations should be within a total ceiling of £600 million.

PRG

PAUL GRAY
1 March 1989

KAYARV

me Pm2AL7

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

22 February 1989

SHORTS

The Prime Minister was grateful for your Secretary of State's further minute of 21 February.

The Prime Minister recognises the further efforts that have been made to tighten control over the management of Shorts. On this basis she is now content with the revised proposal for a financial injection this year, on the understanding that this will not take place until after the appointment of a senior partner from Touche Ross to the Board of Shorts and subject to final confirmation that the injection will lead to an interest saving.

It might be helpful if your Secretary of State was to circulate a report before next week's meeting of E(A) on the position now reached at Shorts.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), Carys Evans (Chief Secretary's Office), Michael Saunders (Law Officers' Department) and Trevor Woolley (Cabinet Office).

PAUL GRAY

Stephen Leach, Esq.,
Northern Ireland Office.

PRIME MINISTER

SHORTS

Tom King has sent you the attached further note this evening reporting the latest state of play. George Guise is abroad today, and has not yet had a chance to see it. But as a final decision on whether to proceed with a financial injection in this financial year is needed by Thursday, 23 February, you may like to look at the note this evening.

You will recall that the original rationale for an immediate injection was that this would maximise the prospects for disposal. You countered this by saying that the pre-requisite was to impose financial controls over the company.

In response Tom King and John Major have adjusted their rationale. They now start from the proposition that control must be imposed, and propose the immediate appointment of a Touche Ross senior partner to the Shorts' Board. But they then say that this "expression of no confidence in the company" must be matched by a short term capital injection to demonstrate the Government's commitment. Ingenious if not wholly persuasive!

The more important point is that they have changed the nature of the proposed injection. They now propose a loan to the company, convertible into equity at some future date, which would effectively replace the commercial debt in the Shorts' balance sheet. This, it is said, yields a small interest saving (even after redemption penalties), which in turn provides a rationale which satisfies accountability worries about not paying over money in advance of need. At the same time the fact that the debt on Shorts' balance sheet remains undiminished is said to remove the need to reduce the company's borrowing limit (George's original idea).

But then we run into the EC approach snag. As you feared, the Commission have said that "proceeding in two stages would certainly make final negotiation of the whole disposal package more difficult". But Tom King and John Major still want to proceed with the short term injection.

Assessment

In your latest conversations, particularly with John Major, you expressed sympathy with the aim of paying money over this year if satisfactory arrangements could be worked out.

My own view is that the case for an immediate injection remains unconvincing, particularly given the Commission's reaction. But, in view of the earlier exchanges, you will want to consider whether you are prepared to accept the latest proposal, on the strict understanding that the injection will only go ahead:

(i) After the Touche Ross appointment;

(ii) If it is absolutely clear that it offers an interest rate advantage.

Do you wish to resist the short term injection?

Or, are you prepared to accept it subject to (i) and (ii) above?

They have really tried and it would help this year's finances

PRG.

PG

21 February, 1989.

- Agree to (ii) above

MT

PRIME MINISTER

SHORTS

My Private Secretary's letter to Paul Gray of 10 February reported on the progress since our meeting with John Major. I am now writing to confirm the latest position.

Potential Buyers

Six preliminary proposals have now been submitted from companies or consortia for the acquisition of Shorts. I would judge that four of these are serious contenders. They are Bombardier, Fokker/GEC, MBB, and Ferranti/Aeritalia. Of these Bombardier and Fokker are the front runners and I have arranged to see them both next week.

Greater Financial Discipline

Following discussion with HOTGAS and the senior partner of Touche Ross, I propose to appoint straight away to the Board of Shorts a senior partner from Touche Ross together with a support team. He will have clear terms of reference which I will ask the Board to approve, designed to enable him to exercise proper financial control of the company in all its aspects, and to monitor and control any new commitments. While I have the power to appoint directors, it is important that his duties are approved by the Board to avoid any legal complications. The presence of this new financial director will help us to obtain the range of information on the company that we need. He will be aware of all financial and other issues coming before the Board and, if he is not happy with possible decisions, can alert Ministers so that we can take the necessary steps.

Further details are still being worked on as a matter of urgency, notably detailed terms of reference for the Touche director. As soon as they are ready I intend to meet Lund and his fellow directors, as it is obviously desirable, though not essential, that we proceed with their acquiescence.

Financial Injection

John Major and I both believe that it is essential to impose tighter financial control, as I propose above. However, on its own, this will be seen as an expression of no confidence in the company and could well cause disturbance among both management and workforce. Even more importantly, it could also disturb the confidence of actual and potential purchasers of the company. It is essential therefore, as a counter-balance, that we take tangible steps to demonstrate our commitment to the company's immediate future. This therefore reinforces the case that we have already made for the capital injection.

Subject to your approval, I therefore propose to inject up to the estimate provision of £390m. This would be in the form of a convertible loan from my Department and would be used to repay forthwith the company's debt to commercial banks. If the interest rate chargeable on this loan is at NLF rates the interest charge would be less than current charges paid by the company, and there would be a saving over the relevant period at an annual rate of £4m/£5m (less any penalties from premature redemption of commercial debt).

I'm told there might be a bit [illegible].
PRCC

We will be taking steps to ensure that the injection can be used only to repay commercial debt without delay. (Again, further work on this is urgently under way.) The uses to which the injection is put will be under the control of the new financial director and the injection itself will be the subject of a legally-binding loan agreement which will prescribe precisely the loans which it will be used to discharge.

I originally proposed the elimination of the debts accompanied by a massively reduced borrowing limit. As the present proposal substitutes one debt for another I do not now propose to change the limit. The company's borrowing limits under the Companies Acts stand at £400m, so they are already very close to the legal limit and will therefore be tightly constrained.

EC Dimension

We had already taken steps to sound senior Commission officials informally on this proposal. They pointed out that the aircraft sector and the company's location in Northern Ireland should make the proposal easier for them to approve. The Commission indicated that the loan should be at market rates, and if they were not satisfied with NLF rates, then we would have to consider rates closer to LIBOR, although if the payment is to be justified the rate would still have to produce a saving in interest charges (after penalties payable) by comparison with current arrangements.

They said that proceeding in two stages would certainly make final negotiation of the whole disposal package more difficult, but confirmed that the Commission would adopt a broadly sympathetic approach. At the second stage the Commission will of course need to see a restructuring plan as counterpart. A formal notification would have to be lodged with them by Friday, 24 February.

Conclusion

Having considered all the aspects including the EC position, I believe it is right to proceed as we discussed with the financial injection now, accompanied by the new controls that I propose. Together these are designed to achieve an early and properly controlled disposal of Shorts. Bombardier, who look particularly interesting, are keen to proceed very quickly, and so I hope we can take the steps outlined above to give us the best possible chance to negotiate with them and the other contenders as appropriate. Given the estimates and EC timetable we shall have to reach a decision on the financial injection by 23 February.

I believe that these steps best protect our interest. Without such a signal of our confidence to the Company and to actual and potential customers by means of a financial injection, and without greater financial discipline, the Company's financial performance will deteriorate further. That in turn would worsen the terms of disposal involving a higher total sum eventually to be paid.

I am copying this minute to the Foreign Secretary, the Chief Secretary to the Treasury (who agrees with it and supports the measures I am proposing) and to the Attorney General.

Stephen Pope

21 February 1989

TK

(Approved by the Secretary of State & signed in his absence)

HOUSE OF COMMONS SESSION 1988-89

TRADE AND INDUSTRY COMMITTEE

Fourth Report

THE PRIVATISATION OF SHORT BROTHERS PLC

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE:-

10·30 HOURS GMT(BST) ON 23 FEB 89

THIS DOCUMENT IS ISSUED IN ADVANCE ON THE STRICT UNDERSTANDING THAT NO APPROACH IS MADE TO ANY ORGANISATION OR [illegible] ABOUT ITS CONTENTS BEFORE THE TIME OF PUBLICATION.

Ordered by the House of Commons to be printed 15 February 1989

LONDON

The Trade and Industry Committee is appointed under SO No 130 to examine the expenditure, administration and policy of the Department of Trade and Industry and of associated public bodies, and similar matters within the responsibilities of the Secretary of State for Northern Ireland.

The Committee consists of eleven Members. It has a quorum of three. Unless the House otherwise orders, all Members nominated to the Committee continue to be members of it for the remainder of the Parliament.

The Committee has power:

(a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;

(b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference;

(c) to communicate to any other committee, its evidence and any other documents relating to matters of common interest; and

(d) to meet concurrently with any such other committee for the purposes of deliberating, taking evidence, or considering draft reports.

The membership of the Committee since its appointment on 2 December 1987 is as follows:

Mr Kenneth Warren, (Chairman)

Mr Joe Ashton
(discharged 18 January 1989)
Mr Malcolm Bruce
Mr Jim Cousins
(appointed 18 January 1989)
Mr James Cran
Mr Stan Crowther

Rt Hon Dr John Gilbert
Sir Anthony Grant
Dr Keith Hampson
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop
Mr Barry Porter

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Notes

References to "q" are to the question numbers in the oral evidence, and "Evidence p..." refers to pages in the written evidence. The evidence will be published on 2 March 1989 as HC 131.

LIST OF WITNESSES

Wednesday 18 January 1989

SHORT BROTHERS PLC

Mr R Lund, Mr R McNulty and Mr A Roberts

TRADE UNION REPRESENTATIVES AT SHORTS

Mr D Haggan, Mr J Watson, and Mr J Bowers

Wednesday 1 February 1989

NORTHERN IRELAND OFFICE AND NORTHERN IRELAND DEPARTMENT OF ECONOMIC DEVELOPMENT

The Rt Hon Tom King MP, Mr P Viggers MP,
Mr D Fell, Mr P McDonnell and Mr D Thompson

LIST OF MEMORANDA RELATING TO SHORTS AND HARLAND & WOLFF

1. Memorandum submitted by LEDU (NI1)
2. Memorandum submitted by The EETPU (Short Brothers) (NI2)
3. Memorandum submitted by The EETPU (Harland & Wolff) (NI3)
4. Memorandum submitted by the Industrial Development Board for Northern Ireland (NI4)
5. Memorandum submitted by MSF (Short Brothers) (NI5)
6. Memorandum submitted by MSF (Harland & Wolff) (NI6)
7. Memorandum submitted by APEX (Short Brothers) (NI7)
8. Memorandum submitted by APEX (Harland & Wolff) (NI8)
9. Memorandum submitted by The CSEU (NI9)
10. Memorandum submitted by The AT & GWU (Short Brothers) (NI10)
11. Memorandum submitted by The AT & GWU (Harland & Wolff) (NI11)
12. Memorandum submitted by The Northern Ireland Chamber of Commerce and Industry (NI12)
13. Memorandum submitted by the Department of Economic Development (Short Brothers) (NI13)
14. Memorandum submitted by the Department of Economic Development (Harland & Wolff) (NI14)
15. Memorandum submitted by Tikkoo Cruise Line Limited(NI15)
16. Memorandum submitted by Harland & Wolff PLC (NI16)
17. Memorandum submitted by the Senior Shop Stewards' Committee at Harland & Wolff (NI17)
18. Memorandum submitted by the General, Municipal and Boilermakers' Union (NI18)
19. Memorandum submitted by Short Brothers plc (NI19)
20. Memorandum submitted by the CSEU Factory Committee at Short Brothers (NI20)
21. Memorandum submitted by the CBI, Northern Ireland (NI21)
22. Memorandum submitted by the Engineering Employers' Federation, Northern Ireland Association (NI22)
23. Memorandum submitted by Dr Richard Harrison (NI23)
24. Appendix by the Northern Ireland Office
25. Supplementary Memorandum submitted by Dr Richard Harrison (NI27)

FOURTH REPORT

SHORT BROTHERS PLC

The Trade and Industry Committee has agreed to the following report:

INTRODUCTION

1. On 21 July 1988, Mr Peter Viggers MP, the Parliamentary Under-Secretary of State for Northern Ireland, announced in the House of Commons that the Government was 'actively seeking the return of Short Brothers plc in to the private sector from state ownership', and invited bidders with the necessary financial backing to come forward as soon as possible.

2. In view of the central place of this important firm in the economy of Northern Ireland, and of the considerable public concern about the handling and consequences of privatisation, the Committee decided on 23 November 1988 to undertake an inquiry into its future and the Government's conduct of its sale.

CONDUCT OF THE INQUIRY

3. We have been assisted by our specialist adviser, Professor Garel Rhys of Cardiff Business School at the University of Wales, whose wide knowledge of the UK manufacturing industry has (as in many of our previous inquiries) been invaluable. We received twenty-seven memoranda relating to the privatisation of Shorts and of Harland & Wolff, and most of them are published with this report. We took oral evidence on three occasions, the minutes of which are also published here. We are grateful to all of those who gave evidence to us.

4. In January, we visited Shorts in Belfast. We are most grateful to the management and the unions for the courtesy and frankness with which they discussed the issues involved. From this visit we gained a deeper understanding of the historical perspective, current performance and future prospects of Shorts.

THE ECONOMY OF NORTHERN IRELAND

5. The future of Shorts needs to be seen against the economy of the Province as a whole. As the Committee has been aware from its previous visits to Northern Ireland, the Province's economy has always been vulnerable. It possesses few natural resources (other than recent discoveries of lignite). Energy costs are high. In the past, Northern Ireland depended heavily on a narrow range of industries - in particular, aerospace, agriculture, tobacco, textiles, and shipbuilding. Since 1969 the Province's political troubles have made it more difficult to attract new investment although there have been some notable and successful new industries which have taken root, such as high-technology electronics.[1]

6. While employment in the more traditional industries has declined considerably since 1945, and it has been hard to bring in newer businesses, the Province's birth rate has remained consistently higher than that of Great Britain. The result has been a widening gap between the size of the population of working age and the number of jobs available. This gap has been reduced by outward migration; but the migration has included a large proportion of the skilled and graduate workers which Northern Ireland needs to develop its economy.

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[1] Seventh Report from the Industry and Trade Committee, Session 1981-82, Government Support for Trade and Industry in Northern Ireland HC 500; First Special Report from the Trade and Industry Committee, Session 1984-85, Northern Ireland HC 119

7. During the late 1970s and early 1980s, Northern Ireland's economic problems became considerably more severe, as the Province was disproportionately affected by the national decline of manufacturing and the worsening of its political troubles. Between 1979 and 1987 the region had the highest unemployment rate in the UK, reaching a peak in 1987 of 18.6%.[2] Successive governments have sought to reduce unemployment and stimulate growth by expanding the public sector, and by policies of industrial support.[3] Most recently, the Northern Ireland Industrial Development Board produced a new strategy, designed to improve its efforts at gaining new inward investment, but also to increase its role in encouraging the maintenance, modernisation and expansion of Northern Ireland's existing industrial base, and to forge a closer relationship with its client companies.[4] In recent years, it and the Local Enterprise Development Unit (LEDU) have had some success: for example in 1987-8 they were able to announce the promotion of 9350 new jobs.[5]

8. Yet the small rises in employment and falls in unemployment in both 1987 and 1988 represent a fragile recovery, heavily dependent on the performance of the UK economy as a whole. Shorts and Harland & Wolff are the two largest industrial employers in the Province. Whatever happens to them will have a profound effect on the economy of Northern Ireland.

THE PROCESS OF PRIVATISATION

9. Short Brothers plc is the oldest aircraft manufacturing company in the world. It now makes small transport and training aircraft, airframe structures and missiles. It is one of the smaller airframe companies in Europe (See Table A). It was taken into public ownership in 1943, but it has never been drawn into the main groupings of publicly-owned aircraft and aerostructure manufacturers in the UK, either during the reorganisations of 1959-60, or that following the Plowden Committee's report of 1965.[6]

10. In December 1984 the Government announced that as part of its privatisation policy it intended to consider how and when the company might be returned to the private sector.[7] In 1985, it appointed Samuel Montague to review the prospects for privatisation; its report recommended that sale to an single corporate investor was the only realistic option. Shorts' management replied in July 1985 to the report, asking for a delay in privatisation until 1988, when it should be accomplished by a share flotation. This, they argued, would bring the Government higher proceeds from the sale.[8] In 1986, the Government decided to defer a decision on privatisation.[9]

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2 Regional Trends, 1988, Central Statistical Office

3 See Seventh Report from the Trade and Industry Committee, Session 1981-82 - Government Support for Trade and Industry in Northern Ireland (HC 500)

4 Encouraging Enterprise, A Medium Term Strategy for 1985-1990, Industrial Development Board for Northern Ireland

5 Northern Ireland Economic Council, Autumn Economic Review 1988, Table 8

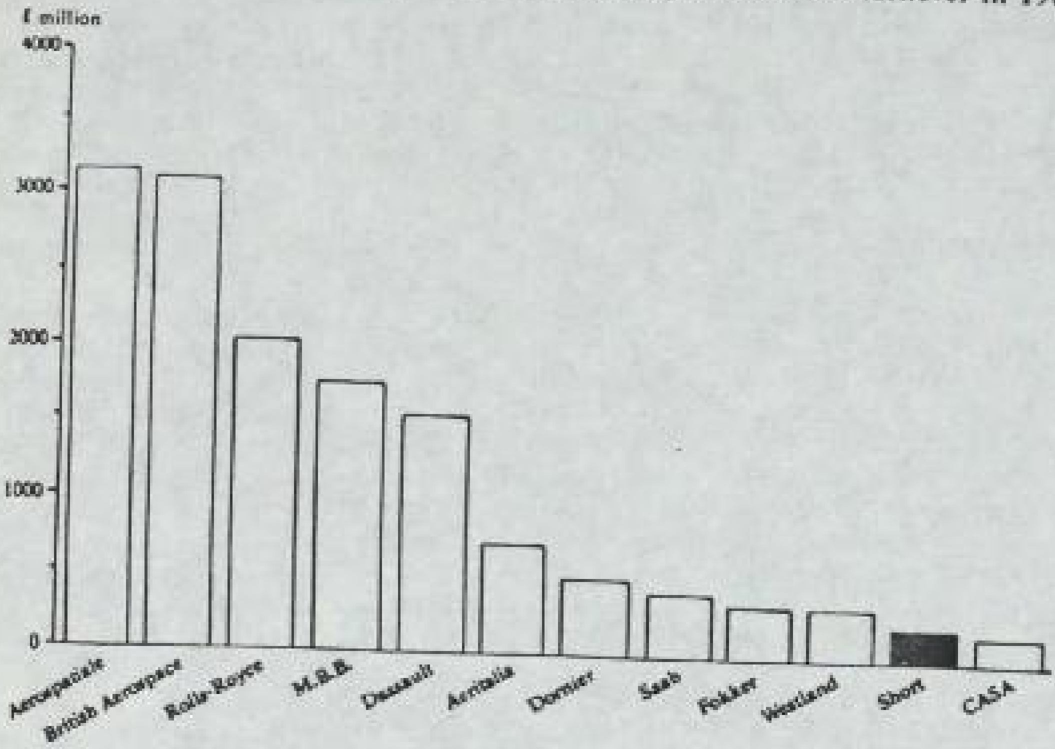
6 Evidence, p.73, para. 1.1, p.74, paras. 3.1-3.3

7 Evidence, p.73, para. 1.2; Official Report 6 December 1984, Col. 229

8 Evidence p.75, para. 7.3-7.4; Q. 316

9 Evidence, p.73, para. 1.2

Table A: Relative size of European aerospace companies: annual turnover in 1986 or 1987



Source: J V Simpson, Shorts an assessment of the economic significance of the firm to the Northern Ireland economy. Prepared at the invitation of Shorts. p.21

11. On 1 April 1988, following the retirement of Sir Philip Foreman, the Government appointed a new Chairman (Mr Rodney Lund) and Managing Director (Mr Roy McNulty). The company then undertook a thorough review of its corporate plans and strategic options including how it might be returned to the private sector. Its conclusions were presented to the government on 30 June 1988. The company argued that there were three possible options for its future. The first, to break up the business and sell its separate parts, would, it argued, be extremely damaging to the firm and expensive for the taxpayer. The second option was to find a single corporate buyer for the whole business. The third was to back the company's development plans, writing off its debt, funding new projects and improving efficiency as a prelude to selling the company to a single bidder or by share flotation, a process which would take about two years. The Board strongly recommended the third of these options.[10]

12. On 21 July, however, Mr Viggers announced to the House of Commons that the Government was 'actively seeking the return of Short Brothers plc to the private sector', and that, although it would prefer the company to be transferred as a whole, it did not, however, 'rule out the sale of the different parts of the business to separate interests'.[11] The Government appointed Kleinwort Benson to act as its financial adviser on the sale, and on 17 November the privatisation was publicly advertised. On 10 January 1989 an Information Memorandum was issued by Kleinwort Benson to those companies which had indicated an interest in purchasing the company.[12]

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[10] Evidence p.96 para. 6.1; p.63 section 1.

[11] Official Report 1987-88, col. 1298

[12] Evidence, p.75, para. 8.1-8.2

13. On 10 January 1989, Shorts published their annual report and accounts for the year ended 31 March 1988, revealing a fall in turnover from £225.9m to £191.8m, a loss before interest and exceptional items of £21.4m, up from a loss of £74,000 in 1987; and exceptional items (including write-off of stocks and work-in-progress) totalling £95.5m. The exceptional items, Shorts told us, were included 'with privatisation in mind': 'It is really trying to make sure that we put our problems behind us and that we are not carrying forward situations on our contracts where we are going to have yet further losses in the future'.[13]

ACTIVITIES AND FUTURE PROSPECTS

14. Shorts operates through three principal divisions: aircraft, aerostructures and missiles. The aircraft division designs, develops and manufactures its own aircraft: currently in production are the SD360 regional airliner; the military multi-role Sherpa transport aircraft and the Shorts Tucano military trainer. The turnover in this division in the year ended 31 March 1988 was £66.5m, down from £98.1m in 1987 and £109.2m in 1986. The aerostructures division produces airframe structures for civil aircraft manufacturers in Europe and the US, including Fokker and Boeing. Turnover in this division was £50.6m in 1988, up from £34.6m the year before. The missiles division designs and manufactures widely-used surface-to-air missile systems. Its principal product today is the Javelin, introduced in 1984. Turnover in this division was £68.6m in 1988, down from £87.7m in 1987.[14] In the international world of aerospace, Shorts is held in respect for the high quality of its manufactured products.

15. While orders for many existing products in all of its divisions are currently strong, Shorts is engaged in design and development of new products to replace those of its aircraft and missiles division which are approaching the end of their life cycles. It has recently begun deliveries of the Tucano for the RAF and secured export customers. Its new aircraft project is for a 40 seat regional jet aircraft, called the FJX, which would take four years to produce at a cost of £500m. Shorts hopes to find partners with whom to share these costs, and expects to contribute about £120m for its own lead participation.[15] The missile project is the Starstreak, now under a production contract for the MOD.[16]

SHORTS AND THE GOVERNMENT

16. Government concern about Shorts has a long history. In 1942, Sir Stafford Cripps, Minister for aircraft production, took the view that the privately-owned firm was inefficient and under current defence regulations, he took it into public ownership.[17] In the mid-1960s, the company's losses provoked pressure from Government for cuts in the workforce and a diversification even into non-aircraft activities.[18] In 1972, it became necessary for the Government to institute a series of emergency measures to support the company.[19] In 1976 a major capital reconstruction was required.[20]

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[13] Qq 163, 165

[14] Evidence, p.94, paras. 4.1-4.3; p.95 paras. 5.1-5.7

[15] Evidence, pp. 95-6 para. 5.5; Qq 181-203

[16] Evidence p.96, para. 5.6

[17] Michael Donne, Pioneers of the Skies: A History of Short Brothers plc (Belfast, 1987) pp 99-100

[18] ibid, p.140

[19] ibid, p.140

[20] ibid, p.144

17. Unlike most other firms in public ownership, Shorts is a public limited company (plc) with the Government as its shareholder. The Northern Ireland Department of Economic Development (DED) owns 90.5 per cent of the company's ordinary share capital; the remaining 9.5 per cent is held by the UK Department of Trade and Industry.[21]

18. The Government monitors the firm, appointing external consultants to assist it. Each year the company presents a Corporate Plan to the DED setting out its expected performance and its External Financing Requirement, on the basis of which the Government sets an External Financing Limit in each financial year.

19. Shorts has been assisted by government funds and guarantees in three ways. First, by standard payments, made to any firm which applies for them - particularly Capital Grants and Tooling Grants. Over the years 1983/84 to 1987/8 Shorts received £10.5m in such grants. Secondly, Shorts has received, over the same five years, £26.6m in specially negotiated, selective grants (after subtraction of royalties on sales repaid to the government). These funds are available on a discretionary basis to all industrial firms in Northern Ireland making an application to the industrial development agencies. Thirdly, in the past, Shorts has received capital funds, in the form of share capital and government loans, amounting to £79.7m since 1975 after subtraction of repayments to the Government. Most of this was paid in the period 30 August 1978 to April 1980, when the Government made available £60m for recapitalising the company. Since 1983, the company has received no special grants or loans from Government, and all of its borrowings have been from the private sector. Government has, however, provided guarantees that the claims of creditors will, in the last resort, be met.[22]

RESULTS AND CAPITAL INVESTMENT

20. A summary of Shorts' profit and loss account for the five years ended 31 March 1988 is included below. In 1984 and 1985 the company made profits before interest and exceptional items. In 1986, 1987 and 1988, however, it made losses of £21.677m, £74,000 and £21.404m respectively. (see Table B)

TABLE B: FIVE YEAR GROUP FINANCIAL SUMMARY

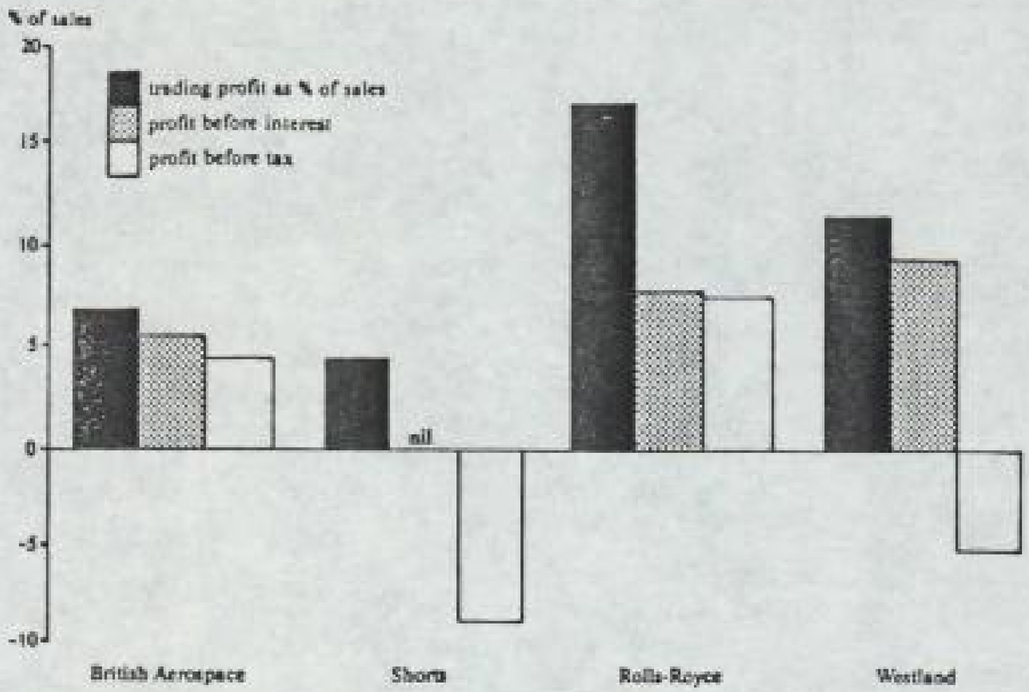
	Years ended 31 March				
	1984	1985	1986	1987	1988
Turnover	163,020	200,856	199,887	225,976	191,871
Trading profit/(loss)	11,654	15,749	(13,570	9,991	(12,052)
Deisgn,Research and Development	(6,775)	(5,540)	(8,147)	(10,155)	(9,411)
Profit/(loss) before interest & exceptional items	5,381	10,674	(21,677	(74)	(21,404)
Interest	(7,752)	(10,151)	(15,548	(19,870)	(25,462)
Exceptional Items					(95,598)
Balance transferred to accumulated deficit	(2,371)	523	(37,225)	(19,944)	(142,464)

21 Evidence p.74, para. 4.1

22 J V Simpson - Shorts: an assessment of the economic significance of the firm to the Northern Ireland economy. Prepared at the invitation of Shorts, December 1988, Section 9; Evidence, p.74, para. 4.2

The recent performance of the four leading UK aerospace companies is set out in Table C.

TABLE C: PROFITABLITY COMPARISON OF MAJOR BRITISH AEROSPACE COMPANIES



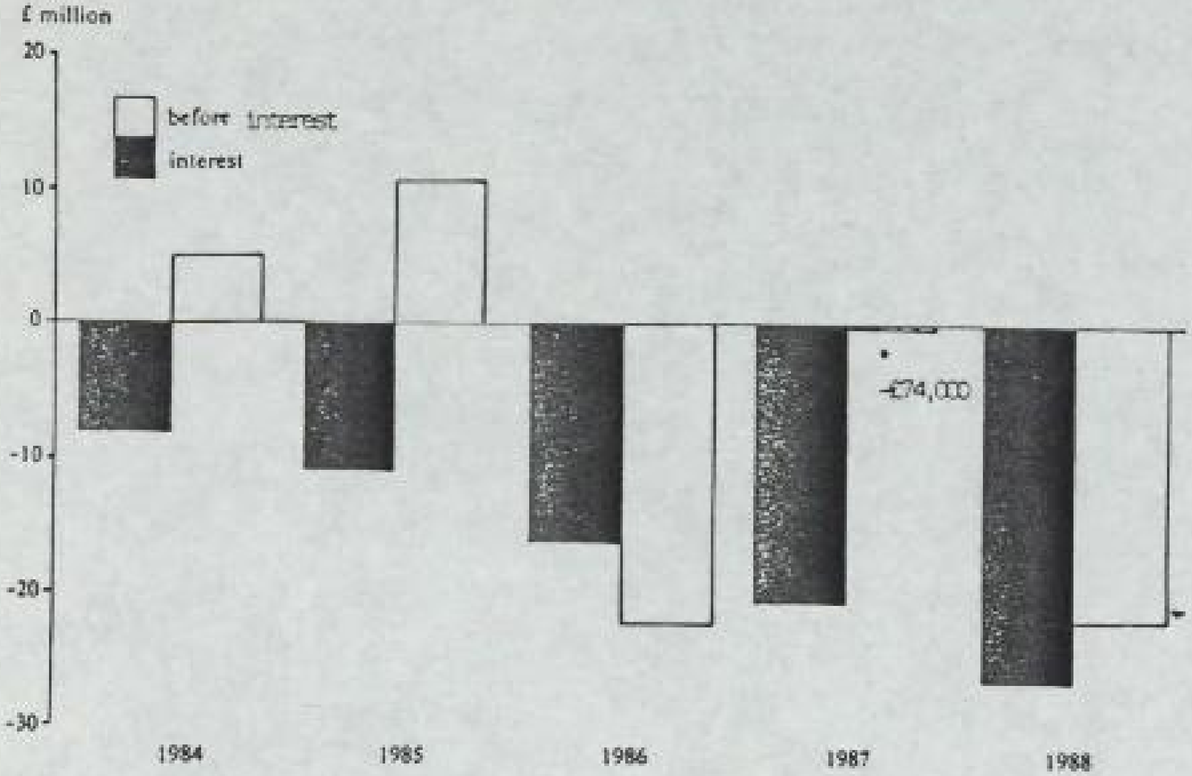
Source: Simpson p14

21. In accordance with the arrangements described in paragraphs 18 and 19 above, Shorts has been forced to borrow heavily from the private sector in order to fund its losses and fixed and working capital. As a result, the company has had to pay substantial interest charges - £19.8m in 1987 and £25.4m in 1988. The balance sheet on 31 March 1988 showed a long term debt of £76.6m, bank loans and overdrafts of £160.5m and a deficit on shareholders' funds of £175.6m.[23] (See Table D) The board would have preferred restructuring of the company's financial foundation in the past to have included equity capital which could have lessened the loan servicing burden.[24] We support that view.

