



10 DOWNING STREET

Prime Minister

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Another example of negotiations
with the Chinese, in which Sir
Edward Gode was involved as the
then Ambassador in Peking.

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THE ROLLS ROYCE SPEY DEAL WITH CHINA

*Her Majesty's Ambassador at Peking to the
Secretary of State for Foreign and Commonwealth Affairs*

SUMMARY

Contracts worth approximately £80 million were signed on 13 December, 1975, for the supply of Rolls Royce military Spey engines and their technology to China (paragraphs 1-2).

2. The course of the negotiations (paragraphs 3-13).

3. The long negotiations and last minute hitches brought out the main concerns on each side (paragraphs 14-17).

4. The decision to rely on co-operation with a foreign firm in an area vital to their defence industries was a difficult one for the Chinese to take, after their experience with the Russians (paragraph 18).

5. The constant Chinese insistence on assurance that the UK would prove a reliable and viable partner in the venture. Significance of the deal for Sino-British relations and future sales to China (paragraphs 19-21).

6. The question now is whether if the Chinese show interest in further purchases from the West of technology for their armed forces, we and our allies can agree. This will require careful calculation of strategic issues and of whether building up Chinese strength in order to offset Soviet power would be in our interests (paragraph 22).

(Confidential—UK Eyes only)
Sir,

Peking,
13 January, 1976.

On 13 December, 1975, Sir Kenneth Keith, the Chairman of Rolls Royce (1971) Ltd, signed contracts with the China National Technical Import Corporation for the supply of 50 Spey Mark 202 aero-engines and for the sale under licence of the technology necessary for their manufacture in China. The value of the contracts will be nearly £80 million; £41½ million for the engine licence; £4½ million for the accessories licence and over £30 million for the sale of the engines depending on the rate of escalation. There are prospects that further contracts, for example, for test facilities, will follow.

2. Rolls Royce are already supplying the civil Mark 512 Spey engine to China in the Tridents sold by Hawker Siddeley. The Spey 202 is the military version used in the Phantom V fighter now in service with the RAF. The significance of this deal is thus considerably greater than that of the Trident

contract, not least because its objective is to assist the Chinese eventually to manufacture military engines on their own.

3. The origin of the deal lay oddly enough in Romania. Dr. (now Sir) Stanley Hooker, the Grand Master of Rolls aero-engine technology, had by early 1972 established an excellent working relationship with the Romanians, and it was Mr. Bodnaras, the Romanian Vice-Premier, who commended him to the Chinese. This was quickly followed by a Chinese invitation to Dr. Hooker to lecture in Peking. During his visit he made a deep impression on Chinese engineers and commercial officials, establishing a confidence which undoubtedly contributed much to the eventual success of the deal