[23] Shorts Annual Report and Accounts p.23; Qq 164, 166-9

[24] Qq 166-9

TABLE D: SHORTS' PROFIT/LOSS AND INTEREST 1984-8



Source: Shorts accounts 1988

22. The loans of £60m provided by government in 1978-80 were the last large sums provided from public funds for capital investment in the company. Some of this has since been converted into share capital. Since 1982 the company's need for additional funds to allow its business to expand has been substantial.[25] The value of the earlier loan had been much reduced by inflation; but the Secretary of State also told us that, although the External Financing Limits set by government in the period 1984 to 1988 included a sum of some £43.5 million for capital investment, only £14.1 million of this was actually applied for this purpose. Much of the money was simply swallowed up in current expenditure: higher costs and losses on contracts.[26] As a result, while some of Shorts production facilities are at the frontier of modern technology, the company needs to be given sufficient investment to allow it to choose to make itself, rather than subcontract, more of the high added value components of its products. The firm's capital investment, even allowing for the fact that much of its equipment and property is leased, is smaller than that of any of its competitors: Shorts has the smallest value of fixed assets per employee of any Western aerospace company (See Table E).[27]

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[25] Q 177

[26] Qq 381, 384

[27] Q 172,176, 178, 179

TABLE E: FIXED ASSETS PER EMPLOYEE IN WESTERN EUROPEAN COMPANIES

COMPANY	FIXED ASSETS/EMPLOYEE £
Northrop	18,938
Boeing	11,442
Lockheed	11,219
Rolls Royce	10,429
Fokker	10,258
British Aerospace	10,127
Rohr	8,293
Dassault	8,246
Dornier	7,492
SHORTS*	3,350

* Shorts' figure is calculated including the value of leased plant and equipment and the full value of leased property. It is unlikely that these elements are reflected fully in the figures for other companies.

Source: Shorts

23. It has been evident to us in our visit to the company that major investment is certainly required. The fact that the firm's productivity remains low, and its unit labour costs are high, is substantially due to the fact that investment has been too low to improve plant and equipment. The number of employees in the company since 1974 is set out in Table F.

TABLE F: NUMBERS EMPLOYED AT SHORT BROTHERS PLC 1974-1988

YEAR	NO. OF EMPLOYEES
31.8.74	5,835
31.8.75	6,259
31.8.76	6,166
31.8.77	6,386
31.8.78	6,461
31.8.79	6,648
31.8.80	6,629
31.8.81	7,076
31.3.83	6,329
31.3.84	6,164
31.3.85	6,587
31.3.86	7,216
31.3.87	7,203
31.3.88	7,679

EMPLOYMENT AT SHORTS AND THE NORTHERN IRELAND ECONOMY

24. With about 7,700 employees in Northern Ireland, Shorts is the largest employer among the Province's trading companies, and the largest industrial company.[28] Shorts also generates an

[28] Shorts: An assessment of the economic significance of the firm pp 6,7a,38; Evidence p.98, paras. 8.1-8.2

indirect effect through further employment in local suppliers of the company, and an induced effect, through higher consumer spending in the local economy. Estimates of these effects vary depending on how the multiplier is calculated. The multipliers used by the Northern Ireland Economic Council in its study of the impact of Harland & Wolff, would suggest that the number of indirect jobs dependent on Shorts is 800 and the number of induced jobs is between 1,700 and 2,500. Figures calculated by Dr J V Simpson, based on the employment effect of the aerospace industry in Scotland in 1979, give a higher result: 900 indirect jobs and 3,700 induced jobs. Taking direct employment alone, Shorts provided in 1987 1.4% of all jobs in the Province.[29]

25. Shorts provides other benefits to the Province's economy. Its high technology products mean that it trains employees to a very high skill level. We saw for ourselves the high quality achieved at the apprentice school at the Balfast Harbour factory. It is also the largest employer of technical and business-related graduates. We heard when we visited the company of its successful collaboration with The Queen's University, Belfast. Closure or removal of the company would exacerbate the already serious skill shortages in Northern Ireland, as former employees leave the Province.[30] Shorts is a vital source of technical skills for the rest of Northern Ireland.

26. Over the past few years, unions and management have improved working practices and conditions. In early 1988 the company concluded a flexibility agreement with the unions. Shorts does however, recognise that there is still a long way to go and it cannot afford industrial action such as the overtime ban in part of 1988.[31]

27. In collaboration with the unions, Shorts has strongly committed itself to fair employment affirmative action programmes. In August 1988 the management and the Confederation of Shipbuilding and Engineering Unions undertook jointly to cooperate fully to ensure that all employees will be able to pursue their employment without fear of intimidation, harassment or unlawful discrimination.

THE GOVERNMENT'S HANDLING OF PRIVATISATION

28. In his evidence to us, Mr Lund confirmed that there had been some differences between the company and the government over the privatisation process, but these have now been settled.[32] The unions put it more strongly: the company felt that the way privatisation was announced in Parliament 'had caused so much damage to the company and to customer confidence'.[33]

29. The Secretary of State, however, told us that 'if one is to achieve change it is necessary for the people in Northern Ireland not to have hidden from them what some of the realities are'. The performance of both Shorts and Harland & Wolff had 'not been as happy a one as actually may be the general public impression in Northern Ireland'; 'achievements have not been matched in terms of productivity and profitability and performance'. Mr King argued that government had to 'tread a very narrow line between maintaining confidence, maintaining the best possible image for the companies, but not letting it carry forward into the sort of attitudes that people

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[29] Shorts: An assessment of the economic significance of the firm, pp 39, 58

[30] The Northern Ireland Economy Review and Prospects. Coopers and Lybrand Associates (NI) Ltd, January 1989, paras. 426-432; Evidence p.100 para. 1.2

[31] Evidence p.97, para. 6.1

[32] Q 250

[33] Q 286

think actually the companies are doing extremely well ... and may not understand also the vital need there was for change'.[34]

30. When the board submitted its review of its corporate plan to Ministers in June 1988, it argued that privatisation could best be achieved by once again delaying privatisation by about two years and in the meantime writing off the company's debt and injecting new funds. In the event, the government decided to sell the company forthwith, and to negotiate any further funding for the firm with possible purchasers.[35]

31. The Secretary of State defended the decision to set proceedings towards privatisation in train in the summer of 1988 by pointing out that privatisation had first been proposed in 1984. A decision became urgent last year, he stated, partly because the owners of Shorts would soon be facing a 'very major decision on a future generation or future model of aircraft which would replace the present SD 330/360 series and would clearly be a key element in the whole shape of Shorts, its profitability and achievements in the next 15 to 20 years'.[36] The Committee recognise that the privatisation of Shorts has been under discussion for a long time. It regrets, however, that it was not developed as part of a carefully planned strategy, but in too precipitate a manner. Now that the privatisation process has gone so far, however, we accept that there is no real alternative to the sale of the company to the private sector. Our major concern is that this should be achieved in a manner which is most likely to ensure its continued existence and successful future within Northern Ireland, and that the uncertainty which currently hangs over the firm should be ended as rapidly as possible.

THE METHOD OF PRIVATISATION

32. The management of Shorts has consistently argued that the company should be sold as a whole, rather than split into its component divisions - aircraft, aerostructures and missiles - which would then be sold separately. The latter course could be extremely damaging, they emphasised to us in oral evidence, and might ultimately be more expensive to government.[37] But in his announcement on 21 July, Mr Viggers said that although it would prefer the company to be transferred as a whole, it did not rule out the separate sale of each division. The Secretary of State has now affirmed, however, that the information memorandum issued to prospective bidders on 10 January 'makes clear that we wish this company to be sold as a whole, and it is the only proposition that is in the information memorandum',[38] but he accepted that if the Government failed to sell the whole firm, it would have to reconsider its decision.[39]

33. Shorts' importance in the local economy - as a supplier of employment and high grade skills - makes it essential that the firm's principal activities are retained in Belfast. The Secretary of State told us that 'three of the assurances we are seeking from potential purchasers concern the future of the company's manufacturing base in Northern Ireland - the future of the company's headquarters, research and development facilities in Northern Ireland and the future level of employment in the company - and the extent of the prospective purchaser's interest in the FJX aircraft project'. He did, however, say that although he attached very great weight to all of these considerations, the actual sale price was still important.[40] Mr King also mentioned

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[34] Qq 372-3

[35] Evidence, p.96 para. 6.1; Q 224

[36] Q 316

[37] Q 220

[38] Q 355

[39] Q 359

[40] Qq 354, 360, 366

defence and security implications which would give rise to the need for other assurances as well. **We recommend that the future of Shorts production and design in Northern Ireland should be firmly secured; that the company should not be broken up; that its historic name and identity be preserved; that its business should remain and continue to develop in Northern Ireland; that it should be allowed to secure the participation of other companies in a new civil aircraft to replace its SD3 series; and that Shorts be allowed adequate funds in a recapitalisation which will modernise and re-equip the firm.**

34. The question also remains of how such assurances will be turned into effective guarantees.[41] The Committee understands that this may be done either by the Government's possession of a golden share in the company (as, for example, was done in the cases of British Aerospace, Vickers Shipbuilding and Engineering and British Steel); by retaining a minority shareholding; or by insisting that any public monies paid to facilitate privatisation should be repaid to the Government if the assurances are not honoured, as was agreed for British Aerospace's acquisition of the Rover Group. **We recommend that the Government should draw on its experience of previous privatisations in order to devise a formula to ensure that the recommendations about the future of Shorts that we have made in paragraph 33 above are met.**

35. The management of Shorts have pointed out how, due to lack of investment in the past, the company now needs a major injection of funds to give it a proper capital structure for the future, and the modernisation and re-equipment of its factories to allow it to compete with other aerospace companies worldwide. There has been some feeling among the firm's managers that the company has not been treated in the same way as other firms which have been recapitalised prior to privatisation.[42] The Government accepts that there has, in the past, been a lack of effective investment in Shorts, and agrees that 'it is absolutely clear that the company needs a proper capitalisation programme', and the Secretary of State told us that 'the proposal is to proceed with the recapitalisation'. This will, however, be done 'on the basis of a changed system': the company first needs 'a new approach and a new situation in which to operate'.[43] Recapitalisation will, therefore, only be carried out after a firm agreement has been made with a buyer. The Committee accepts the essential need for recapitalisation. **We recommend recapitalisation sufficient to modernise Shorts productive capacity.**

36. The financial arrangements for a successful privatisation will, of course, be open to negotiation between Government and the prospective bidder. In privatising the company, the government will, we assume, need to meet the existing liabilities of the company, and it has made clear its commitment to a recapitalisation of the company. The sums involved are likely to be substantial: the company's accumulated deficit at 31 March 1988 was £266.9m; on top of this, sums will be required to guarantee future liabilities, and to establish its working capital and as launch aid for its new aircraft, the FJX. Our own estimates indicate that the total costs to public expenditure will be in the range £700m - £850m. These costs are very large compared with those involved in the privatisation of other, much larger, aerospace companies in the UK. British Aerospace, whose equivalent turnover then was seven times larger than Shorts' is now, required a capital injection of £100 million in 1981. Rolls-Royce, with an even greater turnover, received £283 million on privatisation in 1987. We note that no provision has been made in the 1989 Public Expenditure Survey for the costs of privatising the company; expenditure on the company is set to diminish slightly, to £5.1m in 1989/90. We understand that any sums required for the privatisation will be met from the contingency fund. The House will in due course have to vote on a supplementary estimate for the necessary expenditure in Class XVIII under Vote 2, Subhead B1 (Department of Economic Development).

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[41] Q 360

[42] Evidence p.96, para. 6.1; Qq 224, 249

[43] Qq 407, 412

37. One investment decision that may be crucial for the future of the company is that on the development of the FJX. Shorts have been working on this project for at least three years.[44] The project, Mr Lund told us, 'is like Rover's new motor car: we need it to be in business'.[45] In order to proceed with it, the company is now looking for partners to share the total costs of about £500 million, although its search for partners has been lengthy and difficult.[46] In order to help finance its own share of the costs (perhaps a third), the company will expect to receive launch aid from the Government: it was, Mr Lund said, 'very' dependent on government launch aid.[47] As yet, as both Mr Lund and Mr King pointed out, the firm has put in no formal application to the Government for such aid.[48]

38. The Secretary of State, however, made it very clear that it was the Government's belief that, while launch aid will be made available for Shorts as it would for other companies in the aviation business, the importance of the decision to go ahead or not with the FJX meant that it would have to be taken by those to whom the firm was ultimately to be sold. He argued that 'the reality is that there are decisions that are going to involve investment in a number of years; they are going to involve very difficult decisions about policy, about whether it is the right model, whether it is exactly the markets that people [want] to go for, and that, inevitably, has to be a decision for the people who will carry forward the ownership and responsibility for the business into the 1990s and beyond the year 2000. That is why at this stage there is not a possibility of agreeing to launch aid for another project in advance hypothetically, not knowing who the new owners will be'.[49]

39. According to Shorts, however, this leaves the company in a difficult position, unable to finalise its arrangements for the FJX before privatisation and thus present its new owners with a profitable, promising new aircraft, because possible risk sharing partners are reluctant to commit themselves before they have firmer information both on launch aid and on the future shape of the company after privatisation.[50] We believe, however, that a contingent decision on launch aid as soon as possible would provide a necessary assurance to investors in the project, and would secure its future. **We recommend, therefore, that a prompt decision be made on the scope of the Government's investment in the FJX jet.**

40. Like the Secretary of State, we believe that Shorts has a distinguished past and deserves a soundly-based future. We stress our belief that the fate of the economy of Northern Ireland is closely bound up with the fate of the company. And we reiterate our conviction that the successful future of both will be best ensured if the uncertainty which now surrounds Shorts is ended as quickly as possible.

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[44] Q 340

[45] Q 182

[46] Q 340

[47] Q 184-5

[48] Qq 187, 331, 335

[49] Q 335

[50] Qq 189, 337

SHORTS

41. In summary, our Recommendations are as follows:

1. We recommend that the future of Shorts production and design in Northern Ireland should be firmly secured; that the company should not be broken up; that its historic name and identity be preserved; that its business should remain and continue to develop in Northern Ireland; that it should be allowed to secure the participation of other companies in a new civil aircraft to replace its SD3 series; and that Shorts be allowed adequate funds in a recapitalisation which will modernise and re-equip the firm. (Para. 33)

2. We recommend that the Government should draw on its experience of previous privatisations in order to devise a formula to ensure that the recommendations about the future of Shorts that we have made in paragraph 33 above are met. (Para. 34)

3. We recommend recapitalisation sufficient to modernise Shorts productive capacity. (Para. 35)

4. We recommend, therefore, that a prompt decision be made on the scope of the Government's investment in the FJX jet. [Para. 39]

WEDNESDAY 23 NOVEMBER 1988

Members present:

Mr Kenneth Warren, in the Chair

Mr Joe Ashton	Dr Keith Hampson
Mr Malcolm Bruce	Mr Doug Hoyle
Mr James Cran	Mr Robin Maxwell-Hyslop
Mr Stan Crowther	Mr Barry Porter

The Committee deliberated.

Resolved, That the Committee do inquire into the privatisation of Short Brothers plc and Harland & Wolff plc (The Chairman).

* * *

[Adjourned till Wednesday 30 November at 10.15 a.m.

WEDNESDAY 11 JANUARY 1989

Members present:

Mr Kenneth Warren, in the Chair

Mr Malcolm Bruce	Mr Doug Hoyle
Mr James Cran	Dr Keith Hampson
Mr Stan Crowther	Mr Barry Porter

The Committee deliberated.

[Adjourned till Wednesday 18 January at 10.15 a.m.

WEDNESDAY 18 JANUARY 1989

Members present:

Mr Kenneth Warren, in the Chair

Mr James Cran
Mr Stan Crowther
Dr Keith Hampson
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop

The Committee deliberated.

Mr Doug Hoyle declared an interest as Joint President of MSF in relation to the Committee's inquiry into the privatisation of Short Brothers plc and Harland & Wolff plc.

Mr John Parker, Chairman; Mr Per Nielsen, Assistant Managing Director, Operations; and Mr Peter Swan, Assistant Managing Director, Commercial, of Harland & Wolff plc were examined.

Mr Peter Williamson, Chairman; Mr John Dunn, and Mr Tom Benson, Senior Shop Stewards' Committee, Harland & Wolff and Mr Joe Bowers, Northern Ireland Confederation of Shipbuilding and Engineering Unions were examined.

[Adjourned till this day at 4.15 p.m.

WEDNESDAY 18 JANUARY 1989

Members present:

Mr Kenneth Warren, in the Chair

Mr James Cran
Mr Stan Crowther
Dr Keith Hampson
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop

The Committee deliberated.

Mr Rodney Lund, Chairman; Mr Roy McNulty, Managing Director; and Mr Alex Roberts, Sales and Marketing Director, Short Brothers plc were examined.

Ordered, That Strangers do now withdraw.

The witnesses were further examined.

Mr David Haggan, Chairman; Mr Jim Watson, Correspondence Secretary, CSEU Factory Committee; Mr Robert Newberry, Senior Steward, MSF; and Mr Joe Bowers, Northern Ireland Confederation of Shipbuilding and Engineering Unions, were examined.

[Adjourned till Wednesday 1 February at 10.15 a.m.

WEDNESDAY 1 FEBRUARY 1989

Members present:

Mr Kenneth Warren, in the Chair

Mr Jim Cousins
Mr James Cran
Mr Stan Crowther
Sir Anthony Grant
Dr Keith Hampson
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop
Mr Barry Porter

The Committee deliberated.

Sir Anthony Grant declared an interest as an adviser to Barclays Bank plc in relation to the Committee's inquiry into the privatisation of Short Brothers plc and Harland & Wolff plc.

Rt Hon Mr Tom King MP, Secretary of State for Northern Ireland; Mr Peter Viggers MP, Parliamentary Under-Secretary of State for Northern Ireland; Mr David Fell, Permanent Secretary; Mr Donald Thompson, Assistant Secretary; and Mr Perry McDonnell, Assistant Secretary, Department of Economic Development, were examined.

Ordered, That Strangers do now withdraw.

The witnesses were further examined.

[Adjourned till Wednesday 8 February at 10.15 a.m.

WEDNESDAY 8 FEBRUARY 1989

Members present:

Mr Kenneth Warren, in the Chair

Mr Jim Cousins
Mr James Cran
Mr Stan Crowther
Mr Doug Hoyle
Mr Barry Porter
Mr Robin Maxwell-Hyslop

The Committee deliberated.

[Adjourned till Wednesday 15 February at 10.15 a.m.

WEDNESDAY 15 FEBRUARY

Members present:

Mr Kenneth Warren, in the Chair

Mr Jim Cousins
Mr James Cran
Mr Stan Crowther
Dr John Gilbert
Sir Anthony Grant
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop
Mr Barry Porter

* * *

The Committee deliberated.

[Adjourned till this day at Four o'clock.

WEDNESDAY 15 FEBRUARY

Members present:

Mr Kenneth Warren, in the Chair

Mr Jim Cousins
Mr James Cran
Mr Stan Crowther
Sir Anthony Grant
Mr Doug Hoyle
Mr Robin Maxwell-Hyslop

The Committee deliberated.

Draft Report (The Privatisation of Harland & Wolff plc) proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 42 read and agreed to.

Resolved, That the Report be the Third Report of the Committee to the House.

Draft Report (The Privatisation of Short Brothers plc) proposed by the Chairman, brought up and read.

Ordered, That the draft Report by read a second time, paragraph by paragraph.

Paragraphs 1 to 41 read and agreed to.

Resolved, That the Report be the Fourth Report of the Committee to the House.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House. - (The Chairman)

[Adjourned till Wednesday 1 March at 10.15 a.m.

Cle HK 14.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

13 February 1989

Dear Stephen,

SHORTS

Thank you for your letter of 10 February, which the Prime Minister has seen.

I should be grateful if you and copy recipients would ensure that this letter is seen by those only with a strict need-to-know.

The Prime Minister is pleased to note the action in hand on the disposal strategy and exploring enhanced financial controls over the company. However, even if satisfactory new controls can be put in place, she sees major difficulties with either of the short-term funding possibilities as currently identified. She feels it would be a mistake to seek to obtain clearance now from the European Community to repaying the debts of £390 million via the operating company because this could then lead to a more difficult second negotiation with the Commission when the final disposal package is in place. And she does not think it would be appropriate for your Secretary of State to contemplate an instruction to the Accounting Officer to pay the money into the holding company.

I am copying this letter to Cary Evans (Chief Secretary's Office), Michael Saunders (Law Officers Department) and George Guise (Policy Unit, No. 10).

Yours,
Paul

(PAUL GRAY)

Stephen Leach, Esq.,
Northern Ireland Office.

13(A-B)

PRIME MINISTER

SHORTS

I reported to you after Cabinet on Thursday the action that Tom King had now set in hand following the series of meetings during the week.

You indicated that you would only want to contemplate a capital injection this year if this could be achieved without putting at risk the need to constrain the existing management. I think you were also concerned about a position where EC approval had to be obtained for two successive capital injections - one this year and one next.

The letter attached at Flag A from Tom King's office reports the position now reached on the various follow-up points. A short comment from George Guise is at Flag B.

The report is encouraging on the key point, namely rapid action on a disposal strategy. A number of promising ? possibilities are also being pursued on means of constraining the existing management:

- the appointment of a new Finance Director;
- reducing the company's current borrowing limits.

Only possibilities?

But I remain concerned about a short-term capital injection this year, even if satisfactory arrangements are completed for restricting the management's freedom of manoeuvre. There are two possible mechanisms:

(i) Repaying the debts of £390 million via the operating company. But this requires clearance with the EC as a state aid. Tom King now proposes an approach to the Commission early next week. This runs into the problem of our having to take two bites at the EC cherry. I assume getting approval for the short-term injection this year would not be too difficult. But we would then be setting ourselves up for a second

B.

And we haven't yet cleared the loan warranty

very difficult negotiation with the Commission next year when the final disposal package is in place. It would be much better in negotiating terms only to have to go to the EC once.

(ii) Putting the £390 million into a holding company trust. But this runs into accountability problems. Since this would simply represent debt repayment, and no longer involves an equity injection, (unlike the original £600 million proposal), Kleinwort Benson will not advise that this improves the disposal prospects. That means that the Treasury Officer of Accounts is not in a position to advise that such a payment "in advance of need" is appropriate; so the Northern Ireland Accounting Officer would not authorise the payment. The only way round that is for Tom King to instruct the Accounting Officer to pay the money - for which the only precedent in recent memory I know of is Tony Benn's instruction in the 1970s to pay money into the Meridan Motorbike Co-Operative. That, as George Guise says, is certainly not a course to be entertained lightly.

We can't do this. We rely on the AO's total integrity.

So on either route, there is a major problem.

Are you content to let Tom King explore these possibilities further, including making an approach to the Commission, and report back to you before the revised Parliamentary deadline for an Estimate this year?

OR

Do you want to tell him that you see major objection with either of the short-term funding possibilities currently identified?

Yes not

PRCG.

PAUL GRAY

10 February 1989

DS2AOT

From: The Private Secretary

12(A-D)

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

10 February 1989

Dear Paul,

SHORTS

Thank you for your two letters of 8 February recording the outcome of the meetings which the Prime Minister had with the Secretary of State, the Chief Secretary, the Solicitor General (for the second meeting only) and George Guise.

2. As your letters record, four main action points were agreed at the meetings for my Secretary of State to follow up. These were:

(i) The Secretary of State should proceed as a matter of urgency towards the disposal of Shorts, as discussed, in particular arranging via Kleinwort Benson to meet those companies who were seriously interested in acquiring Shorts (or parts of it).

(ii) Steps should be taken which would effectively limit the existing management of Shorts from entering into further commitments. The possibility of sending a letter to the Chairman of Shorts requiring him not to take on further avoidable commitments did not now seem attractive, since there was no way of enforcing its terms.

(iii) The Secretary of State should consider further whether a way could be found to meet the accountability problems attaching to an early payment into the Shorts holding company trust.

(iv) The Secretary of State should investigate further whether the Parliamentary timetable arrangements would enable a supplementary estimate (which could contain provision for Shorts) to be submitted later than yesterday (given that the uncertainties of the situation made it impossible to take a considered decision by that deadline).

B

3. I am now writing to report the progress achieved so far on these remits. To take first the important question of the timetable for the Estimates, the Secretary of State instructed officials on Wednesday night to undertake a fundamental scrutiny of the timetable,against the background that Ministers had now decided that in Estimates terms only two options were being considered - an injection of £390m or no injection at all. Following discussions between the Northern Ireland Department of Finance, the Treasury, our legal advisers, and the Chief Whip's Office it has now proved possible, through a series of quite exceptional measures, to find an extra two weeks before irrevocable decisions have to be made. Two versions of the Spring Supplementary Estimates (SSE) are now being printed: one will contain no provision for Shorts, while the other will contain a provision for a £390m injection (this represents the total of the company's debts as at 6 January 1989). The Estimates need to be laid before Parliament by Tuesday 28 February in preparation for a debate in the Commons which has been put back to 9 March. The deadline for deciding which set of Estimates should actually go forward for Parliamentary approval is Friday 24 February.

4. The current position on remits (i) to (iii) is as follows:

(i) Disposal Strategy. Kleinwort Benson are providing the Secretary of State with briefing on those companies which have a serious interest in bidding for all or part of Shorts, and will arrange meetings with the contenders to start in the week beginning 20 February. (The potential purchasers have until 17 February to let us have their responses to the Information Memorandum and Kleinworts have advised against meeting them before the 20th.) The list of seriously interested contenders will probably include Bombardier, Daimler Benz, and Fokker.

(ii) Enhanced Financial Controls on Shorts. A careful path needs to be steered in imposing rigorous financial controls on the company. It appears that a letter to Mr Lund requiring him not to enter into further commitments would be unenforceable. It would in theory be possible to dismiss him and the Board and replace them with others who would exercise more rigorous financial controls, but the upheaval and controversy of dismissing the Chairman might well alarm potential purchasers, cause major disruption in the company and jeopardise the disposal strategy, thereby potentially increasing the costs to the public purse. Whilst not yet entirely dismissing this option, the Secretary of State is therefore now carefully considering a third option, which would involve putting into the company, say as Finance Director, an experienced partner from a major London

C

accountancy firm. The Northern Ireland Department of Economic Development (DED) would appoint him to the Board. The new Finance Director would implement strict financial controls and would report regularly to the Secretary of State on the Company's progress. (He might well also bring a small team of people with him to assist his work.)

Although further work is needed on this proposition, the preliminary indications are that it should be feasible. While the existing Board might resent it, the fact is that they do not currently have a Finance Director as such and have expressed concern that senior management are overstretched. The Secretary of State would make clear to the Chairman and the Managing Director, and subsequently to the other members of the Board, that acceptance of the appointment and remit of the new Finance Director would be a precondition of the company receiving a capital injection of £390m (should the Prime Minister agree to this). It should be possible to make the funding available through a financial assistance agreement (FAA) containing specific and legally binding conditions which the Board would have to accept. Finally, it would be possible to take the additional step of changing the Articles of Association of the company to reduce its borrowing limit from the current £400m to, say, £50m (as the shareholder DED can effect this change with some rapidity). There could well be a strong case for doing this in any event. Control of borrowings up to this limit would be the responsibility of the appointee Finance Director.

(iii) <u>Accountability</u>. The Secretary of State believes that there is a strong case for putting in £390m to pay off the Company's accumulated debts, and thus save the ever-increasing interest burden. There could of course be no question of doing this without the establishment of strict financial controls which would ensure that the money went directly from the company to the creditors, and Kleinworts have advised that it should be possible to devise a foolproof system which would achieve this, perhaps using the new Finance Director were this idea to be pursued. For example, there could be a legal requirement in the FAA to repay specific loans. (DED do not have the <u>vires</u> to pay the money directly to the banks; it must touch down, however briefly, in the operating company first.) It would of course be necessary to clear any such capital injection with the EC, and a successful clearance cannot be guaranteed in advance. The Secretary of State considers that we should aim to secure Commission clearance as soon as possible and has therefore instructed DED officials to consider the next steps with officials in DTI and FCO. It is proposed that officials should make a preliminary approach to Brussels early next week.

but matched by an interest cost to the Exchequer.

D.

The meetings on 8 February also noted that an early injection might give the wrong signal to the current management. However, if it were coupled with the introduction of a new Finance Director and other financial controls the Secretary of State considers that it would be seen as the Government demonstrating its commitment to the early privatisation of Shorts and taking a firm and measured line with a weak management team.

The Secretary of State believes that this is the best course to take. If, however, it were to fail at the European hurdle, a possible fallback would be to pay the £390m into a holding company trust. This would however raise some difficulties of accountability: the Northern Ireland Treasury Officer of Accounts has advised that the DED Accounting Officer would probably be unable to authorise the payment. It would of course be possible for the Secretary of State to override this problem by instructing the Accounting Officer to pay the money into the holding company, but this would be an unusual and controversial step and would attract the automatic attention of the C&AG and the Public Accounts Committee. There are therefore drawbacks with this option, but the Secretary of State has asked officials to consider the implications further.

5. The Secretary of State hopes that this account of the current position will be helpful. He will liaise closely with the Chief Secretary and write further to the Prime Minister and other colleagues with firm proposals in respect of new financial controls and the capital injection in good time before the 24 February deadline, together with the latest information on the disposal options. The Chief Secretary concurs with this account.

6. Copies of this letter go to Carys Evans (Chief Secretary's Office), Michael Saunders (Law Officers Department) and George Guise (No 10 Policy Unit).

Yours,

Stephen.

S J LEACH

11.

PAUL GRAY 10 February 1989

SHORTS

Rather than wait for a further bounce on February 24, it might be appropriate to minute straight back to Leach that:

1 A transfer of £390M into the operating company is not acceptable unless both the Finance Director appointment is made and the articles are changed to curtail borrowing powers substantially.

2 It seems an unnecessarily high risk for Tom King to overrule his Accounting Officer if the EC blocks a transfer to the operating company. If there are further disasters with Shorts involving enquiries etc, such an action will add to suspicions of something fishy.

GEORGE GUISE

10(A-B)

NOTE FOR THE FILE 8 February 1989

FA

cc: Andrew Turnbull
Paul Gray

SHORTS

The possibilities being considered both for money transfer and management constraints:

Money Transfer

1. Any sum less than the KB recommended amount of £600m cannot be transferred into the holding company. David Fell as accounting officer could not authorise it.

2. A lesser sum such as £400m (approximately debt position at December 1988) could be transferred direct to the operating company subject to EC clearance. The transaction could be announced at once and got into this year's Treasury accounts.

Management Constraints

1. The kind of letter suggested by the Prime Minister cannot be made to work legally.

2. One possibility is to load the board with NIO civil servants so that management will be straightjacketted. In effect the company's operations would be subject to continuous board monitoring.

3. A better possibility is to fire Lund and the non-executive directors tonight and appoint a non-executive Chairman who would be an experienced receiver (eg Michael Jordan, senior partner of Court Gully). He would then deal with KB and oversee all details of the business operation until sales or closure achieved.

GEORGE GUISE

9(A-B)

2 8 2 A O T

cc. G.G.
R Wilson

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 February 1989

Dear Stephen,

SHORTS

The Prime Minister had a meeting this morning with your Secretary of State and the Chief Secretary to discuss the latest position on Shorts in light of your Secretary of State's paper, E(A)(89)4. Mr George Guise (No 10 Policy Unit) was also present.

I should be grateful if you and copy recipients would ensure that this letter is seen only by named individuals with a strict need to know.

Your Secretary of State said that he had undertaken in his E(A) paper to report on the latest position regarding likely bidders. He had now received advice from Kleinwort Benson on this. Expressions of interest had been received from Daimler Benz, Fokker, Bombardier, GEC, Ferranti, Thomson, CSF and Rolls Royce; with more tentative interest also expressed by some other companies. His preliminary view was that, with the possible exception of Daimler Benz, all these potential bidders were interested in retaining only one part of the Shorts business; and Daimler Benz themselves were probably preoccupied with the takeover of Messcherschmidt. Against that background, your Secretary of State's present expectation was that there would be no genuine bidder for the company as a whole - the basis on which the Information Memorandum had been formulated. He now proposed urgently to arrange meetings with Kleinwort Benson and each of the companies that had expressed interest, with a view to identifying which particular parts of the Shorts business they were interested in and preparing a strategy for the disposal of the company in parts. He wanted to proceed on the fastest possible plan.

Meantime, there was a need to ensure that the existing management of Shorts did not take on new obligations which would further increase the Government's financial exposure. Once the round of discussions with Kleinwort Benson was completed, your Secretary of State envisaged the possibility of appointing a receiver to take control and co-ordinate the process of disposal. Such a course of action offered political attractions. But it could not be put into effect immediately, which left the difficulty of control over existing management in the interim.

In discussion, the tactics now proposed by your Secretary of State for handling the range of disposal options were welcomed. But it was argued that, in advance of the possible appointment of a receiver, it was essential to take further powers to restrain the existing management from entering into new commitments without reference to your Secretary of State. That was an essential pre-requisite before the possibility of a short-term capital injection could be entertained. In any event, there could be no question at this stage - particularly in the light of the revised disposal strategy now proposed - of considering an injection greater than that necessary to clear existing debt.

Summing up the discussion, the Prime Minister said it was agreed that:

(i) Your Secretary of State should now proceed as a matter of urgency with the revised strategy for disposal that he had outlined in the discussion. He should aim to complete the round of discussions and assessment of the possibilities within the next fortnight.

(ii) Your Secretary of State should now send a letter to the Chairman of Shorts which effectively limited the existing management from entering into further commitments. This letter should also include an effective stop on further development work for the FJX. The letter would need to be prepared in consultation with the Treasury and the Law Officers, and agreed with the Prime Minister.

(iii) If the terms of such a letter could be settled during the course of today, and the letter transmitted to Mr Lund, arrangements could also be put in hand today to submit a Supplementary Estimate for 1988-89 providing for an immediate capital payment into a holding company trust, equivalent to the repayment of the outstanding debt up to a recent date, such as December 1988.

I am copying this letter to Carys Evans (Chief Secretary's Office).

Yours,
Paul

PAUL GRAY

Stephen Leach, Esq.
Northern Ireland Office

SUBJECT a MASTER.

SECRET: COMMERCIAL IN CONFIDENCE

KL3DHW
8

Meeting record

file

bc George Guise
Richard Wilson

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 February 1989

SHORTS

Further to my letter of earlier today, the Prime Minister had another meeting this evening with your Secretary of State, the Chief Secretary, the Solicitor General and Mr. George Guise (Policy Unit).

I should be grateful if copy recipients would ensure that this letter is seen only by named individuals with a strict need to know.

In discussion it was noted that various difficulties had been identified in providing an immediate capital payment into a holding company trust equivalent to the repayment of the outstanding debt up to a recent date. The present view was that, unlike the original proposal for an injection of £600 million, this latest proposal would not materially improve the prospects for a sale of Shorts, and could not therefore be defended on propriety grounds. That difficulty might be overcome if the sum could be transferred direct to the operating company. However such an approach would need to be subject to EC clearance, and could involve the drawback of giving the wrong signal to existing management.

The Solicitor General said that difficulties had also been identified with the proposed letter to the Chairman of Shorts designed to limit existing management from entering into further commitments. Although such a letter could be sent, there was likely to be no recourse short of dismissal which would effectively enforce the terms of the letter.

Following a further brief discussion, the Prime Minister said it was agreed that, given the present uncertainties, no action should be taken today to submit a Supplementary Estimate for 1988-89. Your Secretary of State should however consider further whether a way could be found to meet the propriety problem concerning an early capital payment into a holding company trust equivalent to the repayment of outstanding debt; and whether the Parliamentary timetable arrangements would enable a 1988-89 Supplementary Estimate to be submitted later than today.

I am copying this letter to Carys Evans (Chief Secretary's Office) and Michael Saunders (Law Officers' Department).

(PAUL GRAY)

Stephen Leach, Esq.,
Northern Ireland Office.

SECRET: COMMERCIAL IN CONFIDENCE

 7a

PRIME MINISTER

SHORTS

Following your talk with John Major earlier today we have now arranged that you will talk further to Tom King and John Major after tomorrow's E(A) discussion on job centres. The Chancellor will not be present for the Shorts discussion.

Tom King and John Major are now both fully seized of your concerns. I have passed on to Tom King's office key points from this morning's discussion and I have had two further long conversations with John Major. But we now need to consider what solution might emerge from tomorrow's meeting. You may want to have a further talk about the possibilities this evening.

There are three main issues to consider:

(i) Should there be any financial injection in the short term or should the Government just rest on words of intent?

(ii) What disposal options should be considered and on what timetable? In whole or in part - when

(iii) What action should be taken to change or tie down the existing Shorts management? New Industry - unless full - profits

Suspend - New management with ...

(i) Injection of money?

You have firmly ruled out injecting £600 million now, and I think John Major recognises he is not going to get that (although will continue to argue for it).

I see two possible compromises:

(a) Agree to repay the banks the existing borrowings up to a convenient recent date - say 31 December 1988.

Conditional on management

We do not know exactly what that figure might be, but it should be less than the £450 million estimated borrowings projected for June 1989 - say £400 million.

(b) Continue to refuse to hand over any money now but make a statement updating the words in the Information Memorandum:

- Information Memorandum covered position only to March 1988. Recognise further losses this year that need to be written off.

- Repeat the earlier statement that "H.M. Government recognises the need to restructure the company's balance sheet before Shorts can be returned to the private sector. The objective of this restructuring will be to inject further funds into the company which will be applied initially in repayment of its various borrowings".

(ii) What disposal options?

The present exercise - in accordance with the last E(A) conclusions - invites proposals for the sale of the company as a whole. If we continue on that course, it will be some time before break-up options are seriously considered.

The alternative is to consider in parallel both bids for the company as a whole and break-up options. This would minimise the delay before the final solution is identified.

(iii) Management changes?

Lund is clearly operating on too loose a rein. The options here would be:

(a) Sack him and find a replacement. The problems here would be finding the right replacement, and the likely severe adverse reaction in Northern Ireland if the Government was seen to remove the man widely perceived as Shorts' saviour.

(b) Keep him but severely restrict his freedom of action to incur further borrowings, either by an overall monthly limit or by stopping certain activities such as the FJX.

The possible way forward

My impression is that the Chief Secretary would fairly readily accept your imposing an outcome on the following lines:

(i) Pay off now the existing debts but nothing further.

(ii) Now simultaneously explore options for disposal as a whole and break-up, working to a tight timetable.

(iii) Either sack Lund or severely curtail his freedom of action.

I imagine you would have no difficulty with points (ii) and (iii) in this package. But you will want to consider whether you are prepared under (i) actually to hand money over - or whether the furthest you are prepared to go is to beef up the existing statements to acknowledge that the debts are now larger than revealed in the Information Memorandum.

PRCG.

PAUL GRAY
7 February 1989

10th → 24th February
(17th).

EL3DHS

SRWBUW

6a-c

CCB/UP.

SECRET AND PERSONAL

K-

PRIME MINISTER

SHORTS: BILATERAL WITH TOM KING AND JOHN MAJOR

This is an update of my earlier note which we discussed this evening.

I suggest you open the meeting by defining the agenda as follows:

(i) what disposal options should be considered and on what timetable?

In principle "Dowty Thorn" Fokker Bombardier. - Canada G.E.C. Plessey. Thompson B-R. United

(ii) what action should be taken to change or tie down the existing Shorts management?

(iii) should there be any financial injection in the short term?

(i) Disposal Options

You might start by inviting Tom King to report on the latest position regarding likely bidders, as he promised to do in the first paragraph of his E(A) paper.

You should work towards a conclusion that:

- the timetable for short-listing parties who are interested in the company as a whole should remain as indicated on page 3 of the Information Memorandum, i.e. 24 February;

- work should start immediately on options for disposing of the company in parts possibly including some closures, e.g. of the aircraft business;

- if by 24 February it is clear that there are no serious bidders for the company as a whole, an immediate announcement should be made that disposal in parts was now being pursued;

- a firm timetable should be set for completing appraisal of all the options - say end April 1989.

(ii) Tying down the Management

You may like to float the possibility of sacking Lund. But you could then accept that, unless a good replacement could be quickly found, this should not be pursued.

But as a fall-back you should insist on agreement to clear steps to limit management's freedom of action, for example:

- no new orders unless these are clearly profitable; Tucano!

- suspend new development work, e.g. on the FJX.

(iii) Any Injection of Money?

You will want to resist any injection of money now, even to cover the existing debts. You will want to re-deploy your earlier arguments, and draw on the minutes of the last meeting which ruled out an "interim re-construction".

But you can accept that a further reassurance needs to be given up-dating what was said in the Information Memorandum. This statement would be in two parts:

- repeat the earlier statement that "H.M. Government recognises the need to restructure the company's balance sheet before Shorts can be returned to the private sector. The objective of this restructuring will be to inject further funds into the company which will be applied initially in repayment of its various borrowings.";

- explicit recognition that the Information Memorandum covered the position only up to March 1988, and that the substantial further losses this year (can these be quantified?) will also need to be written off.

Other Points

You will also want to consider whether to say anything about the need to beef up the existing Northern Ireland Office personnel, e.g. by a secondment.

Some kind of report-back to E(A) will be necessary, given that Tom King's paper has already been circulated to the Committee. This might take the form of a further paper from Tom King reporting the outcome of your discussion, which E(A) could note at the next meeting scheduled for Thursday 23 February.

Papers

I will have with me all the background papers. But you may like to have to hand:

Flag A minutes of the December E(A) meeting

Flag B Tom King's paper, attaching the Kleinwort Benson and Touche Ross reports

Flag C Chief Secretary's personal minute to you, which Tom King has not seen

Flag D the earlier Kleinwort Benson letter

Flag E the Information Memorandum

Flag F George Guise's minute of 6 February

PRG.

(PAUL GRAY)
7 February 1989

iii. Shorts

THE SECRETARY OF STATE FOR NORTHERN IRELAND said that he was attempting at this stage to sell Shorts business as a whole. There had already been some expressions of interest. As had previously been announced, and agreed with the Shorts management, he was committed to offering Shorts for sale as a single entity first before considering bids for parts of the business. Touche Ross were already working for the Government on providing estimates of the cost of various options for disposing of Shorts, at the Treasury's request.

Shorts had lacked a sensible capital structure for many years. Its substantial debt burden would have to be dealt with if the company was to be privatised. He therefore proposed that there should be an interim capital reconstruction of Shorts which would involve providing a sum of about £300 million to enable most of the company's debts to be repaid. The details needed to be worked up. The intention would be to undertake this reconstruction in the current financial year. He had put forward this proposal to assist his colleagues who wished to see as much of the costs of Shorts' disposal as possible fall into 1988-89.

In discussion the following main points were made -

a. It was unfortunate that estimates of the cost of disposing of Shorts had not been available for this meeting, as had been requested by the Sub-Committee in October (E(A)(88) 13th Meeting). Reliable estimates might not, of course, be available until detailed negotiations with potential purchasers had taken place. Nevertheless, the work which Touche Ross were now undertaking should be given high priority. It would not be appropriate to approve an interim reconstruction of £300 million at this stage without much fuller information on Short's overall liabilities. Instead, officials in the Northern Ireland Office and the Treasury should work with Touche Ross to provide an estimate of what a once-and-for-all capital reconstruction might cost. It would be preferable for the Government to undertake a single financial reconstruction rather than to make substantial repayments in stages without knowing the full extent of what could be required. The sales memorandum on Shorts, which was due to be circulated on 16 December, should preferably not be published until a decision had been taken on a single reconstruction.

b. It would be difficult to obtain the agreement of the European Commission to an interim capital reconstruction. Facilitation of the privatisation was unlikely to be regarded by the Commission as sufficient reason to allow a substantial reconstruction and writing off of part debts. It might be somewhat easier to obtain approval for a once-and-for-all reconstruction, linked to a plan for the future of the business.

THE PRIME MINISTER, summing up the remaining discussion, said that the Sub-Committee believed that there should be a fresh look at Shorts finances. It should cover the feasibility of a once for all reconstruction; this was preferable to an interim reconstruction, which should not be pursued. It should also include estimates of the cost of disposing of Shorts. The Secretary of State for Northern Ireland should report back to the Sub-Committee in time for a further discussion at the beginning of February. Meanwhile, he should continue to stay in close touch with the Chief Secretary Treasury.

The Sub-Committee -

5. Took note, with approval, of the Prime Minister's summing up of the remainder of the discussion.

6. Invited the Secretary of State for Northern Ireland to report back to the Sub-Committee on progress made in privatising Shorts, in time for a discussion at the beginning of February.

Cabinet Office

2 December 1988

7/2 RA

cc/bo

064442
MDHIAN 1379

RESTRICTED
FM KUWAIT
TO DESKBY 071000Z MODUK
TELNO U/N
OF 070850Z FEBRUARY 89
AND TO DESKBY 071000Z FCO, ACTOR

Oh dear!

CNOP

SIC ACA/Z8G/ZMC

PERSONAL FOR SIR COLIN CHANDLER, DESO FROM AMBASSADOR

?!

MY TELNO U/N 010730Z FEB

SUMMARY

1. TUCANO DEAL SIGNED. 16 AIRCRAFT FOR POUNDS 37.5 MILLION. ALTHOUGH BIG DROP FROM STARTING PRICE, SHORTS CLAIM TO BE SATISFIED. KUWAITIS DELIGHTED.

DETAIL

2. I HAVE JUST RETURNED FROM ATTENDING THE SIGNING CEREMONY FOR THE SALE OF 16 SHORTS TUCANO AIRCRAFT WORTH POUNDS 37.5 MILLION. SHAIKH NAWAF, THE MINISTER OF DEFENCE, SIGNED FOR KUWAIT AND MR STEUART DAVIDSON-HOUSTON, THE CONTRACTS MANAGER, SIGNED FOR SHORTS. THERE WAS A VERY DISTINGUISHED TURN OUT INCLUDING THE CHIEF OF STAFF, COMMANDER OF THE AIR FORCE, AND REPRESENTATIVES OF THE MINISTRY OF DEFENCE, MINISTRY OF FINANCE AND THE KUWAIT INVESTMENT AUTHORITY. BEFORE SIGNING SHAIKH NAWAF MADE A SPEECH WARMLY CONGRATULATING ALL CONCERNED ON THE OUTCOME OF THE NEGOTIATONS AND EXPRESSING THE HOPE THAT THIS DEAL WOULD BE THE FIRST OF MANY IN THE DEFENCE FIELD. I REPLIED APPROPRIATELY.

3. TELEVISION CAMERAS WERE PRESENT AT THE MEETING (THIS MAY HAVE BEEN FOR A PRIVATE MOD VIDEO AS OPPOSED TO KUWAIT TELEVISION) AND THERE WERE PHOTOGRAPHERS PRESENT. SHORTS ARE ATTEMPTING TO CLEAR PRESS RELEASE WITH THE KUWAITIS AS THEY WOULD WELCOME SOME DOMESTIC PUBLICITY AS A BOOST FOR THEIR PRIVITISATION OPERATION. IT SEEMS LIKELY THAT THERE WILL BE SOME KUWAITI INSPIRED PUBLICITY LOCALLY AS WELL.

COMMENT

064442
MDHIAN 1330

4. DESPITE DROPPING THEIR PRICE FROM POUNDS 52 MILLION TO POUNDS 37.5 MILLION SHORTS CLAIM IT IS A GOOD DEAL. ON THE FACE OF IT IT IS THE KUWAITIS WHO HAVE RAISED THEIR BUDGET FIGURE FROM POUNDS 29 MILLION TO THE PURCHASE PRICE WHO HAVE COME OUT OF IT BETTER AND IT IS FORTUNATE THAT YOUR SECRETARY OF STATE'S MESSAGE WAS NOT SENT AT A TIME THAT THE COMPANY WAS CLAIMING THAT THEY HAD REACHED THE END OF THE ROAD - SINCE THEN THE PRICE DROPPED A FURTHER 4 AND A HALF MILLION POUNDS EXCLAM. THE KUWAITIS APPEARED DELIGHTED AND ALSO SEEMED SINCERE IN THEIR WISH TO DO BUSINESS WITH US ON OTHER ITEMS - THE FAST PATROL BOATS ARE NOW PROBABLY OUR BEST BET. LORD TREFGARNE'S VISIT, IF IT TAKES PLACE AS PROVISIONALLY PLANNED TOWARDS THE END OF THIS MONTH, WILL THEREFORE BE WELL TIMED.

5. I MUST PAY TRIBUTE TO THE HARD, BEHIND THE SCENES, WORK DONE BY ALISTAIR YOUNG, FIRST SECRETARY DEFENCE. HIS SUPPORT FOR SHORTS HAS BEEN INVALUABLE AND THIS CONTRACT IN ITSELF AMPLY JUSTIFIES HIS PRESENCE IN THIS EMBASSY.

HINCHCLIFFE

YYYY

DISTRIBUTION 87

MAIN 73

LIMITED	PS
MED	PS/MR WALDEGRAVE
DEFENCE	PS/PUS
NENAD	MR MUNRO
ERD	MR BOYD
WED	MR GORE-BOOTH
SEND	MR GOULDEN
SEC POL D	MR CARRICK
RID	

ADDITIONAL 14

PS/NO 10 DOWNING ST	SEC(O)(C) MOD
CABINET OFFICE	
DES(O) MOD	

NNNN

054/2761

PERSO[...]ND CONFIDENTIAL

CCBLV1

FROM: CHIEF SECRETARY
DATE: 6 February 1989

PRIME MINISTER

SHORTS

I am concerned at the possible policy direction on Shorts.

Kleinwort Benson's advice

2 Kleinworts' letter inadequately reflects the force of their earlier verbal advice. It nevertheless confirms that there are clear advantages in the route Tom King proposes. Against that Kleinworts also spell out the risks. (I have annexed what seem to me the key passages and my comments on them). The balance of advantage and risk is a matter of judgement. My clear judgement is that Tom's proposals best promote the objective of privatising Shorts as a whole, which is the objective E(A) set.

3 I understand your concern about our negotiating position. However Kleinworts' recommendation is for a sum of £700 million. Our proposal of £600 million is designed to minimise the risk of bidding up.

The merits of a £600 million injection

4 Shorts is bankrupt and we own it 100 per cent. It already owes around £400 million that the Government is under an obligation to pay. (This is a loss that has already been incurred and it is likely to rise to £450 million by June - the earliest possible date for sale). We cannot duck that payment and no-one will pay it for us. It is not new money for Shorts. And no-one will take this business if we do

no more than clear its debts. The additional £150 million is the lowest credible figure, below all the advisers' forecasts. The question is when and how we pay it in order to have the best chance of a satisfactory disposal. I believe it is appropriate to pay it to the holding company now as a firm indication we are clearing the decks for negotiations and sale of the company.

Management and workforce

5 Shorts management is a shambles and the Chairman is hostile. He would prefer us not to sell and has been obstructive and difficult throughout. Placing a significant sum up- front and proceeding to negotiations with potential purchasers immediately makes our commitment to sale absolutely undoubted and indicates the speed and decisiveness with which we are prepared to act.

6 This money will not be available to the company. It will be in the holding company, under our control and repayable with interest if disposal is not achieved. It is sufficient to encourage purchasers to consider seriously the purchase of the company as a whole and to be presented as our full and final dowry (although both Kleinworts and Touche Ross believe we will need to provide more eventually).

7 After 25 years of public ownership the workforce is extremely suspicious of the implications of sale. Their attitude is crucial, and only a clear demonstration that we are prepared to turn the company into a going concern is likely to secure their co-operation.

8 There is a further point. If a single purchaser cannot be found the capital injection will have provided a public indication of our endeavour to find one and to preserve employment in Northern Ireland as far as possible. In view of the fact that we are likely to have to close down Harland and Wolff I do regard this perception as important. It will then be far easier to move to the part-sale and part closure of Shorts that may be necessary if we cannot find a purchaser for the whole.

This too [illegible]

The money

9 This is a ghastly sum to pour into this bottomless pit and I resent every penny of it. Around £400 million has already gone and more is going daily. The extra £150 million represents the best option available for limiting this liability, and I do not think we should lightly dismiss it. The cost of closure, assuming sale of the missiles division, is estimated at around £1 billion.

10 If payment is deferred we can of course meet this unavoidable sum next year. That may be necessary but is scarcely satisfactory in public expenditure terms given the pressures that we already know exist. But the primary consideration is what steps will best achieve our objective for Shorts. I believe Tom King's proposal offers the best (although still by no means certain) chance of achieving that.

John M.

JOHN MAJOR

KB POSITIVE POINTS

1. Signal Government intention to make a substantial further commitment in support of future development of the company beyond the elimination of existing borrowings

Comment
No one would even contemplate taking on business as a whole if all Government was prepared to do was sell it debt free. Business has fundamental weaknesses which will cost money to correct and would not justify on commercial grounds the application of such sums - pay back period too long and risks of failure too great.

2. Considerable reassurance to the management employees and customers of the company. Given need for government to disengage itself from assurances potential benefits to this process from confidence generated by the proposed injection should not be under estimated.

Comment
The potential cost of assurances to Government is extremely high as indicated by KB's costing of disposal as a whole as in the range of £750 - £1000m Given that £450m needed to clear debt, that range of uncertainty indicates how much perception could influence the cost of the outcome.

3. Meets crucial test of increasing the likelihood that a buyer will be found for the company as a whole, with the risks that the terms may be more onerous. Assessment of this risk is a value judgement.

Comment
Here we came to the heart of the matter. The chances of selling the business as a whole are slim. But if Government wishes to maximise these chances then a cash injection is appropriate. It may increase the cost of disposal as a whole, but it also reduces the chances of having to face the higher costs imposed by other forms of disposal.

KB NEGATIVE POINT

1. Showing hand at early stage would encourage potential purchasers to hold out for a more extensive reconstruction than they otherwise would have done.

Comment
Yes. But without clear indication that Government is prepared to go as far as "a substantial commitment in support of future development of the company" it is unlikely that offers for the whole will be made. And a statement that quantified that commitment would have the same effect as a cash injection on encouraging expectation. And informed purchasers must known what their own minimum price would be although they may not appreciate that Government realises what a costly business Short's disposal would be.

PRIME MINISTER 1

SHORTS

[illegible] out on p.2 of the [illegible] Don't [illegible] anything [illegible] Ross [illegible] will [illegible]

Although E(A) is not until Wednesday, you will want to know the latest position.

Both Tom King and John Major have decided to stick to their guns and persist in proposing an early £600 million injection. This position is reflected in:

- Tom King's formal E(A) paper, which has just been circulated, at Flag A. He also attaches the promised Kleinwort Benson and Touche Ross reports.

- a personal minute from John Major to you, not copied to Tom King, at Flag B.

I also attach for reference:

- the Kleinwort Benson letter of 30 January at Flag C;

- the note I put to you over the weekend, together with the Information Memorandum, at Flag D;

- a further note from George Guise, after he had seen the Chief Secretary's minute but before he had seen the E(A) paper, at Flag E.

You should be aware that I had a long private conversation with the Chief Secretary about all this before the weekend - although I should be grateful if you did not reveal to him that you know about this conversation. I stressed to him:

- your firm opposition to an immediate £600 million capital injection as emphasised in your meeting with Tom King;

- the fact that he was not at that stage committed on paper to the £600 million injection;

- the need to base any case for an early injection not on the timing convenience for the Treasury of paying over money this year, but on the benefits for the privatisation objective of making a firm commitment to inject £600 million now rather than later;

- my own view, for what it was worth, that the Information Memorandum had already indicated a clear Government commitment to a large injection and that it would be unwise in negotiating terms publicly to quantify that commitment before serious buyers had been identified.

But, having reflected over the weekend, John Major has decided still to press the case for an immediate £600 million injection. You will want to consider the arguments in his minute at Flag B. The one point that is to some degree new is the argument in his paragraph 8 that, given the political and work force problems, an early commitment to a large injection might make it easier to get to the eventual solution of part-sale/part-closure. There is a read-across here to the point Kleinwort Benson now make in the attachment to Flag A (page 2) that "we are increasingly of the view that it may be more realistic to envisage the sale of the missile business separately from the rest."

But the essential point remains whether it is necessary or desirable to go further at this stage than the Information Memorandum already takes us, namely:

- page 3 says: "H M Government proposes to restructure the balance sheet .... in advance of sale to provide a framework for the successful transition of the company into the private sector. ... It is accepted that prospective purchases will not wish to make c

tentative offers for the company until they have had the opportunity to make further enquiries ... a short list of prospective purchases will be established, each of whom will then have the opportunity to refine its proposals in consultation with H M Government";

- page 22 says: "An objective of re-structuring will be to inject further funds into the company which will be applied initially (my underlining) in repayment of its various borrowings". In other words the public document is already clearly hinting an injection that goes further than clearing the debt (c.f. paragraph 4 of the Chief Secretary's minute).

On this basis the case for an early injection remains, at best, unproven. What is, perhaps, increasingly urgent is to expedite an assessment of the prospects for part-sale/part-clousre.

Handling

You were, I think, anxious to avoid a confrontation with Tom King and John Major in E(A). Unfortunately, neither of them has responded to the efforts to get them to change their position.

Since Tom King is in Belfast until late on Tuesday evening, it will not now be possible for you to have another private word with him before the E(A) meeting at 1030 on Wednesday. But, if you wished, there might be an opportunity for you to talk to John Major tomorrow after the MISC 138 meeting and before we start Questions briefing.

Do you want to have a word with John Major at that time?

If so, do you want the Chancellor also to join in?

PAUL GRAY

6 February 1989

SL2ASM

PRIME MINISTER 6 February 1989

SHORTS

The Chief Secretary's letter contains no fresh arguments and no commercial case. It is probably true that no-one will buy this business without Government support but that is no case for handing the money over in advance however tightly it is controlled. The Rover sale illustrated how much less than the 'bare minimum' a private sector purchaser can live with. HMG rarely negotiates toughly on the detailed terms of a privatisation because once the political decision is made, impatience to get shot of the business prevails. In some cases this may even be the right course.

However the Shorts case has not been researched through proper testing of the market. All we have are two gloomy documents from Kleinwort Benson and Touche Ross bemoaning the company's plight which is basically that it cannot satisfy a strong order book! It is becoming an article of faith on all sides that the Government faces a potential liability of a billion pounds on Shorts without any proper evidence to demonstrate it. This figure largely arises from Lund's claim that, if missiles are sold separately, the aero structures workforce will stage a sit-in thereby preventing contract deliveries to Boeing and Fokker who would then sue.

The Chief Secretary comments that Shorts' management is a shambles and that the Chairman is hostile. He then proceeds to the complete non-sequitor that a vast amount of up-front money has to be visibly pledged before a sale can be achieved. Northern Ireland Ministers and officials also seem blind to the danger that once the sum is placed in the Shorts' holding company, whatever the legal constraints on its release, Lund will become even more ungovernable. As soon as the funds have been transferred he will claim that the Government has publicly supported development of the FJX aircraft. How on earth can Tom King and Peter Viggers then deny that the money is for this purpose but is simply sitting in a bank account doing nothing?

I continue to advise that transfer of funds to the Shorts' holding company in advance of a sale should be strongly resisted.

George Guise

GEORGE GUISE

49-c

SECRET

PRIME MINISTER

SHORTS

Following your talk yesterday with Tom King, I have had a number of further discussions with his Office. I have also alerted the Chief Secretary to the key points of your discussion with Tom King.

The original plan was for the paper for next Wednesday's E(A) discussion to come round before the weekend. But I have now agreed that, in the light of the further work and thought implied by your talk with Tom King, it need not be circulated until Monday.

I am trying to keep in close touch with Tom King and John Major's latest thinking, and will talk to their Offices again early on Monday. It may be that there would be advantage in your having a talk with the two of them - and perhaps with the Chancellor as well - before the E(A) discussion. One possibility would be to fit this in on Monday afternoon. I will report to you further on that on Monday.

Meantime, I have got from Tom King's Office some detailed background material on Shorts' financial performance, which you may like to glance at over the weekend. The key document is the Information Memorandum issued by Kleinwort Benson to prospective purchasers. It is immediately below this minute, and contains summary profit and loss and balance sheet information for the last five years. In case you want to dig further, I also attach the Annual Reports back to 1985.

The Information Memorandum is a revealing document and I have highlighted the key passages. Major points that emerge are:

- the timetable for prospective purchasers to declare a preliminary interest is 10 February; the original plan for drawing up the shortlist was by 24 February (but you have told Tom King you want that speeded up). Page 3 brings out the earlier Government statements of a "preference for the sale of the company as a whole";

SECRET

- the Government is at present clearly committed to stand behind the Company. Apart from the fact that it is wholly owned by the Government, page 23 sets out the clear commitments to creditors that have been given;

- the recent trading performance has been abysmal. A five year run of profit and loss figures is given on pages 20-21. It shows massive losses in 1988. These are particularly concentrated on the aircraft division, which is also responsible for the lion's share of the exceptional items of stock adjustments and provisions for future losses. This makes all the more bizarre the commitment of existing management to developing the new FJ (pages 7-8); p.27

- a five-year run of balance sheets is on page 28. It shows up the massive growth of borrowings in 1988 as the trading losses have accumulated. There is no question that, whatever the eventual outcome, there is a huge balance sheet deficiency that will have to be written off;

- there are repeated references through the document to the Government's recognition of the need to restructure the balance sheet before privatising, eg pages 3 and 22. And this recognition goes as far as including an illustrative reformulation of the balance sheet at March 1988 to show the effect of stripping out borrowings;

- these adjustments broadly correspond to the first £260 million element of the capital injection proposed by Tom King in the letter you saw earlier in the week (extract attached). But in addition the proposed total restructuring of £600 million included allowances for anticipated 1988-89 losses (£130 million), further borrowings to June 1989 (£60 million) and a "capital base" (£150 million).

Patricia A. Parkin.

pp PAUL GRAY Duty Clerk.

3 February 1989

I accept Kleinworts' broad conclusion, including their view that we ought to inject a substantial sum into the company as soon as possible, and I would wish to take immediate steps to this objective. Both Kleinworts and Touche Ross have been calculating a range of disposal costs, as sought by E(A)(88)(13th meeting), and I shall be reporting fully on these later next month, but both have indicated that, whatever option we pursue, the cost is unlikely to be less than £750m. Based on these initial estimates of the net cost to Government, Kleinworts have suggested that £700m would be an appropriate sum to provide at this stage. We will ultimately have to put in at least £450m to clear the borrowings alone, and we will also need to give the company a proper capital base after repayment of borrowings. Nevertheless I could not recommend a sum of £700m as this is quite close to the bottom end of the range estimated by Kleinworts, and consequently suggest that a figure of £600m would be more appropriate. The break-down of this figure is as follows:-

	£m
Actual borrowings at 31 March 1988	260
Estimate of EFR to 31 March 1989	130
Estimate of further borrowings to 30 June 1989	60
Capital base (including £50m future losses provided in 1987-88 accounts)	150
Proposed restructuring	£600

I regard this sum as the final recapitalisation of the company, although clearly we may face further costs which would constitute a "dowry". The funds would initially be placed into a separate

 3a. 3/2. PSe

PRIME MINISTER

ORIGINAL FILED ON:-
MANPOWER: Semi A21

MEETING OF E(A): 8 FEBRUARY

There are two items for the agenda:

- privatisation of Jobcentres;

- Shorts

Jobcentres

I enclose Norman Fowler's paper on Jobcentres, which you may like to look at over the weekend. It reflects the points brought out in the discussion with him earlier in the week. You may like to look in particular at the proposed timetable (paragraph 22 onwards) which involves setting a cracking pace for the exercise, with the announcement of detailed conclusions on how vacancy finding and job placement is to be privatised by early May. An announcement that the exercise is under way is proposed before the end of this month.

I will let you have Cabinet Office and Policy Unit briefing next week.

Shorts

I am enclosing in your boxes some detailed background material on Shorts. But I have agreed with the Northern Ireland Office and the Treasury that, in the light of the further work and consideration implied by your comments to Tom King yesterday, they need not circulate the E(A) paper until Monday.

PRCG.

PAUL GRAY

3 February 1989

PM3AHW

From: The Private Secretary

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

80

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

PR

3 February 1989

Dear Paul,

SHORTS

I understand the Prime Minister would like to see Shorts' accounts for the last few years. I attach copies of the accounts for the last four years (with apologies for the condition of the 1986 accounts). The Prime Minister might find it more convenient, however, to begin by looking at the information memorandum which was sent to prospective purchasers of Shorts on 10 January, and a copy of this is also attached. This summarises (on pages 19-22) some of the more important elements of the company's accounts in recent years.

Could I also take this opportunity to record our agreement that the E(A) paper we are preparing will reach the Cabinet Office by close of play on Monday 6 February.

Yours,

Stephen.

S J LEACH

CRS/SOFS/4934

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

file

SECRET

2a

PRIME MINISTER

SHORTS

Following your talk yesterday with Tom King, I have had a number of further discussions with his Office. I have also alerted the Chief Secretary to the key points of your discussion with Tom King.

The original plan was for the paper for next Wednesday's E(A) discussion to come round before the weekend. But I have now agreed that, in the light of the further work and thought implied by your talk with Tom King, it need not be circulated until Monday.

I am trying to keep in close touch with Tom King and John Major's latest thinking, and will talk to their Offices again early on Monday. It may be that there would be advantage in your having a talk with the two of them - and perhaps with the Chancellor as well - before the E(A) discussion. One possibility would be to fit this in on Monday afternoon. I will report to you further on that on Monday.

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The Information Memorandum is a revealing document and I have highlighted the key passages. Major points that emerge are:

- the timetable for prospective purchasers to declare a preliminary interest is 10 February; the original plan for drawing up the shortlist was by 24 February (but you have told Tom King you want that speeded up). Page 3 brings out the earlier Government statements of a "preference for the sale of the company as a whole";

b

- the Government is at present clearly committed to stand behind the Company. Apart from the fact that it is wholly owned by the Government, page 23 sets out the clear commitments to creditors that have been given;

- the recent trading performance has been abysmal. A five year run of profit and loss figures is given on pages 20-21. It shows massive losses in 1988. These are particularly concentrated on the aircraft division, which is also responsible for the lion's share of the exceptional items of stock adjustments and provisions for future losses. This makes all the more bizarre the commitment of existing management to developing the new FJ (pages 7-8);

- a five-year run of balance sheets is on page 28. It shows up the massive growth of borrowings in 1988 as the trading losses have accumulated. There is no question that, whatever the eventual outcome, there is a huge balance sheet deficiency that will have to be written off;

- there are repeated references through the document to the Government's recognition of the need to restructure the balance sheet before privatising, eg pages 3 and 22. And this recognition goes as far as including an illustrative reformulation of the balance sheet at March 1988 to show the effect of stripping out borrowings;

- these adjustments broadly correspond to the first £260 million element of the capital injection proposed by Tom King in the letter you saw earlier in the week (extract attached). But in addition the proposed total restructuring of £600 million included allowances for anticipated 1988-89 losses (£130 million), further borrowings to June 1989 (£60 million) and a "capital base" (£150 million).

PAUL GRAY

3 February 1989

SECRET AND PERSONAL 1

Subject a master

file

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 February 1989

Dear Stephen,

SHORTS BROS PLC: PRIVATISATION

Further to my letter of 1 February, the Prime Minister and your Secretary of State had a discussion about Shorts following Cabinet this morning.

I should be grateful if you would treat this letter on a personal basis.

The Prime Minister said she was strongly opposed to any capital injection being made unless this was linked to the funding of a final settlement in which a purchaser or purchasers took over the whole of the public sector's present liabilities. To do otherwise would seriously prejudice the Government's negotiating position. The Prime Minister asked your Secretary of State to ensure that when he reported to the meeting of E(A) next Wednesday a clear indication was available of those companies who were expressing a serious interest in taking over the whole of the Shorts businesses; if none of these seemed to offer a serious prospect of disposal she would also want to be aware of the possibilities for disposing of separate parts of the company.

Following a brief discussion your Secretary of State agreed to take into account these points in the preparation of his paper for E(A). He also agreed to let the Prime Minister have a sight of accounts and balance sheets of Shorts for the last few years.

Yours,

Paul

(PAUL GRAY)

Stephen Leach, Esq.,
Northern Ireland Office.

SECRET AND PERSONAL

Note
Discussed with PM and
accepted letter to capital
PRC 6/2

PRIME MINISTER

SHORTS

You saw last night the note from George Guise giving advance warning of the likely proposal for an early massive capital injection. We discussed the idea this morning, and you indicated your firm opposition.

As expected the proposal has now formally come forward - see Tom King's covering minute addressed to you (flag A) attaching a more detailed letter to the Chief Secretary.

George Guise's note at flag B reinforces the advice he gave last night.

The key points about this bizarre proposal are:

- the rationale put forward for an immediate capital injection - in order to improve the chances of early privatisation - simply does not stand up. The holding company device will not in itself achieve a recapitalisation. Tom King undermines his own argument about giving bidders greater certainty when he admits (bottom of page 3 of letter to the Chief Secretary) that a further "dowry" may be required. And putting all this money up front will fatally undermine the Government's negotiating position.

- the truth is that this is all simply a device - probably at the instigation of the Treasury - to get the money paid over in this financial year rather than next. That is confirmed by George's intelligence that the Kleinwort's letter is one they were urged to write (you should NOT of course reveal we know that).

I imagine you will want firmly to resist the proposed short term injection. As you know we are already arranging an E(A) discussion for next week to discuss Job Centres, and you may like to consider asking Tom King to submit a further paper to that meeting on the options we now face for Shorts. I attach a possible letter I could send out in these terms.

Content for me to minute out as attached?

PAUL GRAY
31 January 1989

EL3DHL

DRAFT

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 February 1989

SHORTS BROS PLC: PRIVATISATION

The Prime Minister has seen your Secretary of State's letter to the Chief Secretary dated 31 January.

I should be grateful if you and copy recipients could ensure that this letter is given a restricted circulation on a strict need to know basis.

The Prime Minister is most concerned at the proposal for an immediate massive capital injection into the Shorts holding company. She does not accept that this is necessary in order to secure the stated objective of maximising the possibility of disposing of the whole business on the best available terms. On the contrary, she believes that for the Government to be seen to be willing to inject such a large sum at this stage would weaken the Government hand for the reasons identified in the Kleinwort Benson letter dated 30 January. The Prime Minister does not therefore agree that this proposal should proceed.

The Prime Minister would be grateful if your Secretary of State would prepare a paper for next week's meeting of E(A) reporting on the outcome of the Kleinwort Benson and Touche Ross studies, so that the Committee can review the options for disposal of the Shorts businesses.

I am copying this letter to the Private Secretaries to members of E(A), Stephen Wall (Foreign and Commonwealth Office), Steven Catling (Lord President's Office), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

(PAUL GRAY)

Stephen Leach, Esq.,
Northern Ireland Office.

cc 4/1

SECRETARY OF STATE FOR NORTHERN IRELAND

Prime Minister

E(A): **SHORT BROS PLC**

When we met at E(A) in early December (E(A)(88) 15th meeting) to discuss Shorts it was agreed that we should not proceed with an interim partial reconstruction of the company's Balance Sheet; that I should bring forward costed options on disposal; and that I should stay in close touch with the Chief Secretary over the whole situation.

Since that meeting the sale memorandum has issued to a number of potential purchasers and both Kleinwort Benson and Touche Ross have been estimating the possible costs of disposal under a range of scenarios. I hope to be able to report on the costings to E(A) later in February. In the meantime John Major and I have been discussing the need to make an immediate and substantial injection of capital into the company not as an interim step but as a definitive recapitalisation. This would be designed to provide potential purchasers with greater certainty about the company's future financial structure and thereby improve the chances of early disposal of the whole company on acceptable terms. The cost of this proposal would fall within this financial year provided we can include it in the Northern Ireland Appropriation Order, which will be tabled shortly.

John's officials and mine, together with Kleinworts, have therefore been working on a proposal for a capital payment to achieve final recapitalisation, and I have formally sent John today the attached letter on the matter. The sum proposed - £600m - is £100m less than envisaged by Kleinworts, and well within the estimated costs of disposal (on any option) as initially assessed by both Kleinworts and Touche. I have to say that I am appalled at the size of the sum involved, and yet I have to recognize that this is dealing with a liability that has built up over a number of years, and has got to be faced one way or another, whatever option we pursue.

We believe we should grasp this nettle now, but I thought I should write personally to you to explain the background. Subject therefore to your and other colleagues' approval, John and I propose that we proceed to include it in the Appropriation Order.

A copy of this minute goes to John.

TK

TK

31 January 1989

Secretary of State

Northern Ireland Office
Stormont Castle
Belfast BT4 3ST

Rt Hon John Major, MP
Chief Secretary to the Treasury
Treasury Chambers
LONDON
SW1P 3AG

31 January 1989

Dear John,

SHORTS BROS PLC: PRIVATISATION

We have recently discussed together the next steps towards achieving the privatisation of Shorts against the background of the particularly difficult situation of the company. I now wish to put to you proposals for an immediate capital injection into the company, on the basis of advice from our merchant banking advisers, Kleinwort Benson, as a means of promoting early disposal.

Kleinwort Benson have left us in no doubt about the particular difficulties associated with the sale of this company as a whole. Their view, which is entirely consistent with advice from Touche Ross and from our officials, is that disposal of the business as a whole, given its profound weaknesses, will be far from easy. My proposals are aimed at maximising that possibility while seeking to drive the best bargain for the taxpayer by way of sale as a whole. But they are structured in such a way as not to foreclose our options should we decide when responses to the sale memorandum are received, that sale as a whole is not feasible.

Shorts is in an extremely bad state. An exceptionally lengthy period in Government ownership has resulted in attitudes in the workforce and management and a performance record which make it a most unattractive investment proposition. Among its characteristics is a long history of incurring serious losses, and this trend has been intensified by further significant losses revealed in the 1987-88 accounts. A consequence of this history of losses is a

SECRETARY OF STATE FOR NORTHERN IRELAND

I accept Kleinworts' broad conclusion, including their view that we ought to inject a substantial sum into the company as soon as possible, and I would wish to take immediate steps to this objective. Both Kleinworts and Touche Ross have been calculating a range of disposal costs, as sought by E(A)(88)(15th meeting), and I shall be reporting fully on these later next month, but both have indicated that, whatever option we pursue, the cost is unlikely to be less than £750m. Based on these initial estimates of the net cost to Government, Kleinworts have suggested that £700m would be an appropriate sum to provide at this stage. We will ultimately have to put in at least £450m to clear the borrowings alone, and we will also need to give the company a proper capital base after repayment of borrowings. Nevertheless I could not recommend a sum of £700m as this is quite close to the bottom end of the range estimated by Kleinworts, and consequently suggest that a figure of £600m would be more appropriate. The break-down of this figure is as follows:-

	£m
Actual borrowings at 31 March 1988	260
Estimate of EFR to 31 March 1989	130
Estimate of further borrowings to 30 June 1989	60
Capital base (including £50m future losses provided in 1987-88 accounts)	150
Proposed restructuring	£600

I regard this sum as the final recapitalisation of the company, although clearly we may face further costs which would constitute a "dowry". The funds would initially be placed into a separate

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serious deficiency in the company's balance sheet which already at 31 March 1988 showed total borrowings of £219m and deficit of shareholders' funds of £175m, and we had identified some time ago a need to remedy this. Moreover, although Shorts has some attractive and profitable products, particularly within the Missile Systems Division, others, notably aircraft, are approaching obsolescence and, more importantly, incur heavy losses, and this performance is a major disincentive to potential purchasers.

We are not talking therefore, as with some other privatisations, about the sale of a formerly loss making company which has been brought to profitability, or indeed the sale of a loss making company to an identified buyer. What we have to offer the market is a heavily loss making company on the promise of a major recapitalisation, but with no return to profitability beforehand. There is also the significant point that the company's location in Northern Ireland may also limit the field of interest in acquisition of the company. I believe therefore that we must take whatever reasonable steps we can to promote interest in the company and bolster the prospect of sale as a whole.

Against this background, we have been taking forward with Kleinwort Benson the question of whether we can take any action which would encourage the early disposal of the company as a whole or, if sale as a whole on acceptable terms is unattainable, would put us in a strong position to argue that we made every effort to secure sale as a whole before moving to other options. Kleinwort have concluded in the attached letter that there is merit in making an immediate and substantial capital injection in order to provide, to the potential purchasers who have now received the sale memorandum, tangible confirmation of the Government's willingness to remedy the balance sheet and to make the company more attractive to those potential purchasers.

SECRETARY OF STATE FOR NORTHERN IRELAND

discretionary trust fund to be managed by SB (Realisations), Shorts' holding company. The trustee - SB(R) - would be empowered to pay such sums to Shorts as are required for the purpose of the privatisation and other stated purposes.

There are a number of considerations on which we must be satisfied in pursuing this course.

Firstly, while the step is intended to maximise the chances of an acceptable sale as a whole, it does not prejudice, and should not be read as prejudicing, consideration of other options. Accordingly, I intend to make it clear to prospective purchasers that the ground rules for the disposal exercise set out in the information memorandum continue to apply, and that it is for the Government to decide which, if any, proposals for acquisition as a whole to pursue and to determine the extent to which funds are provided to a purchaser on the strength of the proposals made. There should be no presumption that the full sum will in fact be provided.

Secondly, there must be no prospect of funds leaking from the holding company into the trading company and we must have cast-iron means of recovering any surplus at the time of sale, including the interest that will accrue on the money injected. I am satisfied on the basis of clear legal advice that I have the necessary powers both to make the injection, to ensure that there can be no prospect of leakage, and to ensure that the funds made available can be recovered if and as far as necessary. It will also be essential to ensure that the passing of funds to Shorts PLC is strictly controlled and that any funds (principal and/or interest) not required can be returned to the Government, by taking steps to ensure that the Board can act only on our instructions.

As you know, this latter point is also essential in terms of our position vis a vis the EC Commission. Senior Commission officials who were sounded on the proposal indicated that providing there were no leakage, we need only inform the Commission of this injection. They helpfully said that questions of state aid would only arise when money passed to the trading company - which is something that we only intend to happen when negotiations for disposal are near completion and we can make the appropriate detailed notification.

Thirdly, there is the matter of my own resources. You will readily appreciate that the Block could not withstand the payment of £600m in this or any other year, and I must therefore make a bid on the Contingency Reserve for 1988-89. If you can agree this, it would be my intention to take provision in the Northern Ireland Supplementary Estimates, and you will wish to note that this will require the NIO also to take a Supplementary Estimate to cover the Northern Ireland grant-in-aid.

Fourthly, my officials have explained to me the accountability dimension of this proposal. While I can accept the conclusion, which took into account the positive views of your officials, that the payment can be reconciled with Government accounting principles, I should nonetheless be grateful for confirmation that you take a similar view.

I should, therefore, be grateful for your agreement to the payment of £600m from the Contingency Reserve in 1988-89 for the purposes I have described, on the basis proposed, and with the safeguards I have described to ensure that there is no leakage into the trading company. Since, as I have explained, it will be necessary for me to take Supplementary Estimates provision and since the last date for incorporation of this provision into those Estimates, having squeezed the normally tight timetable to the limit, is 8 February, I should be grateful for an early reply to this letter, and in any case in advance of this date.

SECRETARY OF STATE FOR NORTHERN IRELAND

I am copying this letter and enclosure to the Prime Minister, other E(A) colleagues, the Foreign Secretary, the Lord President, the Defence Secretary and to Sir Robin Butler.

Tom

TK

PRIME MINISTER 31 January 1989

SHORTS

The only merit of the proposal to transfer £600 million into the Shorts Holding Company is that it helps to spend this year's Treasury surplus! It seems to have no commercial merit at all. Indeed, there are two strong arguments against:

i. The transfer of the funds will become public knowledge and Rodney Lund will appear to have triumphed over HMG. It is highly probable that he will soon claim that the Government has decided to fund the development of his new FJX aircraft.

ii. Once the funds have been transferred any prospective buyer will regard them as an integral part of the deal. The buyer will then focus on how much extra can be pressed out of the Government.

EC POSITION

Provided that the release of funds from the holding company to the operating business remains under HMG's control, Brussells need only be informed that the transaction has taken place. However approval will be needed when funds are utilised. This is presented as an argument in favour of the proposal even though any practical deal will involve both debt extinction (£450m) and financing working capital (£150m) which will have to go to Brussells anyway - cf Rover/British Aerospace.

DISPOSAL COSTS

The NIO have received the following overall cost estimates of disposal of the business:

i. Touche Ross - £700-800 million;

ii. Kleinwort Benson - £750-1,000 million;

iii. Touche Ross also claims that this cost would be increased to £1,075 million if the missile division were sold separately. The argument here is that if missiles are sold there will be no incentive for a buyer to take the rest of the business and it would have to be closed.

We must not accept these colossal figures without intense scrutiny. Indeed the King/Major letter states on page 3 that he will be reporting fully on disposal costs later next month. He has therefore presented no quantitative case for injecting this sum forthwith other than unsubstantiated horror stories.

ALTERNATIVE COURSE

The proper way to pursue this privatisation is to establish where serious purchasing interest lies, preferably for the business as a whole but also separately, and to hone down interest to a few front runners. Detailed negotiations should then be entered which would establish the total quantum of HMG funding needed to make a clean break. Once this is established EC approval should be sought and the funds subsequently released from Treasury. The real cost of pre-empting this process by transferring £600 million now is the inevitability of a much larger eventual cost to the taxpayer.

VIEWS OF NIO AND KLEINWORTS

Peter Viggers phoned me twice today to lobby in support of the deal. He pointed out that even though Lund had been supportive of HMG at the Select Committee last week, the holding company would not have him on the Board which would consist of only the other Shorts non-executive directors together with Government appointees.

I then spoke to a personal contact at Kleinwort Benson who effectively told me that all the pressure for this transfer came from the Treasury. This is consistent with the tone of the letter attached to King's submission which reads as though it has been wrung out of KB - an excellent example of how merchant bankers always play the tune which is called.

RECOMMENDATION

Oppose the transfer of any recapitalisation funding to Shorts until a realistic sales proposal has been achieved.

GEORGE GUISE

Kleinwort Benson Limited

A MEMBER OF TSA AND OF THE AIBD

P.O. Box 560
20 Fenchurch Street
London EC3P 3DB

Telephone 01-623 8000
Telex General 888531
Foreign Exchange 886771

6

CJF/fst

30th January, 1989

D. Fell, Esq.,
Department of Economic Development,
Netherleigh,
Massey Avenue,
Belfast. BT4 2JP

Dear Mr. Fell,

SHORTS

We have discussed with DED in recent weeks the sales prospects for Shorts. The Company is far from being an attractive target for a private sector purchaser: it is engaged in a high risk industry, it is the largest manufacturing employer in Northern Ireland, it has a dismal financial record, and it will require substantial investment and re-organisation if it is to earn an adequate return.

Against this background, you have asked us to consider whether the prospects for a successful privatisation of the Company as a single unit could be improved by an immediate transfer of a sum likely to represent a substantial proportion of the expected final cost to Government. In the light of the advice which we have given to you separately I consider £700 million to be such a sum. I would expect the final cost to the Government whichever option is pursued to be greater than that figure. You explained that, for reasons connected with notification of any capital reconstruction to the European Commission, it would not be possible to inject this sum directly into Short Brothers PLC at this stage and you are considering transfer to SB Realisations (the immediate holding company of Shorts) where it would be expected to remain until it is applied to the recapitalisation of the Company.

In the light of the above you have asked us to write to you to summarise our views on the possible commercial implications of such a capital transfer for the conduct of the sale. In framing our advice, we have had particular regard to the fact that the nature and extent of the transfer will immediately become public knowledge. Accordingly, if the transfer proceeds, we consider it important that there should be a simultaneous letter to prospective

Cont/....2

purchasers explaining that this provision does not necessarily imply that this entire sum will be injected into the Company. Rather, by this payment HM Government wishes it to be understood that, in addition to the elimination of borrowings, it is prepared to consider a substantial further commitment in support of the future development of the privatised Company. The extent of this further commitment will be determined by the perceived desirability of the proposals put forward by the ultimate purchaser.

The commercial case for making the transfer

The principal attraction of making a transfer is that it would signal to prospective purchasers that in addition to the elimination of existing borrowings the Government is prepared to make a substantial further commitment in support of the future development of the Company. This will clearly be attractive to prospective purchasers as it will indicate that substantial funds could be available to them to effect the turnaround in the Company's fortunes that must be the objective of any purchaser who acquires the business on a going concern basis. This in turn should, when linked to the statement set out in the Information Memorandum about the importance which the Government attaches to the long term future of Shorts and its employees, encourage prospective purchasers to come forward with proposals for the purchase of the whole of the business.

In addition, the availability of a sum of this magnitude should be of considerable reassurance to the management, employees and customers of the Company, that HM Government is prepared to make the very large financial commitment necessary to return the Company to the private sector as one entity and with a properly capitalised balance sheet. Given that the effective extrication at lowest cost of HM Government from the potential liabilities which could arise from the assurances that have previously been given is one of the more important aspects of this privatisation, the potential benefits to this process from the confidence generated by the proposed injection should not be underestimated.

The commercial case against making the transfer

The risk associated with making the injection is that, as it will be public knowledge, HM Government will have shown its hand at an early stage in the negotiation process and that this may encourage potential purchasers to hold out for a more extensive reconstruction than they would otherwise have done. Government could, however, endeavour to protect its negotiating position by making it clear to prospective purchasers that the final amount which is injected into the Company will vary depending upon the attractiveness of the proposals put forward by potential purchasers for the future development of the Company.

Summary and Conclusions

The commercial considerations involved in making the proposed injection may be summed up as, on the one hand, encouraging prospective purchasers and those other parties involved with the Company by giving them an indication of Government's potential willingness to finance a substantial regeneration of the Company whilst, on the other hand, risking weakening the Government's bargaining position and encouraging acquirers to demand a more extensive reconstruction of the company than they might otherwise have done.

In other circumstances, our instinct would be not to show the Government's hand until absolutely necessary. However, this privatisation has been conducted against the background of significant media interest and there have already been various articles which have alluded to the sort of sums that HM Government might need to make available to secure privatisation. Accordingly, informed purchasers can be presumed to have a fairly clear idea of the potential magnitude of the sums involved.

To conclude, the proposal under consideration does, in our view, satisfy the crucial test of increasing the likelihood that a buyer will be found for the Company as a whole, but with the risk that the terms which buyers demand will be more onerous. The assessment of whether this risk is worth taking is as much a value judgement as a matter of commercial appraisal. However, given that the Government ascribes a high priority to sale as a whole - and against the background of the expected difficulties of disposing of the Company as a single unit and the assessment which has been made of the risks associated with a break up - then provided that the potential purchasers are made aware of the Government's action as soon as possible on the lines set out above, we consider that there is merit in the proposed transfer.

Yours sincerely

Kit Farrow

C.J. Farrow

Prime Minister[2]
You may like to be aware
that this rather worrying proposal ~~may~~
may arrive shortly.
PRCG 30/1.

PAUL GRAY 30 January 1989

NO – this is
outrageous.

SHORTS

You were right. Papers are currently being drafted for despatch tomorrow from Tom King to the Chief Secretary (copied here), and a personal note to the Prime Minister. The proposal is to inject £600 million into the Shorts' holding company called Short Bros Realisation which will have the effect of making the consolidated balance sheet look attractive to potential purchasers. It is not intended that any of this money will be drawn down into the operating companies prior to disposal of the business. However, Rodney Lund is chairman of this holding company and the proposal to appoint HMG directors with power to block the release of funds downwards may not be adequate.

The Treasury have agreed, indeed it may be a Treasury initiative, because of this year's surplus. However it will be extremely counter-productive for the NIO's future handling of Rodney Lund who will appear to have triumphed! Theoretically, the money can be released back to government by liquidating the holding company if no sale happens. For obvious reasons one must be highly sceptical of that assurance. The £600 million sum proposed is over double the cost of developing the new FJX aircraft and allows for existing debt write off.

I understand that the NIO and the Treasury hope to get agreement in principle for this move through correspondence, thereby presenting E(A) with a fait accompli. We shall have more details tomorrow but the principle of the scheme seems at odds with the position taken by the Prime Minister and E(A) on December 1.

Europe?

GEORGE GUISE

Rodney LUND
26/7

file

CCL

filing

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

Ack | 21 July 1988

I attach a copy of a letter the Prime Minister has received from Mr. Rodney Lund of Short Brothers PLC.

I should be grateful if you could provide a draft reply to Mr. Lund for the Prime Minister's signature, to reach me by lunchtime on Monday 25 July please.

S/S meeting Mr Lund at 1100 tomorrow. PQ will be briefed: draft to us thereafter
J 25/7

PAUL GRAY

Martin Donnelly, Esq.,
Northern Ireland Office.

C/F
Did the NIO reply come in? If so, for your file
J 20/7

Mr. Parkinson: My hon. Friend has identified the Opposition's problem. That is why they sit muttering and shouting from sedentary positions. They are wholly opposed to the entire nuclear programme. Had they been in power, they would have closed Dounreay years ago, and thousands of other people in the industry would have been put out of work.

Short Brothers plc

4.49 pm

The Parliamentary Under-Secretary of State for Northern Ireland (Mr. Peter Viggers): With permission, Mr. Deputy Speaker, I wish to make a statement about Short Brothers plc.

My right hon. Friend the Secretary of State for Northern Ireland informed the House on 29 June that we are seriously interested in possibilities for privatisation. We are, therefore, actively seeking the return of Short Brothers plc into the private sector from state ownership.

In this connection, I wish to make it clear that the Government are ready to consider suitable proposals that might lead to the acquisition of Short Brothers by private sector interests. I invite organisations which can secure the necessary financial backing to come forward as soon as possible.

The Government would prefer to transfer the company as a whole to the private sector. We would not, however, rule out the sale of the different parts of the business to separate interests.

In considering any proposals, the Government will give full weight to the contribution that a continuing viable business could make to the Northern Ireland economy.

My statement today follows the government's consistent approach throughout the United Kingdom of seeking to replace state ownership with the benefits and opportunities that flow from effective private sector leadership. Those benefits have been clearly demonstrated in the companies that have already been privatised.

Shorts has many achievements to its name, especially in exports, and it is an important contractor for the Ministry of Defence. The Government believe that the future of a strong viable business at Shorts is best served not by continued dependence on public ownership, but by the disciplines and opportunities of the private sector. Returning the company to private ownership, therefore, offers the best prospects of its future development and levels of employment in the longer term.

Mr. Jim Marshall (Leicester, South): I hope that the Under-Secretary will not misunderstand if I welcome him to the Dispatch Box. We have read a great deal about the Government's intentions towards Government-owned companies in the North of Ireland, but the presence of Ministers in the Chamber to make those intentions clear has been rare. Even the Under-Secretary will have to agree that the Opposition, especially my hon. Friend the Member for Kingston-upon-Hull, North (Mr. McNamara) have had to go to great extremes to encourage the Under-Secretary to make a statement before Parliament rises at the end of next week.

Although the statement has been made today, the Under-Secretary must agree that it is very short on what will happen to Shorts and long on the Government's intentions. We believe that it is regrettable that the future of Harland and Wolff will still be subject to conjecture and uncertainty. The future of Shorts should be determined as quickly as possible. I am sure that the Minister agrees that we are witnessing the continued victory of Thatcherite economic dogmatism over the real economic needs of Northern Ireland. The Minister must also accept that the Government are seeking to escape their responsibility for the industrial and economic well-being of the Province.

When will the Minister begin to understand that Shorts, with Harland and Wolff, are regarded in the Province as symbols of the Government's continued commitment to the economic and industrial infrastructure in the North of Ireland? The announcement today, and the Under-Secretary's previous announcements on Harland and Wolff and Northern Ireland Electricity give the impression to many people especially those in Northern Ireland, that the Government are trying to shed their responsibility for continued industrial and economic development in the North of Ireland.

I hope that the Minister will accept that the Opposition's view is that Shorts should remain a publicly owned company. If it is to be privatised, I urge the Minister to accept that the company should be privatised as a whole and not broken down into its three main constituent parts. Further, I urge the Minister to accept that guarantees about job losses must be obtained. The Minister must surely accept that, if the company is privatised and there are large-scale job losses, that will seriously undermine not only the economic development of Greater Belfast, but that of Northern Ireland as a whole.

May I, Mr. Deputy Speaker, with your permission ask a number of specific questions? First, will the Minister state whether the Government intend to introduce any capital restructuring of the company prior to privatisation? If so, will it require the approval or the agreement of the Commission in Brussels, as occurred with the privatisation of the Rover Group?

Secondly, what will happen to the proposed $60 million order from the Pentagon if the company is privatised?

Thirdly, what prospect is there of Government funds for the company, especially for the new 90 to 100-seater Jetfan aircraft experiment?

Fourthly, can the Minister confirm that both Boeing and McDonnell Douglas have been approached to take over Shorts, but have declined?

Fifthly, what consultations have taken place specifically with the management, but, more generally, with the work force?

Sixthly, can the Minister confirm that the losses for this financial year are likely to be about £130 million?

Seventhly, if divisions are sold separately, will the Minister give a cast-iron guarantee that the important missiles division will not be sold to foreign competitors?

Short Brothers is a company of which all of us can be proud. I am sure that the Minister agrees that it is operating on the very frontiers of new and high technology — in many aspects exciting technology — and that it would be a disaster for the company to be run down and the highly trained and skilled work force to be lost, not just to Belfast but to the United Kingdom.

Mr. Viggers: I shall deal first with the hon. Gentleman's last point. We fully recognise the importance of Shorts and its skilled work force in Northern Ireland, and we pay due regard to their interests.

The hon. Gentleman said that the statement was short on what will happen. That is true, because what we have announced today is our intention to move the company to the private sector. The future of the enterprise will very much depend upon the intentions of those who approach us and negotiate with a view to undertaking parts, or the whole, of that operation.

The hon. Gentleman's question gives me the opportunity to say that the Government recognise the direct interest of Shorts' suppliers, customers and work force. We wish to make it clear that the Government will continue to provide support for Shorts while we move towards its privatisation. I especially wish to confirm the Government's continuing commitment to the statement first made in a parliamentary answer on 23 December 1981, that the Government will stand behind the company.

The hon. Gentleman asked about the Government's commitment to Northern Ireland and their intention to improve employment there. I am very proud of the fact that unemployment in Northern Ireland has reduced substantially in the past two years and is now some 19,000 fewer than in September 1986. That is all credit to the industry—substantially the private sector industry—of Northern Ireland, which has been successful in taking advantage of United Kingdom policies.

The hon. Gentleman asked a number of specific questions. The first was whether capital restructuring will require EEC permission or authority. That will, of course, depend on the approaches that we receive from the private sector, wich I have invited today. At this stage it is a hypothetical question.

The hon. Gentleman asked about the future of the prospective $60 million Pentagon order for the American National Guard. If the enterprise in Belfast — be it within the public sector, as Shorts is now, or within the private sector — can supply the American Government with orders, that prospect is extremely good. However, I cannot give a cast-iron guarantee that the order will be successful. At the moment, Shorts has been negotiating for some time with the American Government and those discussions are at an advanced stage. Whether the order can be fulfilled depends on the work force rather than the ownership of the company.

The hon. Gentleman asked about the FJX. That will also depend on the manner of approach to Shorts and its enterprise of those who wish to undertake it. The Government have not approached Boeing or McDonnell Douglas about taking over Shorts. We would welcome approaches from all quarters. In reply to the hon. Gentleman's specific question, we have not made approaches to the two companies to which he referred.

The hon. Gentleman asked about discussions with management. Those have taken place, but our first priority was to give the House a statement of our intention that the company should be moved to the private sector. He also asked for a statement of the current loss this year. The overall loss of Shorts in 1985-86 was £37 million. The overall loss in 1986-87 was £20 million. The figures for the current year have not yet been audited and it is not possible for me to make a statement on them.

The hon. Gentleman asked whether the missiles division would be undertaken by foreign control and management. That will depend entirely on the approaches that we receive for the company. The number of jobs and the prospects of the enterprise in Belfast depend on its ability to produce and sell products that customers want to buy. We wish it well.

Several Hon. Members *rose*——

Mr. Deputy Speaker (Mr. Harold Walker): Order. I remind the House that we are now eating into the time of some very important debates. I hope that questions can be brief.

Mr. James Kilfedder (North Down): It is appalling that Shorts, which has an international reputation for excellence and is on the frontier of high technology, is to be split up by the Government and sold off in parts. It amounts to the fact that commercial vultures will come along. When they have picked the bones clean, they will go elsewhere. Privatisation may be all right for England where the economy is strong, but that cannot be said of Northern Ireland where this action and decision will upset a very fragile economy.

Is the Minister aware that the excellent work force of dedicated and skilled men will deeply and bitterly resent the Government's decision? That applies not only to the work force, but to the people of Northern Ireland. Will the Government think again about this matter in view of the high unemployment in Northern Ireland—and I adopt and echo the comments of the hon. Member for Leicester, South (Mr. Marshall)—and ensure that they will not sell the company in part? Will they reconsider? If they have to sell it, they must sell it in one piece and ensure that it is maintained as a viable unit.

Mr. Viggers: The hon. Gentleman cannot have heard my statement in which I said:

"The Government would prefer to transfer the company as a whole to the private sector. We would not, however, rule out the sale of the different parts of the business to separate interests."

We have certainly not ruled out the transfer of the company as a whole.

With regard to the future of Shorts in private sector ownership, 17 major businesses have been privatised in the United Kingdom including the British Airports Authority, Rolls-Royce, Royal Ordnance, British Airways, British Telecom, British Gas, British Aerospace, Jaguar, and Cable and Wireless and 655,000 jobs have been moved to the private sector. Those who work within the new private sector areas are very pleased that that is the case. For instance, the profits of the National Freight Corporation have risen from £4·3 million in 1981 to £370 million in 1986. The hon. Gentleman is unnecessarily gloomy. There is no reason why the enterprise should not have a profitable and successful future in private enterprise.

Mr. Roy Beggs (Antrim, East): This statement can only add to the distress of those who are unsure and uncertain whether they will have a job should the proposal proceed. There are very special circumstances in Northern Ireland where there are more people unemployed than currently work in the manufacturing sector. Is the Minister aware that the proposals to privatise Shorts, Harland and Wolff and Northern Ireland Electricity collectively are perceived as phased British economic withdrawal from Northern Ireland? That perception is there and is causing concern. Overseas investors will be watching what happens very carefully and this proposal may cause them to consider further whether to invest in Northern Ireland if the Government are seen to pull out from our major employers.

I am not reassured by the statement that the Government would prefer to see the company purchased and retained as one single entity. There is a let-out there. As we are not all fools and we are aware that the attractive sectors of Shorts — the profit making sectors — will probably be snapped up by investors, will the Minister undertake, in the event of the company being broken up, to continue to fund those sectors that are not yet profitable to retain employment and give encouragement? What can the Minister say today to reassure those who question whether there is now British economic withdrawal from Northern Ireland?

Mr. Viggers: I say again to the House that the Government's preference, as stated in my statement, is to transfer the company as a whole to the private sector. That, I reassure the hon. Gentleman, is what I said and it is what I mean. However, we would not rule out the sale of different parts of the business to separate interests, but our preference is that the business should be transferred to the private sector as a whole.

With regard to the hon. Gentleman's substantial point, any talk of economic withdrawal from Northern Ireland is nonsense. The Government and our predecessors have provided substantial economic support to the Province. This year public expenditure in Northern Ireland will total £5 billion, of which some £1·6 billion is the amount of the United Kingdom subvention to Northern Ireland. That enables the Northern Ireland Office and my Department in particular — the Department of Economic Development — to fund a very wide range of programmes through the Industrial Development Board and the Local Enterprise Development Unit which are highly successful and have led to a wide range of investment and employment opportunities. That is why we are so proud that unemployment has fallen in Northern Ireland.

It is necessary for us to take account of the manner in which money is spent to ensure that we obtain good value for money. In that way we can have some confidence that the level of unemployment will continue to fall leading to more confidence and prosperity in Northern Ireland.

Sir Michael McNair-Wilson (Newbury): Will the sale of the company be conditional upon the purchaser maintaining Shorts at Queens Island for a five-year period as a minimum? If the company was sold to a foreign aircraft company which decided to rationalise its product line, it is conceivable that it might want to move its production facilities to its own factories which might be outside Northern Ireland. That undoubtedly would be a serious blow to the employment prospects in the Province. On that same point, are the Ministry of Defence contracts, particularly those for the Short Tucano, absolutely secure, no matter who buys the company?

Mr. Viggers: On the first point, I assure my hon. Friend that employment in Northern Ireland is the main basis upon which financial support is given to industry. It would certainly be the Government's continued intention to support enterprise, industry and employment in Northern Ireland. In my statement I said that the Government would give full weight to the contribution that a continuing viable business could have to the Northern Ireland economy—and that of course is in Northern Ireland.

I am pleased that the Tucano project is now making good progress with further deliveries to the Royal Air Force. That contract is held by Shorlac and I see no reason why it should be disturbed by any proposals that we have to switch the operation to the private sector. In common with the general point that I made, I think that the private sector would have enhanced opportunities to seek further export orders for the Tucano aircraft.

O[illegible] STATEMENT

SHORT BROTHERS PLC

With permission Mr Speaker I wish to make a statement about Short Brothers plc.

My Rt Hon Friend, the Secretary of State for Northern Ireland, informed the House on 29 June that we are seriously interested in possibilities for privatisation.

We are therefore actively seeking the return of Short Brothers plc into the private sector from state ownership.

In this connection I wish to make it clear that the Government is ready to consider suitable proposals which might lead to the acquisition of Short Brothers by private sector interests. I invite organisations who can secure the necessary financial backing to come forward as soon as possible.

The Government would prefer to transfer the company as a whole to the private sector. We would not, however, rule out the sale of the different parts of the business to separate interests.

In considering any proposals the Government will give full weight to the contribution that a continuing viable business could make to the Northern Ireland economy.

My statement today follows the Government's consistent approach throughout the United Kingdom of seeking to replace State ownership with the benefits and opportunities that flow from effective private sector leadership. These benefits have been clearly demonstrated in the companies that have already been privatised.

Shorts has many achievements to its name, particularly in the export field, and is an important contractor for the Ministry of Defence. The Government believes that the future of a strong viable business at Shorts is best served, not by continued dependence on public ownership, but by the disciplines of the private sector. Returning the company to private ownership therefore offers the best prospect of its future development and levels of employment in the longer term.

DMC/3474

RESTRICTED
COMMERCIAL IN CONFIDENCE
From THE PRIVATE SECRETARY

CC Press
AB
CDP
DC.

PA S

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

Paul Gray Esq
Private Secretary
10 Downing Street
LONDON
SW1A 2AA

21 July 1988

Dear Paul.

SHORTS: STATEMENT

I attach a draft statement which Mr Viggers, Parliamentary Under Secretary of State, plans to make this afternoon. I should be grateful for any immediate comments you may have by 2.00pm, please.

Copies go to Jill Rutter (Treasury), Neil Thornton (DTI), Peter Smith (DTI), Brian Hawtin (MOD), Alison Smith (Lord President's office) and Trevor Woolley (Cabinet Office).

Yours sincerely.

David Watkins.

D J WATKINS

RESTRICTED
COMMERCIAL IN CONFIDENCE

DMC/3475

ORAL STATEMENT

SHORT BROTHERS PLC

With permission Mr Speaker I wish to make a statement about Short Brothers plc.

My Rt Hon Friend, informed the House on 29 June (Hansard Col 404) that we are seriously interested in any possibilities for privatisation.

We are therefore actively seeking the return of Short Brothers plc into the private sector from state ownership.

In this connection I wish to make it clear that the Government is ready to consider suitable proposals which might lead to the acquisition of Short Brothers by private sector interests.

The Government would prefer to transfer the company as a whole to the private sector. We would not, however, rule out the sale of the difficult parts of the business to separate interests.

? delete

In considering any proposals the Government will give full weight to the contribution that a continuing viable ~~aerospace~~ business could make to the Northern Ireland economy.

My statement today follows the Government's consistent approach throughout the United Kingdom of seeking to replace State ownership with the benefits and opportunities that flow from effective private sector leadership. These benefits have been clearly demonstrated in the companies that have already been privatised.

Shorts has many achievements to its name, particularly in the export field, and is an important contractor for the Ministry of Defence. The Government believes that the future of a strong viable business at Shorts is best served, not by continued dependence on public ownership, but by the disciplines of the private sector. Returning the company to private ownership therefore offers the best prospect of its future development and levels of employment in the longer term.

DMC/3474

SHORTS

Rodney Lund

RL/CMH

July 20, 1988

The Rt. Hon. Margaret Thatcher M.P.
10 Downing Street
LONDON SW1

Dear Prime Minister,

This is a request for your help in trying to recover what could be a serious loss of business giving rise to a substantial additional burden for the taxpayer.

I would like you to know that my Board is committed to the privatisation of Shorts as soon as is practicable and in a controlled manner which will give the best return for the Exchequer. A full review describing the means of achieving these aims was submitted recently to Government (a copy of the Review is enclosed for your Private Office).

The Review makes it clear that certain courses of action, particularly those involving any break-up of the mainstream businesses in Shorts, will need to be handled with extreme care. Handled badly they could give rise to a loss of customer confidence which could in turn trigger a sudden and uncontrollable downturn in the Company.

Last week Government, without consulting with me or informing me, gave press briefings which announced Government's readiness to break up and sell the business in parts, an announcement with which they knew we could not agree. Quite apart from other considerations we calculate this to be the most costly route for the taxpayer. These briefings also leaked confidential information - losses and provisions of £130m which I intend to propose as part of a capital re-construction of the business. The announcement of this extraordinary loss without mention of the restructuring is very damaging.

By Monday morning reports such as that attached from the front page of Saturday's Times were on our customers' desks around the world. The repercussions are most serious. The immediate conclusion in the Industry is that Government's real intention is to close the aircraft/aerostructure business - a view re-inforced by the derogatory remarks about Management.

.../... 2

The Rt. Hon. Margaret Thatcher, M.P. July 20,1988

Customer confidence is shaken. Boeing is asking for urgent clarification of what the split in the business will mean. The chances of our selling our target number of aircraft this year must be seriously damaged. Particularly sad is the news received yesterday that the contract we won only last week for 12 military aircraft to the Kenyan government is now in serious doubt.

We believe it would be in the national interest if as a matter of urgency a positive statement could be made by Government refuting the information that there are plans to break up the company in the immediate future, giving a vote of confidence in the Management, making it clear to the world that we have positive plans to bring the Company into profit, and explaining that hopes are high for a successful privatisation.

The Board of the Company are in absolutely no doubt of the problems of the business and they have put a great deal of thought into planning the way forward. My Board is most experienced, and wise men like Sir John Sparrow, Sir Sidney Bacon and Sir Donald McCallum stand firmly behind the conclusions of my Review as indeed do Sir Martin Jacomb and his team in B.Z.W.

We are disappointed that Ministers in Northern Ireland do not feel they can accept our advice.

Yours sincerely

Rodney Lund

PRESS CUTTINGS

SHORTS

TIMES SAT 16TH JULY

Government dumping Ulster 'millstones'

Shorts to be offered for sale

By Richard Ford, Political Correspondent

The state-owned Short Brothers aircraft company in Northern Ireland is to be offered for sale in the latest of a series of moves by the Government, which is determined to rid itself of the province's loss-making industries.

An announcement of the sale of Shorts, which is the province's largest manufacturing employer, is expected next week when it will be made clear that the Government will welcome offers for either the whole company or any of its three divisions.

The move by the Government follows yesterday's announcement of plans to privatize Northern Ireland electricity and the decision to offer another loss-making, state-owned company, Harland and Wolff, to the millionaire Indian shipowner, Mr Ravi Tikkoo.

Tentative approaches have been made for Short Brothers, which employs 7,600 workers.

There is confidence that buyers could be found for the profitable missile division which manufactures the Blow Pipe and Javelin weapons and is engaged in developing the Star Streak on a Ministry of Defence development-and-production contract.

It is also hoped that the aero structure division, which makes a range of products such as wing sets, undercarriage doors and underflaps for a number of airline companies including Boeing and Fokker, will prove attractive.

But the prospects for selling the unprofitable aircraft division are much gloomier and there are fears ministers would be prepared to let this division close with the loss of 3,000 jobs.

The division, which makes the SD-360 commuter aircraft and Tucano trainer aircraft for the RAF, is presently having discussions with Dornier, a West German aerospace firm, with a view to forming a partnership to develop the 44-seat FJX twin jet regional airliner for the 1990s.

Ministers and officials are exasperated with the air of unreality that exists at Shorts, where losses and provision for future losses are likely to be almost £130 million when the accounts for 1987/1988 are published. In 1986/1987 the company lost £20 million and £37 million in 1985/1986, having made a profit of £500,000 in 1984/1985.

The Government believes that as long as the company is state-owned there is no prospect of it facing up to its problems.

"The gap between reality and expectations at the company is quite astonishing. The bubble of complacency must be burst. You have got a heavy and growing financial burden with a management that leaves a lot to be desired," the source said.

PAPER

CONFIDENTIAL

P 03177

PRIME MINISTER

Short Brothers PLC

Paper by the Secretary of State for Northern Ireland

E(A)(88)36

DECISIONS

Mr King reports a grim and rapidly deteriorating financial situation at Short Brothers. He has decided to reject the plans which the company's new chairman has put forward. Instead he has given instructions that immediate steps to conserve cash be taken, and he proposes to get the advice of an outside industrialist on the right strategy for the company. He says that whatever course is taken, it is likely to be costly, perhaps £300-£400 million, for which he has no provision.

2. Mr King's paper simply invites colleagues to note the position. You may however wish to consider whether the Sub-Committee can reach any decisions in principle now: and in particular whether, as the Chief Secretary will argue, the Sub-Committee should decide in principle that the objective should be to dispose of Shorts to the private sector.

BACKGROUND

3. The recent history on Shorts is as follows:

June 1986	E(NI) decided on a fully costed assessment of the strategic options with a view to decision in early 1987.
July 1987	Mr King told E(NI) that he was not satisfied with the company's assessment and promised to bring forward proposals later in the year.

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Dec. 1987	Mr King wrote to E(NI) that further uncertainties had arisen, and promised a review by February 1988.
March 1988	Mr King proposed deferment of decision while the new Chairman re-examined the Corporate Plan, within three months.
July 1988	Mr King proposes fresh assessment by outside industrialist.

4. Short Brothers is wholly-owned by the Government. It is the largest manufacturing employer in Northern Ireland with a workforce of about 7,000. It has three divisions: aircraft, aeronautics and missiles. Its performance has deteriorated sharply in the last few years, as shown by its trading loss of £46 million in 1987-88 and by the figures for its external finance:

	£m
1984-5	6
1985-6	26
1986-7	36
1987-8	120

There have also been serious failings in the company's financial management control and monitoring. The company now faces an immediate cash problem: it reports that its year-end EFL will be £82 million but it has already borrowed £78 million.

ISSUES

Proposal for Another Review

5. Mr King proposes to ask a 'much sharper industrialist' than the present Chairman to assess the right course for the company. He will report further on this at the meeting. We understand that he will say that Lord King has agreed to release Mr Gordon Dunlop of British Airways for the task and that his review is expected to take only a couple of weeks.

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6. Over the last two years Ministers have wanted but failed to get a systematic assessment of the options facing the company. During that period the company's calls on the Exchequer have risen sharply. Depending on what Mr King says in his oral statement, you may wish to impress on him that this review must be the final one.

Possible Disposal

7. You may also wish to go further and record a decision in principle that the objective should be to dispose of the whole company to the private sector, and that the further report should take this as its starting-point. The Chief Secretary will argue for this: the Treasury believe that privatisation would be practical, though no doubt a dowry would be necessary. Mr King himself says (paragraph 7) that 'our future action must be aimed towards the company's early return to the private sector'. You may however wish to check whether disposal of Shorts on the terms likely to be available would require the agreement of the Commission.

Finance

8. Mr King says (paragraph 8) that all courses, presumably including disposal, would cost perhaps £300-400m in public expenditure. The Treasury accept that the costs could be high. The company's bank borrowings, for example, total £300m. Mr King says that he will need to discuss with the Chief Secretary how to finance these costs which cannot be met from within the block. You may wish the Sub-Committee to agree that Mr King and the Chief Secretary should discuss the financing accordingly, without prejudging the outcome of these talks.

Short-term points

9. You may want to ask Mr King:

i. what immediate measures he has in mind to stop the cash outflow. The Chief Secretary will also wish to comment on this. If there is any disagreement, you might ask the two Ministers to resolve it urgently outside the Committee;

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ii. whether he has yet reached any conclusion on the possibility of suing the auditors, Price Waterhouse, or the Government's advisers, Touche Ross;

iii. what consideration he has given to the position of the new Chairman, whose report he has found inadequate.

Next Steps

10. E(A) may need to consider the terms and conditions of disposal. You may want to ensure that there is minimum further delay before this happens. You could ask Mr King to circulate a further report to E(A) in September. It would be possible to decide at the time whether this required discussion.

HANDLING

11. You will wish to ask the Northern Ireland Secretary to introduce his paper, and in particular to give the promised oral report on the further action he proposes to take. The Chief Secretary, Treasury will wish to comment.

RTJW.

R T J WILSON
Cabinet Office
12 July 1988

CONFIDENTIAL

Prime Minister

SofS's words which conceal yet another procurement disaster.

CDP 3/6

MO 26/11V

PRIME MINISTER

TUCANO

1. The contract for the supply of 130 Tucano basic trainer aircraft for the RAF specified the delivery of the first production aircraft in January 1987. As you know, the programme has encountered a number of technical difficulties, but the trials programme is now well advanced and the first aircraft was delivered to the RAF earlier this month. We expect the second to be handed over within the next day or so and the remainder to follow at a rate of about two a month thereafter.

2. Many of these technical problems arose out of the need, clearly foreseen at the time the Tucano was ordered, to upgrade the aircraft to the standard required of a military trainer. Although deliveries [a disgrace] have begun some 17 months later than planned, the Tucano now meets the requirement defined by the RAF and, as the contract was placed on a firm price basis, the delay has caused no increase in the cost of the programme to the Ministry of Defence. The only additional expense arises out of the need to continue running the rather more expensive Jet Provost, which the Tucano will replace, for longer than expected. Although the Jet Provost fleet is ageing, it will continue to meet the RAF's training needs and the Tucano will take over the task progressively from the middle of 1989.

3. The Tucano saga is not I am afraid a particularly happy one and the delays are regrettable, but I believe that these problems are now behind us. I am sure that the aircraft will provide the RAF with a first class trainer that will offer effective service for many years to come.

4. I am sending a copy of this minute to the Secretary of State for Northern Ireland and to Sir Robin Butler.

G.Y.

Ministry of Defence
30th June 1988

C.P. Pt. B/F 1 week.
PRLG
5/1

10 DOWNING STREET

Note

Spoke J. Taylor (Treasury).
Agreed more appropriate for handling in E(A) than E(NI).
He will come back to me when Treasury have worked out their views on the substance.

PRLG
5/1

CCB/

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

SECRETARY OF STATE
FOR
NORTHERN IRELAND

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

4 January 1988

Dear Chancellor,

SHORTS

Thank you for your letter of 8 December about strategic options and other matters relating to Shorts.

At E(NI) last July I agreed to come back to colleagues before the end of the year with considered options for the future of the company. As your officials are aware, I now believe that it would be more productive for us to discuss not only the strategic options, including the scope for privatisation, but also the company's Corporate Plan and the current year EFL.

The Corporate Plan, and the additional work on strategic options which I requested, is currently being reviewed by our officials and Touche Ross Consultants. In addition, I have recently received the company's report on privatisation and I wish to examine this in the overall context of the company's future prospects.

A number of uncertainties in the current year, which could affect not only the EFR for this year but also the company's future strategy, have arisen which make it very difficult to forecast accurately the final outturn. These uncertainties, which have already been notified to your officials, include shortfall on sales of SD 360 and missiles sales, hold-up on Tucano acceptances, and problems which are affecting Fokker 100 wingset deliveries. Taken together these difficulties suggest that this year's EFL will be exceeded but I cannot yet given a firm figure.

The strategic options for the company, the prospects for privatisation, the Corporate Plan and the current year EFR are all closely inter-related and it is, therefore, logical that we should discuss these subjects together. The current evaluation by officials and consultants is being undertaken as rapidly as possible and I would like to ask for a discussion in February. I consider this to be the earliest possible date for a thorough Ministerial review and I trust this revised timescale is acceptable to you.

I am copying this letter to the Prime Minister, members of E(NI) and to Sir Robin Butler.

Yours sincerely,

Robin [illegible]

for TK
(Approved by the Secretary of State
and signed in his absence)

IND POL : Shova PT2

mjd 2/26Jn

CONFIDENTIAL

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

9 December 1987

The Rt Hon Tom King, MP
Secretary of State for Northern Ireland
Whitehall
LONDON SW1A 2AZ

NBPM

Dear Tom

SHORT BROTHERS

When we last discussed the company in E(NI) on 22 July, it was agreed that you would bring forward longer term strategic proposals for the company for discussion before the end of 1987.

I understand that you do not feel that the company's latest corporate plan provides you with a sufficient basis for such a paper and that further urgent work is needed to achieve this.

However, I would find it helpful if now, in advance of such a paper, you could write setting out your present understanding of the company's position and prospects, summarising their corporate plan, and indicating the approach you will be taking to ensure that, early in the New Year, you can come forward with a paper on which substantive discussions of the strategic options for the company can then be based.

I am copying this letter to the Prime Minister and to members of E(NI).

Yours ever
Nigel

NIGEL LAWSON

CCBG

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-930 7022

MO 19/3L

8th July 1987

N BM.

Dear Robin,

attached

E(NI)(87)8 - SHORT BROTHERS PLC

Your Secretary of State sent the Defence Secretary a copy of the above memorandum, which is to be discussed at the meeting of E(NI) tomorrow.

The Ministry of Defence will not be represented at the meeting but Shorts are an important Defence supplier and Ministers here, whilst agreeing with the recommendations of the paper, would wish to be kept closely involved in the preparation and consideration of the longer-term strategic proposals which your Secretary of State has in mind to bring forward later this year.

I am sending a copy of this letter to the Private Secretaries to the other members of E(NI), and to Trevor Woolley.

Yours sincerely

(I C F ANDREWS)
Private Secretary

Robin Masefield Esq
Northern Ireland Office

PRIME MINISTER

ms

TUCANO

You asked to see the paper originally circulated to colleagues when Cabinet considered Tucano in March 1985. It is attached.

On the particular points which you raise:

(i) "there was never any doubt that the Tucano fitted with the improved Garrett engine would meet the requirement".
This was made clear in paragraph 3 of the Cabinet paper ("in technical and performance terms either aircraft is capable of doing the job satisfactorily") and in paragraph 3 of the Comparative Assessment attached to the Cabinet paper ("both the PC9 and the Tucano meet the minimum specification prescribed by MOD"). But of course there was never any doubt - and this too was made clear in the papers - that the RAF preferred the PC9.

(ii) "the risks associated with the then untried engine and the admittedly tight timescale were recognised in the papers presented".
Again paragraph 3 of the Cabinet paper ("The Tucano carries some technical and programme risks in that the engine variant now proposed is not yet in service, but despite the tight timetable for introduction into service, the risk is considered acceptable.") and paragraph 4 of the Comparative Assessment ("The Garrett engine proposed for Tucano would be a new variant of an existing engine and the RAF would be the launch customer. This creates some technical risk but not in the MOD's view an unmanageable one") deal with this. However, these were just assertions and no supporting evidence was circulated to colleagues: you had to accept the MOD's word for it.

C.D.P.

Charles Powell
29 July 1986

DG2BGW

ccpc

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The most casual minute I have seen from any dept. for a long time

Prime Minister
This does not get us much further forward. The fact is that Shorts bid an unrealistically low price to get the contract. But, realistically we cannot turn back. Officials are still looking at your idea of linking release of funds for [illegible] to performance on Tucano.
CDP 25/9

MO 26/11E

PRIME MINISTER

TUCANO

In his letter of 30th June, your Private Secretary invited my comments on aspects of the report circulated by the Northern Ireland Secretary on 26th June in which he described progress on the Tucano contract.

2. I have looked very carefully at the handling of the competition for the Future Basic Trainer for the RAF. You may find it helpful to see the attached diary of the main milestones which led to the decision to award the contract to Shorts. The PC9 was the preferred aircraft as far as the RAF was concerned throughout the competition but there was apparently never any doubt that the Tucano, fitted with the improved Garrett engine, would meet the requirement; and it was cheaper in terms of both initial acquisition and running costs. The risks associated with the then untried engine and the admittedly tight timescale were recognised in the papers circulated to colleagues. May I see the relevant papers

on the part of Shorts?

Although my own preference as the then Scottish Secretary was for the PC9, it would have been very difficult, as we recognised at the time, to have set aside the results of a fair and open competition to reject the Tucano when it met the requirement at the lowest total cost. The contract went to Shorts because, on the facts as presented, the aircraft represented the best value for money in both the short and long term.

3. The advantage which Shorts were able to achieve in terms of basic price was, of course, crucially determined by their judgement on the timing of deliveries and the overcoming of the acknowledged technical hurdles. The company may well have underestimated the number of changes that would have to be made to the aircraft to accommodate the Garrett engine, but these were all relatively minor and their assessment that none of the basic design parameters would be compromised has been shown to be correct. Such problems are not uncommon in the procurement of complex equipments such as aircraft and although our own assessment of the programme slippage is more pessimistic than that of Shorts, the consequences are manageable and do not call into question the outcome of the competition. Our latest forecast is that early deliveries may be delayed by as much as ten months but that this can be recovered and the final aircraft will be no more than three months late. We have already acknowledged publicly that any delay will have some operational and financial consequences for the RAF but the additional cost of £0.7M is not so serious when set against the saving in operating cost of £9M (discounted over the life of the aircraft fleet) represented by the Tucano over the PC9.

The judgement rested on this?

Before [illegible]

How calculated

!!

4. Whether at the end of the day Shorts lose money overall on the deal will not be known for some years but the risk of commercial loss is of course inherent in fixed price contracts and I have no doubt that the MOD drove a hard bargain. Of

course, if they do make a loss, it will be possible to argue that this nationalised company took risks, underwritten by public funds, which its private sector competitor BAe could not. But that argument does not hold up as far as the lower running costs are concerned and it was these that tipped the balance conclusively in favour of the Tucano.

5. You may be interested to learn that the Chief of the Air Staff visited Shorts recently and flew the prototype aircraft fitted with the Garrett engine. He expressed himself well pleased with what he saw.

6. I am sending copies of this minute to the Secretary of State for Northern Ireland, the Chief Secretary to the Treasury and Sir Robert Armstrong.

G.Y.

Ministry of Defence
23rd July 1986

ANNEX

TUCANO DECISION - DIARY OF EVENTS

18 Jun 84 — Invitations to Tender issued for the supply of Future Basic Trainer aircraft.

1 Oct 84 — Bids received from:

AAC - Westland	-	A20
Hunting	-	Firecracker
BAe	-	PC9
Short Brothers	-	Tucano

c 29 Oct 84 — Secretary of State for Northern Ireland minuted Prime Minister recommending that Shorts be authorised to proceed with their bid and be given a provision of £2.6M grant towards their design, development and labour learning costs and a capital grant of £2.0M.

15 Nov 84 — Prime Minister's agreement given.

19 Nov 84 — Report on the evaluation of the technical and training aspects of the bids concluded that:

a. The A20 and the Firecracker would not satisfactorily meet the specification.

b. The Tucano offered a satisfactory solution to the specification, although its performance in a number of areas was marginal.

c. The PC9 easily met the specification, was well suited to the training requirements of the RAF, and was recommended as the preferred solution.

30 Nov 84 — Report on the evaluation of the financial aspects of the bids concluded that:

a. The A20 and the Firecracker were both considerably more expensive than the other two aircraft and indeed were a more expensive option than continuing to run a refurbished Jet Provost fleet.

b. It would be to MOD's financial advantage to replace the Jet Provost with either the PC9 or the Tucano.

c. The acquisition cost of a PC9 fleet was 12% more than that of the Tucano.

7 Dec 84 — Defence Equipment Policy Committee (DEPC) concluded that the choice lay between the PC9 and Tucano; that, while noting the preference of Controller Aircraft and the Royal Air Force for the PC9, they did not wish at that stage to express a preference between the two; and that "best and final" offers should be sought from industry.

18 Dec 84

1. Defence Secretary warned Chief Secretary of decision to invite best and final offers.

2. Minister of State for Defence Procurement (Minister(DP))gave Written Answer announcing decision.

3 Jan 85 — Instructions for re-tendering issued.

31 Jan 85 — Revised bids received.

22 Feb 85

1. Report on evaluation of the technical and training aspects of the revised bids concluded:

"However, the PC9 is the aircraft with demonstrably the best performance, the best handling and the lowest programme risk. It is also the aircraft preferred by the Royal Air Force and on technical and operational grounds is judged to be the best solution, albeit by a short head."

2. Report on the evaluation of the financial aspects of the bids gave the firm prices for total acquisition cost (excluding VAT) as:

PC9	£164.9M
Tucano	£158.9M

(NB. This and subsequent prices for the Tucano all reflect the grants totalling £4.6M made to Shorts by NIO, ie they are the prices to be paid by MOD.)

28 Feb 85 — Controller Aircraft circulated paper (EP 3/85) to Equipment Policy Committee (EPC) recommending it to "approve the purchase of 130 BAe PC9 aircraft".

7 Mar 85 EPC concluded:

> "provided that the continuing post-tender discussions with BAe and Shorts resolved outstanding cost issues and revealed no significant price differential, the PC9 should be purchased as the new basic trainer."

14 Mar 85 Following further negotiations with BAe and Shorts, the comparative figures for total acquisition cost were:

PC9	£162.9M
Tucano	£144.8M

15 Mar 85 Late bid received from BAe reduced firm price by £8M, giving following figures:

PC9	£155.3M
Tucano	£144.8M

18 Mar 85 Defence Secretary decided to recommend to colleagues that Tucano proposal should be accepted.

19 Mar 85

1. Defence Secretary circulated memorandum to Cabinet (C(85)7) reporting on the competition and pointing out that the PC9 was preferred by his "military advisers"; that the Tucano carried some programme and technical risk; that the PC9 was some 5% more expensive than the Tucano; and that other factors were evenly balanced. The memorandum stressed the vital importance of competition and sought agreement to the purchase of the Tucano.

2. BAe made further late price reduction of £9M. Comparative figures now:

PC9	£146.3M
Tucano	£144.8M

Reported by Defence Secretary to Prime

Minister and Cabinet in minute which also mentioned that Tucano was £0.85M p.a. cheaper to operate and that discounted value of this over life of trainer fleet was £9M: minute reaffirmed Defence Secretary's recommendation to purchase the Tucano.

<u>21 Mar 85</u>

1. Cabinet discussed Defence Secretary's memorandum. They recognised the merits of the PC9, but felt it was not possible to set aside the results of the competition. They therefore endorsed Mr Heseltine's recommendation to choose the Tucano (CC(85) 11th Conclusions, Minute 5).

2. Defence Secretary advised House of Commons that the Tucano was the winner by a clear margin on cost.

IND POL
SHORTS
PT 21

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a BG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

8 July 1986

SHORTS

The Prime Minister was most grateful to the Chancellor for chairing E(A) on 30 June and for his minute of 4 July which set out the conclusions of the meeting.

DAVID NORGROVE

Tony Kuczys, Esq.,
H.M. Treasury.

RT4.93 CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

Content with this outcome?

SHORTS

DCS 7/7

You may like to have a brief report on the E(A) discussion I chaired on Monday, 30 June (E(A)(86)17th meeting) about Shorts' Corporate Plan and privatisation prospects.

The Secretary of State for Northern Ireland explained that although Shorts achieved a modest profit in 1984-85, its net loss for 85/86 was now estimated to be £27 million. This meant that privatisation this side of the general election was not feasible, although it should remain the Government's ultimate objective. Neither he nor other members of the Sub-Committee felt the continuation of civil aircraft production as before was realistic; but equally abrupt cessation of civil aircraft production would mean the loss of 3,000 jobs and affect the viability of Shorts' Aerostructures Division. The effective choice was between "phased cessation" and "consolidation" of civil aircraft production. The Sub-Committee agreed that the Secretary of State should seek costed options from Shorts, including the option of a missiles-only business, in a new Corporate Plan to be submitted by September 1986. In the meantime Shorts would be placed under a tighter financial discipline and be set for 1986/87 an External Financing Limit of £36 million and a loss target of £7 million, and urgent steps should be taken to improve their management, both operational and non-executive. This will provide a chance to prove whether Shorts can achieve the recovery plan sales target it has set itself.

The Sub-Committee also considered the Super Sherpa and Tucano projects, in the latter of which you have expressed particular interest. As you know, the overall production programme for Tucano is now some three to four months late, although the company claim that they will recover this by the 30th aircraft. The Committee considered your suggestion that actual approval of collaborative development of the Super Sherpa be delayed until specific development milestones had been achieved on Tucano; and that the staged release of funding for Super Sherpa be linked to Shorts' continuing performance on Tucano. It was agreed that, before the Sub-Committee could agree to give approval in principle to the Super Sherpa project, officials should conduct a quick commercial appraisal of all aspects of the project - including your Tucano points - and that the Northern Ireland Secretary should report the outcome to members of the Sub-Committee.

NL

N.L.

4 July 1986

File SRWAFU cc bg.

CONFIDENTIAL

10 DOWNING STREET

30 June 1986

From the Private Secretary

EA(86)27: SHORT BROTHERS PLC

This is to confirm a proposition I put to you by telephone this morning before the E(A) to be chaired by the Chancellor.

In view of the report on the Tucano given in Neil Ward's letter to me of 26 June, the Prime Minister suggested that the Chancellor might consider imposing conditions on the Super Sherpa project as follows:

(i) that if the Super Sherpa project is to be approved, actual approval should be delayed until specified development milestones on the Tucano have been achieved;

(ii) that the staged release of funding for the Super Sherpa should be linked under Northern Ireland Office control to Short's continuing performance on the Tucano project.

I am copying this letter to Neil Ward (Northern Ireland Office) and Brian Unwin (Cabinet Office).

(DAVID NORGROVE)

Tony Kuczys, Esq.,
HM Treasury.

CONFIDENTIAL

CONFIDENTIAL File

LPO
cPC

10 DOWNING STREET

From the Private Secretary

30 June 1986

Dear John,

TUCANO

The Prime Minister has seen the report attached to Neil Ward's letter of 26 June to David Norgrove on the Tucano. She finds it very disturbing.

The salient facts seem to be that:

(i) Shorts failed to take into account the additional design work and time required to adapt the airframe and systems to the Garrett engine. As a result the design work is some 5-7 months behind schedule;

(ii) even in the company's view - likely to be optimistic - the overall production programme is some 3-4 months late. It would be helpful to know the MOD's view on this;

(iii) a time of only 28 weeks has been allowed between completion of design work and delivery of the first production aircraft. This seems inherently unlikely to be achieved;

(iv) as a result, and even allowing for the most optimistic projections of export sales to be achieved in practice, the contract will lose £1.4 million.

The Prime Minister would welcome the Defence Secretary's comments. She points out that many of these problems were foreseen at the time that the placing of the contract was under discussion. While it is true that the forecast loss is (not yet) as great as the saving over the original British Aerospace offer on the PC-9, and BAe might in practice have faced some of the same problems, the difference is that BAe as a private sector company would meet the loss rather than the Government.

/In the Prime

dg

In the Prime Minister's view the facts now revealed suggest that the contract was placed on a false basis and that there has been another serious procurement mistake.

I am copying this letter to Jill Rutter (Chief Secretary's Office), Jim Daniell (Northern Ireland Office) and Michael Stark (Cabinet Office).

Yours sincerely,

Charles Powell

CHARLES POWELL

John Howe, Esq.,
Ministry of Defence.

Prime Minister!
Agree to write as proposed? (It will give NIO a weapon.)
DRN 27/6.

Though this was known at the time the contract was awarded. Please look back at the papers.

CONFIDENTIAL

PRIME MINISTER 27 June 1986

We must look again at yet another procurement mistake MT

SHORTS AND THE TUCANO

Following a small profit last year Shorts have slumped to a £27m loss on a turnover of £192m this year. Much of this is due to management losing its grip, in part through being over-stretched (notably in convincing the US Congress about anti-catholic bias). Northern Ireland Office are genuinely angry.

Despite a successful maiden flight in February, the story on the Tucano is also bad: Shorts have told MOD that initial deliveries could, at worst, be six months late. MOD are worried they might be even later, and that throughout the programme deliveries will fail to catch up with original commitments. Even on Shorts optimistic projections, and assuming that they get all of the 90 export sales forecast, they will still make a loss before interest on the MOD contract of £1.4m.

This is entirely as BAe always said this would happen. The contract was placed on a false basis.

There are explanations: the contract was awarded three months later than planned but delivery dates were maintained, a 10 week overtime ban (which management ultimately faced down) caused further delay. Nevertheless, the loss on the Tucano is very disappointing, but it would need to grow very much larger before it nullified the major savings achieved through the competitive tender against British Aerospace. (And of course there is no guarantee that British Aerospace would not have had equivalent problems, for which one way or another the Government would have ended up paying). NB. - it is a private sector company.

Unfortunately, given Shorts dominant position in Northern Ireland it is difficult to discipline the company without causing major damage to the local economy. One possibility, however, is to link performance on the Tucano with the new

Super Sherpa project which Shorts are keen to commence. (The Super Sherpa is a £5m development of their existing planes, in which both Pratt & Whitney and De Havilland are interested in participating. If Shorts are to continue to manufacture planes then the Super Sherpa is potentially a sensible project).

You could therefore ask the Chancellor to consider:

1. that if the Super Sherpa project is to be approved, actual approval should be delayed until specified development milestones on the Tucano have been achieved and

[illegible]

2. that the subsequent staged release of funding for the Super Sherpa should be linked under Northern Ireland Office control to Shorts continuing performance on the Tucano project.

Peter Warry

PETER WARRY

Mr Nagrove
CCB

CONFIDENTIAL

P 02142

CHANCELLOR OF THE EXCHEQUER

Short Bros plc: Corporate Plan and Privatisation
(E(A)(86) 27)

CONCLUSIONS

1. You will wish the Sub-Committee to reach conclusions on the proposals set out by the Secretary of State for Northern Ireland in E(A)(86) 27:

i. to accept that privatisation of Shorts is not feasible this side of the General Election;

ii. to encourage the introduction of new senior management;

iii. to seek costed options from Shorts in a new Corporate Plan to be submitted by September 1986;

iv. to place Shorts under a tighter discipline in 1986-87 and be guided by Shorts' performance in longer-term strategic decisions;

v. to authorise development of the Super Sherpa <u>in principle</u> subject to a satisfactory review by officials;

vi. to set Shorts an EFL of £36 million and a loss target of £7 million for 1986/87;

vii. to convert a £22.7 million non-interest bearing Government loan to equity and reiterate the Parliamentary statement of 1981 assuring creditors of Government support for the company.

BACKGROUND

2. Shorts is not a statutory corporation but a PLC wholly owned by the Government. It is subject to EFL disciplines like a nationalised industry, but finances itself by Government-guaranteed borrowing rather than (as in the case of Harland and Wolff) drawing funds directly from the Government. The Department of Economic Development (DED) in Northern Ireland holds 91 per cent of the issued shares; and the Department of Trade and Industry the rest. The Company has 3 Divisions:

Aircraft - manufacturing small commuter/military transport aircraft and the Tucano basic trainer (the Corporate Plan paper does not seem to us to deal adequately with the importance of the latter to this part of Shorts business);

Aerostructures - manufacturing parts built on a subcontract basis for major aircraft manufacturers;

Missiles - manufacturing Blowpipe, Javeline and Seacat missiles. The award to Shorts of the contract for Starstreak was announced a few days ago, apparently as a result of a need to let British Aerospace know quickly that Shorts had won the competition by a large margin. This decision has yet to be approved formally by Mr Younger, let alone cleared interdepartmentally!

3. Shorts is the largest manufacturing employer in Northern Ireland; its workforce of 6,800 comprises about 7 per cent of manufacturing employment in the province.

4. I assume that the Treasury will have provided you with detailed briefing on Shorts' activities and recent record. Their performance in the last year has been uncommercial and unsatisfactory: the question now is how to enforce the improvements which

will open the way to privatisation on a satisfactory basis as soon as possible.

MAIN ISSUES

5. The main issues for discussion seem to be:

a. are Ministers satisfied that early privatisation, possibly involving partial closure, is not practicable?

b. Have the right strategic options for the future shape of the company - essentially relating to the aircraft manufacturing activities - been identified?

c. Are the proposed financial disciplines adequate?

d. Is enough being done to improve the management of the company?

e. What issues will be brought back to Ministers, and when?

Privatisation

6. Privatisation - except possibly on the basis of paying somebody handsomely to take the company away (and probably close a substantial part of it down) - does not seam a realistic option in present circumstances. But it must be sensible to ensure that the company is subject to a genuinely commercial environment, so that it is capable of eventual success without the Government standing behind it.

Options for the future

7. Four options are listed in paragraph 8 of the paper. Two of them - to carry on as hitherto with aircraft production, and close aircraft production down without delay - are obviously unacceptable: Shorts will not have the resources to develop by themselves a completely new generation of aircraft to replace the present SD 330 and SD 360 models, while abrupt cessation of aircraft production would impose large and immediate burdens on the public purse (and would at the least raise questions about satisfactory completion of the Tucano contract for MOD). The only difference

between the 'phased cessation' and 'consolidation' of aircraft production options appears to be that only the latter would permit development of the Super Sherpa to go ahead, subject to the availability of sufficient third party support. For both these options the long-term future of the aircraft production side of the business would depend on Shorts finding partner(s) for the collaborative development and production of new aircraft types; this point does not emerge very clearly from the Northern Ireland Secretary's paper. But no immediate decisions are needed, and there is no reason to dissent from Mr King's proposal to ask the company to cost the options (including also that of a missiles-only business) in a new corporate plan to be presented in September 1986.

Financial Disciplines

8. Given its recent experience, the company must be put under a tighter financial discipline. The regime described in Appendix II to the note attached to Mr King's paper seems reasonable for this purpose, although - not least because of Shorts' role as supplier of aircraft and missiles to MOD - it would be unlikely to be possible in practice to impose some of the sanctions listed. It will be important to ensure that Shorts in future competes fairly with other suppliers for MOD contracts; arguably it is unfair that they should be able to quote a potentially loss-making price to secure the Tucano contract against competition from British Aerospace, and then have the Government in effect make good the loss (in principle this is the same point as arose in the case of the AOR order going to Harland and Wolff against competition from Swan Hunter). On the other hand it must be questionable whether an increase in Shorts' EFL can be justified on the basis of a change in the phasing of MOD payments for the Tucano, which would be tantamount to relieving pressures on the defence budget by transferring the burden to the N.Ireland block. Subject to the introduction of new financial disciplines, there appears to be no alternative to accepting the £36 million EFL and £7 million loss target for the current year, and to converting the £22.7 million loan to equity.

Management

9. Clearly every effort should be made to strengthen the management, although circumstances in N.Ireland are bound to make this more difficult than else where in the British Isles.

Further discussion

10. Major and far-reaching decisions on the future shape of Shorts are not required now. The immediate requirements are to commission the new corporate plan, to consider and cost the options, to set the new monitoring procedures in place and to make whatever improvements are possible in the management. So far as the immediate future of the aircraft business is concerned, it will be necessary for officials of the Departments concerned (NIO, Treasury and DTI as sponsor of the aircraft industry) to satisfy themselves that there is sufficient third party support to warrant the development of the Super Sherpa (about which DTI may have some doubts). Thereafter Ministers will need to consider - probably towards the end of this financial year - the future shape of the aircraft business in the light of the options in the corporate plan, progress with the immediate recovery plan, and progress in developing future collaborative projects which would provide a continuing future for the business in the 1990s when the present generation of aircraft have become outdated.

HANDLING

11. It does not appear that the Secretary for State for N.Ireland's proposals, so far as they go, will attract much dissent. You will wish to invite him to introduce them. The Chief Secretary, Treasury will wish to comment on the financial and privatisation implications. The Minister of State for Industry may have views about the wider industrial implications. The Secretary of State for Defence may wish to comment on defence aspects in general and the Tucano order in particular.

JBU

J B UNWIN

Cabinet Office

27 June 1986

CC BG

COMMERCIAL-IN-CONFIDENCE

From: The Private Secretary

RESTRICTED

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON

26 June 1986

Dear David,

SHORT BROS PLC: TUCANO

Thank you for your letter of 19 June. I attach a report on the Tucano on the lines sought by the Prime Minister.

Copies go to the Private Secretaries to other E(A) members, to the Secretary of State for Defence and to Sir Robert Armstrong.

Yours Sincerely
Neil Ward.

N D WARD

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SHORTS' TUCANO

Introduction

1. The Prime Minister has sought a report on Shorts' progress with the Tucano basic trainer for the RAF, covering state of development, production and actual/projected costs against the price being paid by MOD. This note has been prepared by DED (Shorts' sponsoring Department) in consultation with MOD officials close to the project.

Background

2. In autumn 1984 Ministers authorised Shorts to proceed with the Tucano project under licence from Embraer (Brazil). Forecast sales included 145 for the RAF and 75 for export markets. Although on central assumptions (especially exchange rates, sales production costs and overheads) an internal rate of return (IRR) of 13.5% was projected, this was acknowledged to be sensitive in particular to production cost overruns and failure to achieve export orders.

3. On 21 March 1985 the then Secretary of State for Defence announced the Government's decision to order 130 x Tucano aircraft to meet the RAF's basic training needs. It was preferred over BAe's PC-9 largely on grounds of initial as well as life-cycle cost, performance of both aircraft being regarded as capable of meeting the RAF's requirements. The firm price per aircraft was £926,000, and the first aircraft was to be delivered in September 1986.

Production

4. The view of company management is that the overall production programme is some 3-4 months late but that this can be recovered over the first twelve months of aircraft deliveries. Within the overall programme, the design phase (including tool design and production engineering) is now expected to be completed some 5-7 months behind schedule. The production programme will be compressed so that delivery of the first aircraft is now forecast for December 1986, some 3 months late. The prototype Garrett-powered aircraft was test-flown on 14 February 1986 and has since performed satisfactorily in the company's view. in MOD's view?

Shorts have identified a number of contributory reasons for the delay, as follows:

(1) late award of contract: the September 1986 delivery date for the first aircraft was part of a timetable which had assumed contract award in January 1985. Award actually occurred some 3 months later. This delay has financial implications in that the company was obliged to sub-contract engineering design work at higher cost rates than assumed. It must be pointed out however that late contract award did not prompt Shorts to seek deferral of first aircraft delivery;

I told MOD this at the time

(2) additional design work: the Tucano ordered by the MOD was in a version powered by a Garrett engine, a configuration which had not been produced. The company now concedes that the additional design work and time required to adapt the airframe and systems was greater than anticipated;

(3) MOD requirements: the company claims that the effect of MOD's clearance procedures had been under-estimated; and also that the customer requested Shorts to evaluate a substantial number of modifications to the proposed design before deciding not to proceed with them. It must be pointed out however that MOD's clearance procedures have not changed. The study requests were notified before award of the contract and the resulting proposals for change were offered by the company on the basis of no delay to the programme;

(4) industrial dispute: for more than 10 weeks between October 1985 and January 1986 Shorts were in dispute with TASS (representing its design engineers). The management eventually faced down the union but, over the period, no overtime was worked, co-operation with sub-contractors ceased and efficiency fell. Additional sub-contracting and overtime working has been necessary to recover the delay caused;

(5) Embraer delays: Shorts have advised MOD that significant delays have occurred in the programme at Embraer, who are supplying major assemblies for the early RAF aircraft.

6. In an attempt to contain the overall delay within 3-4 months, Shorts plan significant compression of the programme. The period allowed between design completion and beginning of flight-testing has been shortened by 7 weeks to 11 weeks. To achieve this, the first production aircraft will have to be delivered a mere 28 weeks after completion of all design work, compared with an original schedule of 42 weeks - a reduction of 33% in allowed time. The company is carrying out extensive flight-testing of the prototype to minimise the risk of further slippage.

7. The planned recovery is to take place during a period which will also include integration and certification of a new power plant. The magnitude of the recovery required suggests that the company will have great difficulty in achieving the currently projected programme - ie to contain overall delay to 3-4 months. The company recognises that its programme is extremely challenging; its worst-case view is that the first plans should be no more than 5 months behind original programme. As a precaution, however, the company has warned MOD that up to 6 months delay may occur in early deliveries but programme recovery should be achieved by delivery of the 30th aircraft. MOD is reviewing the programme status and is likely to conclude that the initial delays will be some months greater, that recovery will be at a slower rate and that a few months delay will persist throughout the RAF delivery programme.

Financial Performance

8. The original IRR for the Tucano project as a whole was forecast on central assumptions to be 13.5%. The company still believes that it can achieve this return, but acknowledges several adverse changes in the short term. The main ones are as follows:

(a) increase in non-recurring costs - £6.7m: this accounts for a significant part of the cash flow deterioration shown at paragraph 49 of the Note by Officals on Shorts' Corporate

Plan to 1990. £5.5m of this stems from the need to sub-contract a greater than forecast volume of work at higher prices in order to compress timetables; from redesign flowing from adoption of the Garrett engine and MOD clearance procedures; and from the effects of the TASS dispute. The remaining £1.2m arises from additional tooling expenditure again reflecting compression of timescales;

(b) increased material costs, mainly on exported aircraft - £4.2m: no increases have been reported in the prices of dollar denominated purchases. Sterling costs have increased, but Shorts have apparently restricted these to export aircraft by making special deals with suppliers.

9. Shorts believe that these main adverse changes are offset by favourable variances. Apart from changes in exchange rate assumptions, the most important of these are:-

(a) change in mix from MOD to export aircraft £5.5m: resulting from exclusion of 15 RAF options. Shorts' current view is that, given prices on export markets of both the PC-9 and Embraer Tucano, the originally assumed export price can be increased from $1.4m to $1.6m. In addition, Shorts have transferred the 15 RAF options (originally assumed to be exercised but in the event not taken up) to export markets, raising the original target of 75 to 90;

(b) other income - £3.0m: Shorts have now included sales of spares and the award of a logistics support contract for the RAF which MOD confirms is about to be placed for a period of 4 years.

10. The known adverse changes in the short term make achievement of the forecast IRR even more dependent than originally on projected improvements. The most important is achievement of export sales at predicted prices. Twenty export sales are worth approximately 3% in IRR terms. If non-recurring costs are allocated evenly over 220 sales (130 x RAF, 90 x export), the MOD contract is forecast to lose £1.4m (at 1984 prices before interest).

11. The company's current forecasts predict 90 export sales and management believe that this is a conservative estimate. MOD's view in 1985 was that 200 export sales could be achieved. However, the Australians have subsequently decided to procure the competing PC-9 (Shorts withdrew on the grounds that the Australian terms for local manufacture and offset were unreasonable) and the PC-9 has been sold with the Tornado and Hawk to Saudi Arabia. These developments and their likely influence on other Tucano customers, together with the publicity associated with the delay in delivery to the RAF, have in the view of the MOD DESO considerably reduced Tucano export prospects. Although MOD believes that Shorts' forecast of 90 export sales is realistic, that number of sales will be achieved in the highly competitive market only with a determined marketing effort by the company and DESO. If this target is not attained and other assumptions prove optimistic, the company recognises that there is a significant risk of losing money on the project overall.

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PGO CST MOD
WSO D/N CO
DOE MAFF Griffiths
WO D/M
DOT HMT

10 DOWNING STREET

From the Private Secretary

19 June 1986

Dear Jim,

SHORTS BROTHERS PLC

The Prime Minister has seen E(A)(86)27 which discusses the Corporate Plan and privatisation prospects of Shorts. This is to be taken at a meeting of E(A) early next month. The Prime Minister would be grateful for a report before that meeting about progress on the Tucano contract for the RAF. This should include a discussion both of the state of development and production of the aircraft and of the financial position (present and projected costs against the price being paid by MOD).

BF

I am copying this letter to the Private Secretaries to members of E(A), the Secretary of State for Defence and Sir Robert Armstrong.

Yours,

David.

DAVID NORGROVE

Jim Daniell, Esq.,
Northern Ireland Office.

CONFIDENTIAL

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PRIME MINISTER

SHORTS

Unless you disagree, the E(A) to be taken by the Lord President next week to discuss TVEI will also consider a paper by Mr. King about Short Brothers.

Agreed MT

Mr. King reports merchant bank advice that a trade sale would be the only way to achieve disposal of Shorts in this decade and that such a sale could only be on unfavourable terms. He concludes that it will not be feasible to privatise Shorts before a General Election.

On other aspects, he argues that the company's problems lie in civil aircraft production and that the choice lies between phasing out such production or continuing on a reduced scale. He thinks a decision can be deferred for the moment, awaiting a full assessment of the options, but proposes approval of a further development of the Sherpa aircraft. Tucano production is planned to continue under all the options.

I need a report on the Tucano and an update of its cost in view of the projected losses in this document

MT

DRN

DAVID NORGROVE

18 June 1986

CONFIDENTIAL

From: THE PRIVATE SECRETARY

Ok U.

CC B S?

CONFIDENTIAL

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON
SW1

13th June 1986

NB PM at this stage

Dear David,

SHORT BROS PLC: CORPORATE PLAN AND PRIVATISATION PROSPECTS

E(A) will shortly consider a note from the Secretary of State on Shorts' Corporate Plan and privatisation prospects.

As background to this dicussion you may wish to see the attached Note by officials which provides a full analysis of the company's Corporate Plan and 1986-87 cash requirements.

I am copying this letter and attachment to private secretaries of other E(A) Ministers, Richard Hatfield (MOD) and to A J Wiggins and Michael Stark (Cabinet Office).

Yours Sincerely

Neil Ward.

N D WARD

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SHORT BROTHERS PLC

REVIEW OF 1985 CORPORATE PLAN UPDATE

June 1986

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APPENDICES

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BACKGROUND

1. Short Brothers PLC (Shorts) is a Company wholly owned by Government and operating in the aerospace industry. It has historically analysed its activities into three divisions as follows :

Aircraft	: manufacturing small commuter aircraft and small military transport aircraft
Aerostructures	: manufacturing parts built on a subcontract basis for major aircraft manufacturers
Missiles	: manufacturing Blowpipe, Javelin and Seacat missiles.

2. Shorts remains the largest manufacturing employer in Northern Ireland, with a current workforce of some 6,800, approximately seven per cent of total manufacturing employment. Its turnover in the financial year to March 1986 was about £192 million of which about £130 million was exported.

3. Control of the Company is the responsibility of the Secretary of State for Northern Ireland acting through the Department of Economic Development (DED) who hold 91 per cent of the issued shares, the balance being held by the Department of Trade and Industry. DED has retained management consultants Touche Ross (TR) to assist in the appraisal of Shorts' Corporate Plan.

4. This note has been prepared by DED drawing on the advice of TR. During the course of its preparation HMT, DTI, MoD and the No. 10 Policy Unit have been consulted.

PERFORMANCE IN RECENT YEARS

5. Until 1984/85 Shorts had not made an overall profit since 1974 and has received substantial cash support. Summary statistics in recent years are :

Profitability	1980 /81 £m	1981 /82 £m	1982 /83* £m	1983 /84 £m	1984 /85 £m	1985 /86+ £m
Turnover	111	122	139	163	201	192
Profit/(Loss) Before Interest	(8)	(6)	(2)	6	11	(12)
Profit/(Loss) After Interest	(13)	(15)	(12)	(2)	1	(27)
Cashflow						
External Funding Limit	27	42	13	16	6	26
External Funding Requirement	26	33	9	15	6	26

* annualised basis - change in accounting year end to 31st March
\+ Latest Estimate

External Funding for years prior to 1985/86 was originally expressed on a cumulative rather than an annual basis. External Funding figures shown above for those years have been now recalculated on an annual basis for consistency.

In addition the basis for calculating EFL has been redefined. This redefinition has resulted in the 1985/86 EFL being restated at £26 million as compared to the figure originally authorised by Ministers of £16 million. Details of the change are shown in Appendix I. It should be noted that this increase is entirely the result of the EFL being restated, and does not represent sanction of additional funds for the company.

6. Previous funding for Shorts has been provided partly by external borrowings from banks, increases in which do not score as part of Government expenditure, partly by interest free Government loans, and partly by Government Grants including Launch Aid, Standard Capital Grant, Project Grant, Industrial Development Grant, Research and Development Grant and Training Grant.

PROGRESS SINCE LAST PLAN SUBMISSION

7. Ministers have endorsed Shorts' plans in recent years subject to certain specific conditions. The 1984 Update was approved in August 1985, subject to the following conditions and comments:

- doubts were expressed on the viability of developing the Light Military Transport (LMT) version of the SD330;
- the company was encouraged to identify a European partner for the High Velocity Missile S14 project;
- the company was requested to seek independent specialist advice on its currency hedging policy;
- the company should demonstrate to DED its plans for working capital reduction;
- the Department should monitor progress on learning curves, productivity and material costs;
- the company should continue to implement recommendations relating to overheads and ensure that target overhead rates be consistent with recent new work proposals.

8. Some progress has been made in complying with these conditions. Details are given in Appendix II. Further progress has been constrained partly by the Company focussing attention on its short term difficulties. Officials recommend that Ministers should reiterate those conditions listed in paragraph 7 which are still relevant.

9. Since approval of the 1984 Update, forecasts of trading results for 1985/86 have shown increasing levels of loss expected to be incurred. The 1984 Update, as amended, forecast profits after interest for the year of £4 million. This has now been adjusted as follows:

Successive Forecasts of 1985/86 Year-End Profit/(Loss)

	£ million
Planned Profit in 1985/86 as in 1984 Update as Adjusted	4
Forecast Profit/(Loss) notified in:	
Accounts to August 1985	2
Accounts to September 1985	(6)
Accounts to October 1985	(8)
Accounts to November 1985	(12)
Accounts to December 1985	(14)
Accounts to January 1986	(23)
Latest Estimate from Shorts for year-end	(27)

10. Performance in 1985/86 is estimated by Shorts as follows:

	ORIGINAL PLAN	NOW FORECAST	
		ESTIMATE	VARIANCE
	£m	£m	£m
Margins:			
Aircraft	10.9	-4.0	(14.9)
Aerostructures	5.2	6.3	1.1
Missiles	19.0	10.2	(8.8)
Total Gross Margins	35.1	12.5	(22.6)
Unallocated Overheads	-18.6	-22.3	(3.7)
Operating Profit/Loss	16.5	-9.8	(26.3)
Interest	-9.1	-15.0	(5.9)
Other Charges	-3.0	-2.6	0.4
Consolidated Profit/Loss	4.4	-27.4	(31.8)
External Funding Requirement	-26.0	-26.0	0.0

11. A full analysis of variances from plan is included in Appendix III. The major identified reasons for the shortfall are:

- productivity shortfalls;
- failure to achieve forecast margins on aircraft sales;
- lack of aircraft orders;
- failure to achieve high margin missile export sales;
- quality control difficulties experienced with missile parts supplied by the Royal Ordnance Factories;
- increases in overheads ;
- higher interest charges.

12 An analysis of variations in EFR from plan is included in Appendix IV. Shorts has stated that it remained within the revised EFL for 1985/86, but only with the aid of the following:

- use of a new year end flexibility scheme which provides finance outside the EFL on completed aircraft not yet delivered to customers. The amount so provided at the year-end was the maximum under the scheme, being £12.5 million;
- discounting of promissory notes from Fokker relating to cost over-runs on the F100 project (see paragraph 59 for details)

INTRODUCTION TO THE 1985 CORPORATE PLAN UPDATE

13. The underlying strategy behind the 1985 Update is dominated by a number of factors, principal amongst which are:

- the poor performance in 1985/86 and the need to recover from that position;
- perceived difficulties in marketing the company's existing aircraft.

14. A separately submitted recovery plan has been prepared by the company. The success of this plan has been assumed in the 1985 Corporate Plan Update. A summary of its contents is attached as Appendix V.

15. The company proposes both further enhancements to the SD 360 and development of a "Super Sherpa", an SD 360 fitted with the SD 330 tail (thus allowing a rear loading door) as ways of improving the market appeal of the SD 360 and overcoming the perceived difficulties of selling the aircraft.

16. To summmarise the changes between the 1984 Update and the 1985 Update:

	1986/87	1987/88	1988/89	1989/90
Overall Profit/(Loss)				
1985 Update £m	(4)	8	11	11
1984 Update £m	10	12	16	
External Funding net inflow/(outflow)				
1985 Update £m	(29)	(29)	4	1
1984 Update £m	(27)	5	2	
Employment				
1985 Update	6,900	6,800	6,900	7,200
1984 Update	7,700	7,800	8,200	

17. The main reasons for these changes are:

- new projects - aircraft

  The 1984 Update included both the proposed SD 450 and LMT aircraft developments. The 1985 Update includes only a proposed SD 360 development, the Super Sherpa;

- interest

  The 1984 Update assumed a capital restructuring which if implemented would have reduced interest costs by about £24 million over the years 1986/87 to 1988/89. The 1985 Plan makes no such assumption.

- current losses and recovery plans

  The 1985 Update takes into account some of the losses incurred in 985/86 and the carried over effect upon both performance and EFR into later years.

A full reconciliation of profit between the 1984 and 1985 Updates is shown in Appendix VI, and of EFR between two Updates in Appendix VII.

18. Subsequent to submission of the 1985 Update, the Company has adjusted its forecasts of 1985/86 profit and EFR. Full details of the adjustments are included in paragraph 103, and reference where applicable is made to them in the text of this note.

ANALYSIS BY DIVISION

Aircraft

19. The Aircraft Division has three major products:

- Skyvan : a small military/freight aircraft of which 149 have been delivered to customers but which is now at or nearing the end of its sales life;

- SD 330 : originally a 30 seat commuter aircraft, now sold only in military/freight variants such as the Sherpa, which has a rear loading ramp, and the Utility Tactical Transport (UTT), designed for a variety of military support roles;

- SD 360 : a 36 seat commuter aircraft which first entered service in 1982.

Skyvan

20. One Skyvan was sold during 1985/86. Skyvan inventories total £3.4 million of which £2.5 million would be needed to produce the six aircraft assumed sold in the plan. With a sales price of £1 million each the company justifies continued Skyvan activity on the basis that, once an order is secured, an investment of £0.5 million in labour costs and minimal additional material allows full recovery of an inventory which would otherwise have to be written off. No speculative activity on Skyvan is assumed. While such a policy may be reasonable, markets for the Skyvan cannot necessarily support the sales volumes in the plan.

21. Subsequently the company has reduced its 1986/87 Skyvan sales and production target from two aircraft to one. Profit and EFR targets have been adjusted accordingly (paragraph 103).

SD 330

22. The SD 330's future largely depends on whether the US armed forces exercise any of the USAF held options for the Sherpa variants of this aircraft. Sales of other variants and to other customers have been very disappointing. During 1985/86 one Sherpa but no UTTs were ordered. The 1985 Update assumed delivery of two Sherpas in 1985/86, both the one ordered in the year and one ordered in 1984/85; in fact neither aircraft will be delivered until 1986/87.

23. Sales of SD 330 variants included in the 1985 Update as compared to the 1984 Update are as follows:

	1985/86	1986/87	1987/88	1988/89	1989/90
1985 Update					
Sherpas for US Forces	12		6	8	8
Sherpas for Others	2				
UTTs		4			
	14	4	6	8	8
1984 Update					
Sherpas for USAF	10				
UTTs	6				
LMTs (including USAF)		15	13	10	
	16	15	13	10	

The LMT development and its replacement in the company's plans by Super Sherpa is described below in paragraph 28. The 1984 Update assumed that any future USAF sales would be LMTs, not Sherpas.

24. It is the opinion of officials and TR that it is becoming increasingly unlikely that the USAF will exercise any of its 48 Sherpa options. Company management has recognised during conversations with officials that its chances of converting any of these options to orders has reduced, but has indicated that a transfer of options to the US Army is possible. This remains to be proven.

25. If none of these Sherpa options is exercised then both margins and cash over the period will be seriously affected. The following table shows the changes to the plan if no USAF options are exercised:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Estimated Reduction in Profits	(10)	(2)	(4)	(4)
Estimated Effect on EFR - Inflow/(Outflow)	4	12	(6)	(10)
Estimated Reduction in Employment	(100)	(530)	(530)	(530)

There are amounts invested in Sherpa related work in progress and development costs estimated as totalling £10 million. If no further Sherpa sales are made and if the Super Sherpa was not produced, this amount would have to be written off and is reflected in the figures above for 1986/87. The beneficial cash effects in the early years reflect the avoidance of a build up of inventory currently assumed in the 1985 Update.

26. The only other SD 330 sales included in the plan are four UTTs planned for 1986/87. These are assumed to be sold to Thailand, but such an order is yet to be confirmed.

27. Included in the plan is the assumption that the existing customer logistic support (CLS) contract under which Shorts maintain the USAF Sherpas continues. Turnover on this contract is about £5 million per year with gross margins of about £1 million per year. This contract commits Shorts to continue to supply both spares and service for the contract period.

Super Sherpa

28. The 1985 Update includes a proposal to develop a "Super Sherpa" variant of the SD 360. This would consist of the SD 360 forward fuselage and the Sherpa tail section including the rear ramp door. This variant replaces the LMT proposed in the 1984 Update, but now abandoned, and is aimed at the same markets. The LMT was proposed to be a Sherpa SD 330 uprated to include more powerful engines. The company was specifically instructed not to proceed with the LMT without government permission, as doubts were expressed on the size of its market. In fact, the company's officers have since decided that the Super Sherpa concept is a more effective way than the LMT of reaching the same performance and design requirements.

29. Sales of Super Sherpa included in the 1985 Update are as follows:

	1986/87	1987/88	1988/89	1989/90
Super Sherpas in 1985 Update	-	4	10	10

30. Shorts have provided TR with information on possible markets for the Super Sherpa. These markets have the following characteristics:

- all involve customers who are military forces, many of which are in the third world;
- many involve the assumed replacement of existing aircraft;
- all are extremely difficult to forecast.

TR remain unconvinced that development of the Super Sherpa would results in sales at the quantities and prices included in the plan. Shorts' management maintain that the nature of the potential market is such that conclusive evidence will never be possible.

31. Officials consider that the speculative nature of the Super Sherpa development is such that this project should not be allowed to proceed until a firm 'launch' order or other method of satisfactorily underpinning the forecast sales volumes or reducing the development risk is found.

32. If the Super Sherpa were not progressed with the effects would be as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Effect of no Super Sherpa				
Profit and Loss - favourable/(adverse)	1	1	(2)	(4)
EFR - decrease/(increase)	1	16	(2)	(8)
Employment - (reduction)	(100)	(630)	(630)	(600)

33. The combined effect of not progressing with the Super Sherpa nor selling more SD 330 Sherpas to the USAF is as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
No Super Sherpa or SD 330 Sherpa Sales				
Profit and Loss - (adverse)	(9)	(1)	(6)	(8)
EFR - decrease/(increase)	5	28	(8)	(17)
Employment - (reduction)	(200)	(1,160)	(1,160)	(1,130)

SD 360

34. The SD 360 remains the main product of the company's aircraft division. Its success has been historically based on its low purchase price and low operating costs on routes up to 200 nautical miles, particularly in the United States.

35. Sales of the SD 360 in 1985/86 were as follows:

Sales to China (ordered in 1984/85)	8
Sales carried over from 1984/85 following production difficulties	4
Other sales	14
	26

This compares with the 29 included in the 1985 Update for 1985/86. Thus three were not delivered by the year end.

36. The full sales forecast over the plan period compared to last year's plan is as follows:

	1985/86	1986/87	1987/88	1988/89	1989/90
SD 360 - 1985 Update	29	26	15	15	15
SD 360 - 1984 Update	30	22	15	5	

In the 1984 Update the introduction of the SD 450 was seen as reducing demand for the SD 360. The SD 450 has been dropped from the 1985 Update.

37. The SD 360's share of the key US market has declined markedly following the introduction of several more sophisticated competing aircraft. Shorts estimate that the total world market for commuter aircraft is around 75 per annum and the plan forecasts that they will obtain 20 per cent of this market from 1988 onwards. This assumes that a series of limited upratings are carried out including the introduction of more powerful engines. These are estimated to cost £6 million in development costs over the years 1986/87 and 1987/88.

38. Shorts' plan recognises that the accuracy of SD 360 forecasts is sensitive to a number of factors outside the company's control. These include:

- the extent to which heavy discounting by competitors continues;
- the extent to which competitors continue to receive support from Governments;
- the effect of Boeing's purchase of De Havilland Canada.

39. An important factor in the success or failure of SD 360 over the plan period will be the level of sales to China. Despite transferring sub-contract production of the SD 360's centre wing from British Hovercraft to China the seven options held by them have not yet been exercised.

40. TR have carried out a brief market study to update their views on the SD 360 market over the plan period. They conclude that the commuter market remains extremely difficult to forecast and that any changes in the competitive structure of the market would impact significantly upon the SD 360's prospects. Recent sales performance would indicate that Shorts may find it very difficult to attain the sales figures in the plan at the prices assumed. DTI officials concur with this view.

41. Subsequently the Company has reduced its production targets for 1986/87 by three SD 360s. Because there were three SD 360s unsold at 31 March 1986 the sales target for the year remains unaltered. There is, however, a beneficial effect upon cash flow resulting from the reduction in production, and this is reflected in the adjustments to EFR in paragraph 103.

42. Officials and TR conclude that the degree of uncertainty associated with the SD 360's markets over the plan period has increased significantly since last year.

Margins

43. The extent to which the 1985 Update's forecast of results for 1986/87 is vulnerable to adverse factors and failures to perform is outlined in paragraphs 75 to 82 below. Much of this vulnerability can be directly attributed to aircraft activities, and this, when considered together with estimates on profitability, raises the question of whether aircraft sales and production are ever capable of making profits under current conditions.

44. Officials and TR consider it unlikely that Aircraft activities will approach break even before interest in the foreseeable future. Taking interest into account it seems probable that aircraft activities will probably lose between £5 million and £25 million a year over the next few years, depending on volumes, performance, exchange rates and other factors.

45. The uncertainty surrounding the aircraft division's market prospects is such that even if development of the Super Sherpa were approved it seems likely that volumes could fall well below those planned and that margins would be significantly lower than planned.

MILITARY

46. The "military" business included in the 1985 Update relates to the RAF Trainer contract. The numbers of these aircraft designated "Tucano" assumed to be delivered over the plan period compared to the 1984 Update are as follows:

	1986/87	1987/88	1988/89	1989/90
Tucano Trainers - 1985 Update	6	26	38	40
Tucano Trainers - 1984 Update	6	24	36	

47. The Shorts Tucano is a turbo prop trainer which is a modification of the Brazilian made and designed Embraer Tucano. The company was awarded a contract for supply of trainers to the RAF in 1985 following a lengthy competitive process. The contract terms under which Shorts will supply the Tucano are such that, without significant export sales at much higher prices than those charged to MoD, the project is unlikely to do better than break even. Since the contract was awarded Australia has decided to purchase the Swiss designed PC9 trainer and Saudi Arabia may also do so. These decisions have reduced the Tucano's chance of achieving the required level of export sales. The overall profitability of this contract must therefore now be in doubt.

48. TR have examined other export prospects of the Tucano and conclude that the company's prospects of achieving the export sales levels and prices assumed in the original submission are now poor.

49. The 1985 Update assumes a significantly worse cash flow in the early years of the plan period than was assumed in the contract terms.

	1985/86	1986/87	1987/88	1988/89	1989/90
Tucano Cash Flow - 1985 Update	(11)	(20)	(1)	7	9
ucano Cash Flow - Contract Terms	(6)	(11)	(5)	4	5

50. Current estimates of both development costs and production costs of the Tucano have changed since the original submission. Development costs have increased, principally because of a redefinition of the allocation of the work package between Shorts and Embraer, by about £7 million. Shorts' management have stated that this has been offset by favourable changes in other elements in the project and that the total cash flow for Tucano up to the end of the plan period will be slightly better than in the original submission.

51. The Tucano project is several months behind programme. Shorts' management cite the lengthy delay in awarding the contract and subsequent changes required to meet the specification. Officials consider that industrial relations problems and other difficulties attributable to the company are also responsible for such delays.

AEROSTRUCTURES

Current Work

52. Sales forecasts for the main aerostructures products currently on hand or under development are as follows:

Product	Unit	1985/86	1986/87	1987/88	1988/89	1989/90
757 Wingflaps	sets	38	49	50	60	60
747 Doors	sets	35	28	30	30	30
737 Rudders	sets	1	120	129	129	129
F28 Wings	sets	14	-	-	-	-
F100 Wings	sets	-	15	26	34	34
BAe 146	pods	90	92	72	72	72
RB 211	pods	103	99	67	40	40
V2500	pods	-	-	-	34	108

53. TR have updated their study, prepared last year, of the large jet aircraft market with particular reference to Shorts' aerostructures business. In addition DTI have expressed their views on possible aerostructure volumes. DTI regard the above figures as being achievable, though somewhat optimistic on the 757 Wingflaps, F100 Wings and RB 211 pods. TR consider most of the significant assumptions on aerostructures markets to be reasonable. They agree that 757 and RB 211 pod figures may be high but believe this may be balanced by underestimates on other products.

54. Following a reassessment by Shorts the above figures have been adjusted in respect of 1986/87 for the following products:

	New 1986/87 Target	Decrease
F100	6	(9)
Boeing 757	35	(14)
RB211 Pods	74	(25)

These targets reflect the latest customer programmes. The cash and profit implications of these changes have been allowed for in setting revised 1986/87 profit and EFR targets (paragraph 103).

New Projects

55. The 1985 Update assumes that Shorts will obtain between five and ten per cent of the Boeing 7J7 project as a project associate. Product development amounting to £35 million is assumed spent during the plan period attracting Launch Aid at 50 per cent. No turnover would be generated by the project until into the 1990s.

56. Since the plan was submitted Shorts have announced that a Memorandum of Understanding has been signed with Boeing for the 7J7 project. Officials understand that the memorandum involves no specific commitments at this stage.

57. The plan's assumption that the company will participate in the 7J7 is highly speculative. All figures in the plan could therefore be changed significantly if participation does not proceed. 7J7 assumptions in the plan are as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Profit and Loss - (loss)	-	(1)	(4)	(10)
Cash - (outflow)	(1)	(2)	(7)	(22)

58. If Shorts were to move away from aerostructure sub-contracting to participating as a project associate or as a risk sharing partner it would have an impact on the overall risk exposure of the company.

F100

59. Since the preparation of the 1985 Update two changes have affected assumptions regarding the F100 project as follows:

- to remain within the 1985/86 EFL Shorts have discounted promisory notes with a total value of £15 million drawn by Fokker in respect of cost overruns on the F100 development programme. The 1985 Update assumed that cash from these notes would be received in 1986/87 and subsequent years. The effect upon 1986/87 is to worsen cash flow by £5 million.

- latest production forecasts show six F100 sets delivered in 1986/87 instead of the 15 assumed in the plan.

The cash and profit effect of these changes has been allowed for in setting required profit and EFR targets for 1986/87 (paragraph 103).

MISSILES

Current Work

60. The main missile product is the Javelin ground to air missile which was introduced as a development of the successful Blowpipe missile. Blowpipe sales continue at a lower level than previously experienced, though at a higher level than forecast in the 1984 Update. The other products of the Missile Division are Seacat, a naval surface to air weapon, and a range of self powered aerial targets. Volumes for missile production in the 1985 Update are as follows:

	1985/86	1986/87	1987/88	1988/89	1989/90
Blowpipe	510	871	851	20	20
Javelin	2,430	2,750	2,840	520	360
Seacat	137	195	275	280	130
S15 (see below)				2,500	2,500
S14 (see below)					1,078

Javelin is covered by orders for its MoD sales until 1988 and Seacat is covered for its MoD sales until 1989.

61. The production difficulties brought about by failures in Royal Ordnance Factory supplied components mean that 1985/86 deliveries fell short of the above figures by about 700 units. The company intends to carry over the part of this shortfall which relates to MoD deliveries to 1986/87 sales targets, but not that which relates to export deliveries. Shorts have stated that this carry over can be achieved without reducing existing 1986/87 missile production targets.

62. Missile sales in 1986/87 were planned to be 24 per cent higher in volume and 50 per cent higher in value than in the figures for 1985/86 prior to reductions caused by the Royal Ordnance problems. The company has stated that, with the addition of about 200 employees, missile production capacity could be raised to 4,500 units per year. Shorts state that this capacity is more than sufficient to meet both 1986/87 sales targets and any carry over from 1985/86.

63. Missile sales and gross margins contribute greatly to Shorts' financial performance. Margins on MoD sales tend to be earned at very much lower rates than on export sales. Because of the high rate of export margins, the level of export sales of missiles is a very important factor in determining the Company's profit or loss. Export sales and margins for 1986/87 are planned to increase as follows:

Sales from £17 million to £36 million
Margins from £8.1 million to £16.8 million.

64. The company has been asked to provide market justification for these assumptions and has replied that it needs to obtain one order for 500 Javelin missiles to achieve the targets for this product. Sales targets for other products for 1986/87 show very significant increases over 1985/86. There is a risk that export sales of missile products will fall short of planned levels, or that sales that are achieved will not earn margins at the rate assumed in the Plan.

<u>New Projects</u>

65. The S15 project is a proposed enhancement to the existing Javelin system by replacement of the current radio link with a more secure guidance system. The S14 project relates to Shorts' contender, named Starstreak, for the MoD requirement for a new high velocity missile close air defence weapon system. The strategy contained in the 1985 Update depends on Shorts securing the continued development and initial production of Starstreak.

66. Shorts emphasise in the text of the Corporate Plan Updates, and Officials and TR concur in this view, that failure to secure S14 would effectively remove most of the missile divisions product hopes for the 1990s. Shorts identify countries with which international co-operation is being explored in respect of S14. These include the USA, Denmark, Italy and in particular Spain.

67. As a general policy the MoD have recently indicated that they wish to change the basis of payment for development and production costs. This will adversely affect cashflow by deferring recovery of such costs. Negotiations continue but 1986/87 cash requirements are likely to be adversely affected.

OVERHEADS

68. TR understand that early in 1985/86, the company's senior management decided that turnover in 1985/86 would total £250 million rather than the £214 million forecast in the 1984 Update. Decisions were taken to gear up the indirect workforce to support these levels. These decisions had to be reversed when it became apparent that turnover would in fact fall short of planned levels. There was a cost penalty associated with the increased levels of employment in the meantime, but Shorts state that this was not significant. The increase in overheads was undertaken without any reference to officials, and only emerged while investigating reasons behind the poor performance in 1985/86.

DIVISIONAL PERFORMANCE

69. This year, following the very poor performance in 1985/86, requests for more detailed information have enabled TR to estimate profitability by division as follows:

1985/86 ESTIMATE
(Based on Shorts' latest estimate)

	Military £m	Aircraft £m	Aerostructures £m	Missiles £m	TOTAL £m
Turnover	-	108	35	49	192
Gross Margins	-	(4)	6	10	12
Unallocated Overheads	-	(9) E	(9) E	(4)	(22)
Other Charges	-	(2) E	(1) E		(3)
Profit/(Loss) before Interest	-	(15)	(4)	6	(13)

E = TR estimate

1986/87 PLAN

	Military £m	Aircraft £m	Aerostructures £m	Missiles £m	Total £m
Turnover	5	103	45	91	244
Gross Margins	1	5	9	20	35
Unallocated Overheads	(1)	(7) E	(7) E	(4)	(19)
Other Charges	-	(2) E	(2) E	(1) E	(5)
Profit/(Loss) before Interest	0	(4)	0	15	11

70. The aircraft and aerostructures businesses of Shorts share many common facilities and are organised within the same management structure. Allocating overheads between them therefore becomes arbitrary in the extreme. In particular, it cannot be assumed that the reduction or elimination of one activity alone would result in a corresponding reduction in overheads.

SPECIFIC MAJOR ISSUES

Strategic Options

71. In the light of the company's current poor performance, officials have considered a range of strategic options. These are presented in a separate paper, which concludes that the company should be given a limited period to implement the recovery plan and demonstrate the viability of collaborative ventures for new product development (sole development of new products is considered too risky for a company of Shorts' size). Such an approach is only acceptable, however, if clear performance targets are defined and sanctions imposed on the company if those targets are not achieved. The sanctions would include the restructuring of activities, hiving off the missile division and changing senior management.

Possible Equity Deficiency

72. Any losses for 1985/86 in excess of £1.8 million result in a negative equity at 31 March 1986. The existence of the DED interest free loan to Shorts of £22.7 million means that this can be converted to share capital relatively easily at no cash cost. Any losses in excess of £24.5 million result in an equity deficiency which could not be covered by existing equity or government loans - Shorts' latest estimate (paragraph 9) is a loss of £27 million. In these circumstances, officials recommend conversion of the interest free loan. This will still leave an equity deficiency, on current estimates, of some £3 million.

73. If Shorts' equity goes into a deficiency they are technically in default of certain bank loans and could theoretically be pressed for immediate repayment. They may also be in default under some contracts to supply aerostructure products. Officials believe that this situation may require the 1981 Parliamentary Statement of support for the Company to be repeated, despite the risk that this might provoke hostile interest in the USA on the grounds of unfair trade.

74. Officials are concerned at the propriety of the company continuing to fund losses by way of bank borrowing. The company's ability to repay such loans can be questioned and their size creates a heavy interest burden. Officials will monitor the situation closely during 1986/87.

MAJOR RISKS AND SENSITIVITIES

Aircraft Sales Prices

75. The 1985 Update assumes a level of sales prices for the products of the Aircraft Division which may prove optimistic. The prices which the company receive for aircraft are largely determined by the competitive forces of the market. At present price discounting by competitors is distorting the market, and Shorts' prices have been forced down. The position is made more complicated by the fact that sales prices in US dollars are being particularly affected by discounting. Prices gained in dollars are expected to realise less than 90 per cent of those in sterling. The geographical mix of sales therefore becomes important in assessing profitability.

76. Recent sales prices for the SD 360 are as follows:

	% of 1986/87 Plan Assumption on Price
US Dollar Sales	
8 Sales to China at \$3,675,000 each	98
4 Sales to Simmons in the US at \$3,241,000 each	86
3 other US sales at \$4,031,000 each	107
Prices associated with recent letters of intent for three aircraft at \$4,100,000 each	109
Other Sales	
2 Canadian sales at C\$4,530,000 each	81
2 Thailand sales at £2,724,000 each	91
1 UK sale at £3,020,000	100
Prices associated with recent letters of intent for four aircraft at £2,850,000 each	95

In the light of the above, TR and officials consider that the 1986/87 target prices of \$3,750,000 and £3,000,000, though achievable, are demanding particularly at the volumes assumed in the plan.

Aircraft Sales Volumes

77. It seems likely that little or no follow on sales of Sherpa aircraft will be made to USAF or other military customers. If the Super Sherpa is not produced, and as has been shown this development is very speculative, the Aircraft Division would be effectively left with the SD 360 as its only marketable product. Sales volumes of the SD 360 itself are difficult to forecast and could be less than those in the plan.

78. Aircraft margin is dependent upon meeting both volume and price targets. As indicated in paragraph 40 the Company will have difficulty in achieving both targets together. To indicate the effects of any shortfall, the average costs of dropping one SD360 sale are £0.5 million off profit and £2.8 million on cash requirements.

79. The penalty suffered if aircraft volumes reduce is not restricted to loss of margin (the achievement of which is itself largely dependent on the company's success in implementing the recovery plan). Any reduction in sales volumes below planned levels will initially result in a build up of unsold aircraft and the attendant negative cash flow will result in interest penalties. In addition reductions in production volumes in line with sales demand can not always be matched by corresponding reductions in indirect costs. For example, each SD 360 is costed to include over £400,000 of indirect attributable overheads (at 225 per cent of labour cost).

Aircraft Development Costs

80. The company has assumed long run lives of aircraft projects in determining rates of launch cost amortisation. These are as follows:

SD 360

Original launch costs were being amortised over 100 aircraft. As from 1985/86 this has been extended to 125 aircraft thus benefiting 1985/86 profit and loss by £1.2 million and penalising 1986/87 and 1987/88 by £1.0 million and £0.2 million respectively. Existing sales and letters of intent cover SD 360s up to number 94 which leaves 31 to be sold to reach 125. Risk of non-recovery exists but the amounts involved are not substantial.

SD 360 Improvements planned for 1986/7 and 1987/88

These are assumed to be amortised over 50 aircraft commencing with No. 107. Achieving 157 total sales, even with improvements, must be subject to a possibility of failure and risk exists therefore that a proportion of the development costs of £6 million may not be recovered.

Sherpa/Super Sherpa

Unrecovered development costs on the SD 330 Sherpa total £2.5 million. The proposal to develop Super Sherpa assumes that this amount is transferred to this project and recovered from Super Sherpa sales. Cancellation of Super Sherpa combined with failure to secure further Sherpa sales would result in this amount being written off.

Aircraft Stocks and Work-in-Progress

81. Any cancellation of aircraft lines will result in extensive stocks and work-in-progress write offs. The amounts involved would be difficult to calculate as they would involve estimating the content of the stocks and work-in-progress which can be used in planned production, and also the value of items which could usefully be carried to support spares sales. Such information as Shorts could make available is as follows:

Skyvan. Value of stocks and work-in-progress currently £3.4 million.

SD 330/Sherpa. Value of stocks and work-in-progress at March 1987, assuming four aircraft are sold in 1986/87, between £5 million and £8 million.

Aircraft Spares Sales

82. Volumes of sales of aircraft spares may be optimistically stated in the 1985 Update. Sales at outturn included in the plan are as follows:

	1985/86	1986/87	1987/88	1988/89	1989/90
	£m	£m	£m	£m	£m
Aircraft Spares Sales	9	10	12	17	19

Gross margins on spares are earned at the rate of about 45 per cent of sales value. Any reduction in the above sales assumptions could therefore have a marked effect on both cash and profits. For example, if spares sales volumes remained the same throughout the plan period as is forecast for 1985/86, the effect would be as follows:

	1986/87	1987/88	1988/89	1989/90
	£m	£m	£m	£m
Effect on Profit and Cash of Aircraft Spares Sales at 1985/86 level	-	(1)	(3)	(3)

Recovery Plan

83. Shorts have submitted a recovery plan to overcome the severe productivity difficulties experienced in 1985/86. The recovery plan has been developed separately from the Corporate Plan, although it is focussed towards meeting the productivity assumptions put forward in the latter. This separate development is cause for concern in that the recovery plan's targets may be unrealistic, developed as they may be from a need to justify the Corporate Plan rather than an assessment of what is attainable.

84. Having reviewed the recovery plan, TR conclude that it is in principle achievable and soundly based. They believe, however, that it will prove extremely difficult to implement to the degree assumed in the Corporate Plan and is therefore optimistic. Furthermore, it will require fundamental changes in attitude, both within management and on the shopfloor, and whilst initial signs are encouraging many factors could push the recovery off course. Given the comments made in the Corporate Plan on the quality of management within the company, the ability of the existing management to achieve a challenging recovery plan must be in doubt, although new more flexible working arrangements recently negotiated with the unions provide a good start.

Shorts Tucano

85. There are a number of risks associated with the Tucano. These include:

Overall Profitability

As has been noted (paragraph 48) export sales of Tucano may not reach planned levels and this will adversely affect profitability by reducing gross margin and overhead recovery. Insofar as the 1985 Update assumes 105 exports, as against 75 in the original submissions, this risk must be seen as increasing, especially as export prospects have if anything worsened given the recent successes of the competitive Pilatus PC9.

Development Costs

The original Tucano proposal showed development, tooling, learning and other costs of £15 million recovered over 220 aircraft. The 1985 Update assumes recovery over 250 aircraft. If export sales fall short of revised plan targets non-recovered costs will need to be written off up to a maximum of about £13 million.

Aerostructure Volumes

86. Any major changes in future production rates of passenger aircraft would affect aerostructures output. In addition the plan assumes success in gaining participation in the Boeing 7J7. As yet no real commitment has been given to develop this aircraft. Shorts would face fierce competition to obtain such work.

87. If the F100 fails to reach 150 sales or if the V2500 fails to meet 375 aircraft sets Shorts will be faced with development cost write offs.

Missile Export Sales

88. The 1985 Update assumes that exports of Missile Division products will double in sales value in 1986/87. The level now planned has been achieved before, in 1983/84. As described in paragraph 64, achievement of these levels may be in doubt. If the missile division delivered the same export volumes in 1986/87 as would have been the case in 1985/86 but for the production problems described in paragraph 11 and Appendix III, profits and EFR in 1986/87 would be adversely affected by about £9 million.

Starstreak

89. If gained, Starstreak volumes could prove to be even greater than those experienced for Blowpipe/Javelin. Conversely failure to be granted development and production of Starstreak would remove the central element of Shorts' medium to long term missile strategy.

MoD Funding

90. As noted in paragraph 67, MoD are negotiating with Shorts, and indeed other suppliers, to change the basis upon which development and production costs are funded. Essentially, such changes will delay the receipt of funds from MoD and necessitate greater investment by Shorts in working capital. The negotiations have not been concluded and Shorts are not able to quantify the likely effects. Officials believe, however, that such changes could increase the company's cash requirements significantly in the short term. This would have an immediate impact in EFR.

Product Development Costs

91. The 1985 Update assumes spend on known new aircraft, military and aerostructures projects as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
SD 360	3	3	-	-
Tucano	6	1	-	-
F100	13	4	1	-
V2500	4	5	4	3
Sub-Total - Committed Projects	26	13	5	3
Super Sherpa	1	4	1	1
7J7	-	3	7	25
Other Uncommitted projects	4	3	3	3
TOTAL PRODUCT DEVELOPMENT	31	23	16	32

Any variation from these estimates will affect both profits and cash flow.

Production Costs

92. The assumptions in the 1985 Update on the degree of success to be achieved in improving productivity and reducing production costs may prove to be optimistic. Among the key features are:

- reductions in labour hours to levels which are significantly lower than those currently experienced. For example, the SD 360 immediate target for aircraft assembly is 29,000 hours, which is 3,000 hours less than recent achievements;

- a further step improvement of five per cent in labour hours, thus reducing the SD 360 target above to about 27,500 hours;

- further progress down learning curves beyond these improvements.

93. If the company failed to achieve these improvements the total cost to both profits and EFR is estimated as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Penalty of Remaining at Current Levels of Productivity	5	6	7	7

Selling Costs

94. The 1985 Update assumes that reductions in selling costs generate a favourable effect upon profit and cash of about £1 million per year from 1986/87. This partly depends on government permission being given for revisions to the sales financing arrangements.

Overhead Savings

95. The company assumes in the plan that an eight per cent reduction in overheads on Aircraft and Aerostructures is achieved by March 1987 (not the 10 per cent saving in all Divisions mentioned in the Update text). The full achievement of these savings must be in doubt, particularly as other parts of the recovery plan involve more indirect activity in the short term. The value of these reductions is as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Savings in Overheads from Current Levels	3.7	3.9	4.2	4.5

Material Prices

96. The 1985 Update assumes that a current drive to reduce real material and sub contract prices will result in a five per cent reduction from 1987/88 onwards. This is estimated to increase profits by £2 million per annum thereafter. Achievement of this target, particularly if, as seem probable, volumes drop significantly, must be in doubt.

Exchange Rates

97. Shorts' sensitivity to fluctuations in exchange rates remains high, although the introduction of increased dollar purchases to support the Tucano programme, particularly engines, has reduced net exposure. A substantial proportion of aircraft and aerostructure income is in dollars, and the sterling/dollar rate thus tends to have a direct effect on profits except where income is hedged.

98. The company has calculated the effect of 'high' and 'low' forecasts for the sterling/dollar exchange rate as follows:

	1986/87 £m	1987/88 £m	1988/89 £m	1989/90 £m
Adverse EFR - Sterling High (rising to $1.85)	-	(10)	(7)	(19)
Favourable EFR - Sterling Low (falling to $1.05)	-	7	20	16

Figures for 1986/87 are unaffected because of the Company having already taken out forward cover.

Sales Financing and Leasing

99. A provision of £1.4 million per annum was included in the 1985 Update for losses resulting from Shorts' liability in the event of customer defaults under the sales financing and leasing arrangements. The Company has subsequently reduced this by £0.9 million for 1986/87 following a decision to recognise certain losses in 1985/86 rather than 1986/87. This leaves a provision of £0.5 million for 1986/87. This provision could prove inadequate. For example, provisions in earlier years have been as follows:

	£m
1983/84	Nil
1984/85	4
1985/86	2

Work-in-Progress Reductions

100. The 1985 Update assumes that reductions in levels of work-in-progress are achieved which result in favourable cash flows as follows:

	£m
1988/89	40
1989/90	26
TOTAL	66

Profit/(Loss) EFR (Requirement)/ Release	1986/87 Median Profit £m	1986/87 Median EFR £m	1986/87 Pessimistic Profit £m	1986/87 Pessimistic EFR £m
1. Figures as in Plan	(4)	(29)	(4)	(29)
2. Changes to Plan subsequently notified by the Company				
. Reduction in production targets for SD 360 and SD 330 aircraft (para 41)	-	6	-	6
. Reduction in production and sales target for Skyvan to one aircraft (para 21)	-	(1)	-	(1)
. Use of F100 Advance Payments and reduction of deliveries to six in 1986/87, offset by increased recovery or non-recurring costs (para 59)	1	(9)	1	(9)
. Reduction in other aerostructure programmes (para 54)	(1)	(1)	(1)	(1)
. Carry over of missile deliveries to MoD from 1985/86 (para 61)	-	2	-	2
. Reduction in provision for aircraft financing losses (para 99)	1	-	1	-
. Increase in Product Liability Insurance to reflect latest rates	(2)	(2)	(2)	(2)
. Effect of all charges upon interest costs	(2)	(2)	(2)	(2)
Sub-Total: Loss and EFR as adjusted for Company originated changes	(7)	(36)	(7)	(36)
3. Possible Policy Decisions				
Remove Sherpa (para 25)	(10)	4	(10)	4
Remove Super Sherpa (para 32)	1	1	1	1
Sub-Total Loss and EFR adjusted for Possible Policy Decisions	(16)	(31)	(16)	(31)
4. Sensitivities:				
. Productivit, Improvements	(2)	(2)	(5)	(5)
. Missile Exports			(6)	(6)
. Development Costs	(3)	(3)	(10)	(10)
. Selling Costs			(1)	(1)
. Overhead Savings	(2)	(2)	(4)	(4)
	(23)	(38)	(42)	(57)

*Explanation of the sensitivities is given in Appendix VIII.

The company's recent performance tends to cast doubt on its ability to achieve these reductions:

Ratio of Sales to Inventory

Years Ended 31 March						
Actual/Estimate				Forecast		
1984	1985	1986	1987	1988	1989	1990
1.83:1	1.69:1	1.68:1	1.68:1	1.64:1	2.05:1	2.41:1

Redundancy

101. An estimated allowance of £2 million has been provided in 1986/87 to cover possible redundancy costs in that year resulting from a net expected reduction of 279 in the workforce. Any further reduction in staffing will require additional redundancy payments. If USAF Sherpas and/or Super Sherpas do not materialise (paragraph 33), over 1,100 jobs are at risk.

Likely and Worst Case Outcomes

102. The trend in the assessment of major risks and sensitivities is clearly towards an outcome in 1986/87 worse than that shown in the 1985 Update.. Whilst Shorts' assumptions in most areas are not beyond the bounds of possibility, they are usually optimistic and taken in the round display excessive confidence in a whole series of events working in the company's favour. In discussions, the Company has not disagreed with this view but has pointed out the need to set challenging targets in the light of current losses.

103. Subsequently, as described in paragraph 18, the Company has partially recognised this view by adjusting its targets for 1986/87 profit and EFR. Officials and TR conclude that the balance of probabilities for 1986/87 is an outcome worse rather than better than even these adjusted targets. To illustrate both the Company originated changes and a possible range of outcomes the following table has been constructed. It is assumed that the Company's forecasts can be regarded as "optimistic". The table first shows how the new Company targets are calculated, goes on to show the possible effects of policy decisions on Sherpa and Super Sherpa, and ends by showing the effects of sensitivities to produce "median" and "pessimistic" forecasts for profit and EFR.

Profit/(Loss) EFR (Requirement)/ Release	1986/87			
	Median		Pessimistic	
	Profit £m	EFR £m	Profit £m	EFR £m
1. Figures as in Plan	(4)	(29)	(4)	(29)
2. Changes to Plan subsequently notified by the Company				
. Reduction in production targets for SD 360 and SD 330 aircraft (para 41)	-	6	-	6
. Reduction in production and sales target for Skyvan to one aircraft (para 20)	-	(1)	-	(1)
. Use of F100 Advance Payments and reduction of deliveries to six in 1986/87, offset by increased recovery or non-recurring costs (para 59)	1	(9)	1	(9)
. Reduction in other aerostructure programmes (para 54)	(1)	(1)	(1)	(1)
. Carry over of missile deliveries to MoD from 1985/86 (para 61)	-	2	-	2
. Reduction in provision for aircraft financing losses (para 99)	1	-	1	-
. Increase in Product Liability Insurance to reflect latest rates	(2)	(2)	(2)	(2)
. Effect of all charges upon interest costs	(2)	(2)	(2)	(2)
Sub-Total: Loss and EFR as adjusted for Company originated changes	(7)	(36)	(7)	(36)
3. Possible Policy Decisions				
Remove Sherpa (para 25)	(10)	4	(10)	4
Remove Super Sherpa (para 32)	1	1	1	1
Sub-Total Loss and EFR adjusted for Possible Policy Decisions	(16)	(31)	(16)	(31)
4. Sensitivities:				
. Productivity Improvements	(2)	(2)	(5)	(5)
. Missile Exports			(6)	(6)
. Development Costs	(3)	(3)	(10)	(10)
. Selling Costs			(1)	(1)
. Overhead Savings	(2)	(2)	(4)	(4)
	(23)	(38)	(42)	(57)

*Explanation of the sensitivities is given in Appendix VIII.

The outcomes as shown exclude any exchange rate effects. Shorts have hedged anticipated dollar income in 1986/87 and hence will be immune to exchange rate movements unless dollar income is significantly more or less than anticipated. The outcomes also exclude any use of the short term financing facility which might offset loss of SD 360 sales income. Profit and EFR figures shown for removal of Sherpa and Super Sherpa assume associated redundancy payments. If the need for such payments were positively identified in time, provision would be made in the 1985/86 accounts.

104. Because Officials do not wish to undermine the Company's resolve to achieve its recovery plans, the above sensitivities have not been agreed with Shorts' management. They represent the views of TR and Officials, but cannot be taken as a statement of Shorts' own view. They nevertheless represent a feasible range of outcomes based on information currently available.

LAUNCH AID

105. Shorts has made no repayments of Launch Aid on the SD 330 and its variants and does not expect to do so as accumulated losses on this aircraft are unlikely to be eliminated.

106. Shorts has made repayments of Launch Aid on the SD 360 in respect of 1983/84 totalling £1.3 million. Changes to anticipated profitability on the SD360 now mean that the Company does not anticipate making further repayments of Launch Aid on the SD 360 except for insignificant amounts resulting from the sale of spares.

The 1984 Update assumed repayments totalling £10 million by 1988/89 out of the total aid paid or committed to Shorts of £16 million. The 1985 Update therefore shows repayments reduced by some £9 million and assumes that aid totalling approaching £15 million will not now be repaid.

EUROPEAN COMMISSION ASPECT

107. Ministers have agreed that, in line with existing UK policy, the launch aid element of the public expenditure contribution to Shorts need not be notified to the European Commission. Officials are agreed that there is no reason to modify this stance in respect of the launch aid to be provided as part of the 1986/87 public expenditure contribution to Shorts. The balance of the 1986/87 contribution, including assistance assumed in the Plan by way of standard capital grant, is also not notifiable to the European Commission on the grounds that it falls within the limit of aid for Northern Ireland under the Commission's Communication on Regional Aid Systems (February 1979) and as such within the discretion of HMG.

RECOMMENDATIONS

108. In these circumstances, officials recommend that:

- the company be advised that its plan causes concern in view of its inherent optimism;

- the company be advised that its proposals for EFR and profit targets, currently assessed at £36 million (requirement) and £7 million (loss) is approved subject to the conditions laid out in paragraph 110 below.

- once the position on MoD funding (paragraph 67) is clarified, any subsequent effects on the company's cash requirements be compensated via an equivalent increase in the approved EFL. The effect in 1986/87 is yet to be determined;

- the company be instructed to examine in detail the consequences of a possible wind-down in aircraft, in particular the options open to the aerostructures division in such an eventuality;

- the company be instructed to submit a new plan in September 1986 which reflects a more realistic assessment of its markets, reports on progress towards collaborative ventures and incorporates a full analysis of options available in the event of a wind-down of aircraft manufacture;

- approval of the EFL and profit targets for 1986/87 be temporary and contingent upon a submission of a new plan by September 1986.

109. Ministers should also note the differences between the Company's proposals and the median view developed in paragraph 103 above and note the consequences for EFR and profit targets.

110. Approval of the EFR and profit targets would be subject to the proviso that the company agreed to:

- develop the Super Sherpa variant of the SD 360 only if a launch order or some other methods of underpinning development costs and production risks satisfactory to the Department be found (paragraph 31);

- continue to seek a European partner for collaborative development of the S14 (paragraph 66);

- report on advice being provided on exchange rate hedging policy and agree future policy in detail with the Department;

- explain in detail why overhead rates now planned exceed those outlined in recent proposals; give full details of expected profitability and cash flow implications on all current projects under these revised overhead assumptions; explain how planned reductions in overheads can be achieved;

- demonstrate clearly their plans for achieving working capital reductions shown in the plan;

- all arrangements imposed by the Department with regard to monitoring progress within the company, both with regard to the Recovery Plan and on any other subject, including the provision of management accounts.

APPENDIX I

CHANGES IN THE CALCULATION OF EXTERNAL FUNDING EFFECT UPON 1985/86 EFL

	£ million
EFL for 1985/86 authorised by Ministers	16
Change resulting from the inclusion of the capital value of lease commitments in external funding	5
Change resulting from the inclusion in external funding of loans taken out to finance traded-in aircraft	5
EFL under the new definitions	26

APPENDIX V

RECOVERY PLAN

The full text of the recovery plan provided to officials is as follows:

The Recovery Plan is represented by the actions and objectives referred to below, in conjunction with the objectives underlying the 1985 Corporate Plan.

(1) Missile Systems Division

As regards MSD, recovery depends on achieving the key overseas sales and production of JAVELIN and Blowpipe. Recovery does not, however, require major changes/ improvements in that division's operations, although delivery performance by Royal Ordnance and other suppliers is a key factor.

(2) Aircraft and Aerostructures

In this area, the Recovery Plan addresses the problems set out below, with particular emphasis on the actions as summarised:

(1) Detailed Parts Shortages have caused programme delays and damaged productivity

- Improve the planning and review of workload, capacity and manpower.
- Transfer manpower from areas particularly affected by shortages to areas where work is available.
- Increase short-term subcontracting substantially in areas which are overloaded, especially Machine Shop.
- Strengthen administration and control of sub-contracting activities.
- Extend Clean Area capacity and increase manpower in Composites Manufacturing on Bond Shop areas.
- Improve Production Scheduling and Progressing.
- Improve Stores facilities and ensure complete coverage by Stores Audit.

APPENDIX V

- Implement Centre by Centre plans for shortage reduction.

- Improve information feedback on performance and progress.

(2) Due to an overload on new projects, Engineering output has been running late and has contained too many errors

- Restrict the input of new work until the workload is closer to Shorts' in-house capacity.

- Improve planning and control of Engineering activities (including subcontract work) and strengthen the links with Project Management.

- Continue recruitment campaign to strengthen and expand design team.

(3) The rapid inflow of new work has shown weaknesses in the Management Organisation

- Change Management Organisation to strengthen top management control, reduce the span of control of some individuals and clarify responsibilities.

- Re-introduce Project Management across all projects.

- Extend the coverage of performance targets and increase visibility on performance.

- Improve Management and Supervisory motivation and performance.

(4) Industrial Relations have been poor and attitudes unco-operative

- Secure the removal of Trade Union embargoes on offload and subcontract from certain areas.

- Introduce, as soon as the shortages permit, a new incentive scheme (the "Reward Scheme").

APPENDIX V

- Achieve agreements necessary for productivity improvement

  - Direct Labour
  - Indirects and Staff.

  These improvements depend particularly on achieving greater flexibility and on securing better co-operation in the introduction of new technology.

- Carry out necessary manpower reductions in line with workload and cost targets.

- Improve communications and extend employee involvement.

- Improve adherence to Procedure Agreements.

(5) New Projects have run late

- Increase senior management involvement and tighten Project Management on these projects with a view to avoiding further slippages on Boeing 737 Rudder, F100 Wings, Tucano and V2500 nacelle.

(6) Facilities need to be modernised further and capacity increased in some areas

- Progress the Capital Expenditure programme in line with the Corporate Plan.

(7) Costs must be reduced

- Wages and salary costs to be reduced in line with Corporate Plan targets (through the measures outlined above and curtailing wage settlements).

- Carry out a detailed review of all Overhead costs.

- Reduce Materials and Subcontract costs, particularly on Aircraft projects.

- Improve Inventory Turnover.

(8) <u>Quality costs, although significantly reduced in recent years, still offer scope for further savings</u>

- Improve quality standards and awareness of the need for improvement.

- Reduce incidence of defects and reduce the costs of operating the systems of quality control.

Shorts document dated 21st March 1986

APPENDIX VI

CHANGES IN PROFIT BETWEEN 1984 UPDATE AND 1985 UPDATE

		1986/87 £m		1987/88 £m		1988/89 £m
PROFIT IN 1984 UPDATE		10		12		16
Changes						
Aircraft						
No SD 450	3		(12)		(17)	
Existing Programmes	(10)		1		9	
New Programmes	(1)		3		12	
Other Changes	1	(7)	-	(8)	2	(6)
Aerostructures						
No Boeing 7-7	-		2		2	
Existing Programmes	2		6		1	
New Work Development	1	3	1	9	(2)	1
Missiles						
Volumes/Margins		4		5		(1)
Overheads				3		
Interest						
Capital Reconstruction	(7)		(8)		(9)	
Other	(5)	(12)	(5)	(13)	(2)	(11)
Special Payments		(2)		-		-
PROFIT/(LOSS) IN 1985 UPDATE		(4)		8		11

APPENDIX VII

CHANGES IN EFL BETWEEN 1984 UPDATE AND 1985 UPDATE

	1986/ 1987 £m	1987/ 1988 £m	1988/ 1989 £m
EFL per 1985 Plan	196	225	221
Deduct Items in 1985 EFL on new basis not in 1984 Plan:			
DED Loans	12	12	12
Finance Leases	13	21	24
Trade Bills	8	8	8
Sales Finance	14	14	15
	47	55	58
EFL per 1985 Plan on same basis as 1984 Plan	149	170	163
EFL per 1984 Plan	121	127	141
Movement	(28)	(43)	(22)

Changes from 1984 Plan

		1986/ 1987 £m	1987/ 1988 £m	1988/ 1989 £m
(1)	Profit/(Loss) Changes	(28)	(14)	5
(2)	Stocks and Work-in-Progress	12	(14)	(22)
(3)	Capitalisation	(13)	(15)	(6)
(4)	Debtors	(9)	(7)	(7)
(5)	Creditors	10	7	10
(6)	Customer Deposits	(2)	(2)	(1)
(7)	Discretionary Grants	2	2	(1)
TOTAL		(28)	(43)	(22)

APPENDIX VIII

EXPLANATION OF SENSITIVITIES IN MEDIAN AND PESSIMISTIC CASES

	Median Profit £m	Median EFR £m	Pessimistic Profit £m	Pessimistic EFR £m
Productivity Improvements				
Assume as pessimistic case no improvement and as median 50% improvement; effects as in para 93	(2)	(2)	(5)	(5)
Missile Exports				
Assume exports at planned levels for median case; assume 66% decrease towards 1985/86 levels for pessimistic case; effects as in para 88.			(6)	(6)
Development Costs				
Assume 10% cost over-run as median case and 30% in pessimistic case; base as figures given in para 91	(3)	(3)	(10)	(10)
Selling Costs				
Assume that reductions quoted in para 90 are not obtained in pessimistic case only			(1)	(1)
Overhead Savings				
Assume 50% of planned savings not achieved in median case and 100% not achieved in pessimistic case; base as figures given in para 95	(2)	(2)	(4)	(4)

Note Profits and Reductions in EFL without brackets
Losses and Increases in EFL in brackets

APPENDIX II

PROGRESS ON CONDITIONS AND COMMENTS

EXPRESSED AS PART OF THE 1984 CORPORATE PLAN APPROVAL

1. LMT Version of SD 330

As has been described in the text the development of the LMT was abandoned but has now been superseded by the proposed Super Sherpa.

2. S14 Collaboration

The company does not have a firm European partner for S14, although the possibility of collaborating with Spain has been expressed.

3. Currency Hedging

The company has sought specialist advice from N M Rothschild Asset Management Ltd on its currency hedging policy. Final results of this process are expected shortly.

4. Working Capital Reduction

No information has been forthcoming on this subject.

5. Learning Curve, Productivity and Material Costs

Despite the size of the problems which the company faces in these areas no significant additional information has been supplied.

6. Overheads

Overhead rates for 1985/86 are now forecast to exceed 380 per cent of direct labour compared to a plan for the year of 348 per cent, and to targets in recent proposals of 325 per cent. The 1985 plan comments on poor performance in 1985/86 and in particular outlines continued actions in line with the Binder Hamlyn Fry report. It does not, however, comment on the increases in overheads caused by management decisions (paragraph 68) or the fact that its new long term target of just under 350 per cent is well in excess of that shown in recent proposals.

APPENDIX III

VARIANCES OF 1985/86 PERFORMANCE FROM PLAN

		£m
Profit planned in 1984 Update as adjusted		4.4
Changes resulting from:		
Aircraft Related Costs		
Labour learning failures	(3.9)	
Changes in deliveries	(3.5)	
Additional sales costs and leasing losses	(2.2)	
Additional Development costs	(1.6)	
Materials costs	(0.8)	
Work-in-Progress reduction	(1.4)	
Others	(1.5)	(14.9)
Aerostructures Related Costs		
Labour learning	(1.3)	
Development costs delayed	1.9	
Accounting treatment	1.5	
Deliveries	(0.5)	
Others	(0.5)	1.1
Missiles Related Costs		
Loss of deliveries (ROF components)	(2.5)	
Changes in sales mix	(7.0)	
Others	0.7	(8.8)
Overheads		(3.7)
Interest		(5.9)
Other Costs		0.4
Total Movements from plan		(31.8)
Loss now estimated for full year		(27.4)

APPENDIX IV

VARIATIONS OF FORECAST 1985/86 EFR FROM PLAN CASH (OUTFLOW)/INFLOW

	£ million
EFR planned in 1985/86 as adjusted	(26)
Changes in Profit and Loss from plan as now forecast	(32)
Capital Expenditure - Reduction	3
Expenditure on Product Development - Increase	(4)
Movements in working capital - reduction	31
Forecast EFR for 1985/86 as now forecast	(26)

One of the main reasons behind the favourable movements in working capital during 1985/86 was the discounting by Shorts of promissory notes drawn by Fokker in respect of cost overruns on the F100 development programme. The 1985 Update assumed that cash from these notes would be received in 1986/87 and subsequent years.

APPENDIX V

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- Improve Production Scheduling and Progressing.
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- Implement Centre by Centre plans for shortage reduction.

- Improve information feedback on performance and progress.

(2) <u>Due to an overload on new projects, Engineering output has been running late and has contained too many errors</u>

- Restrict the input of new work until the workload is closer to Shorts' in-house capacity.

- Improve planning and control of Engineering activities (including subcontract work) and strengthen the links with Project Management.

- Continue recruitment campaign to strengthen and expand design team.

(3) <u>The rapid inflow of new work has shown weaknesses in the Management Organisation</u>

- Change Management Organisation to strengthen top management control, reduce the span of control of some individuals and clarify responsibilities.

- Re-introduce Project Management across all projects.

- Extend the coverage of performance targets and increase visibility on performance.

- Improve Management and Supervisory motivation and performance.

(4) <u>Industrial Relations have been poor and attitudes unco-operative</u>

- Secure the removal of Trade Union embargoes on offload and subcontract from certain areas.

- Introduce, as soon as the shortages permit, a new incentive scheme (the "Reward Scheme").

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  These improvements depend particularly on achieving greater flexibility and on securing better co-operation in the introduction of new technology.

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- Improve communications and extend employee involvement.

- Improve adherence to Procedure Agreements.

(5) New Projects have run late

- Increase senior management involvement and tighten Project Management on these projects with a view to avoiding further slippages on Boeing 737 Rudder, F100 Wings, Tucano and V2500 nacelle.

(6) Facilities need to be modernised further and capacity increased in some areas

- Progress the Capital Expenditure programme in line with the Corporate Plan.

(7) Costs must be reduced

- Wages and salary costs to be reduced in line with Corporate Plan targets (through the measures outlined above and curtailing wage settlements).

- Carry out a detailed review of all Overhead costs.

- Reduce Materials and Subcontract costs, particularly on Aircraft projects.

- Improve Inventory Turnover.

(8) Quality costs, although significantly reduced in recent years, still offer scope for further savings

- Improve quality standards and awareness of the need for improvement.
- Reduce incidence of defects and reduce the costs of operating the systems of quality control.

Shorts document dated 21st March 1986

APPENDIX VI

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Aircraft						
No SD 450	3		(12)		(17)	
Existing Programmes	(10)		1		9	
New Programmes	(1)		3		12	
Other Changes	1	(7)	-	(8)	2	(6)
Aerostructures						
No Boeing 7-7	-		2		2	
Existing Programmes	2		6		1	
New Work Development	1	3	1	9	(2)	1
Missiles						
Volumes/Margins		4		5		(1)
Overheads				3		
Interest						
Capital Reconstruction	(7)		(8)		(9)	
Other	(5)	(12)	(5)	(13)	(2)	(11)
Special Payments		(2)		-		-
PROFIT/(LOSS) IN 1985 UPDATE		(4)		8		11

APPENDIX VII

CHANGES IN EFL BETWEEN 1984 UPDATE AND 1985 UPDATE

	1986/ 1987 £m	1987/ 1988 £m	1988/ 1989 £m
EFL per 1985 Plan	196	225	221
Deduct Items in 1985 EFL on new basis not in 1984 Plan:			
DED Loans	12	12	12
Finance Leases	13	21	24
Trade Bills	8	8	8
Sales Finance	14	14	15
	47	55	58
EFL per 1985 Plan on same basis as 1984 Plan	149	170	163
EFL per 1984 Plan	121	127	141
Movement	(28)	(43)	(22)
Changes from 1984 Plan			
(1) Profit/(Loss) Changes	(28)	(14)	5
(2) Stocks and Work-in-Progress	12	(14)	(22)
(3) Capitalisation	(13)	(15)	(6)
(4) Debtors	(9)	(7)	(7)
(5) Creditors	10	7	10
(6) Customer Deposits	(2)	(2)	(1)
(7) Discretionary Grants	2	2	(1)
TOTAL	(28)	(43)	(22)

APPENDIX VIII

EXPLANATION OF SENSITIVITIES IN MEDIAN AND PESSIMISTIC CASES

	Median Profit £m	Median EFR £m	Pessimistic Profit £m	Pessimistic EFR £m
Productivity Improvements				
Assume as pessimistic case no improvement and as median 50% improvement; effects as in para 93	(2)	(2)	(5)	(5)
Missile Exports				
Assume exports at planned levels for median case; assume 66% decrease towards 1985/86 levels for pessimistic case; effects as in para 88.			(6)	(6)
Development Costs				
Assume 10% cost over-run as median case and 30% in pessimistic case; base as figures given in para 91	(3)	(3)	(10)	(10)
Selling Costs				
Assume that reductions quoted in para 90 are not obtained in pessimistic case only			(1)	(1)
Overhead Savings				
Assume 50% of planned savings not achieved in median case and 100% not achieved in pessimistic case; base as figures given in para 95	(2)	(2)	(4)	(4)

Note Profits and Reductions in EFL without brackets
Losses and Increases in EFL in brackets

PART 1 ends:-

MS/NIO to FST 8-1-86

PART 2 begins:-

NIO to JRN 13-6-86

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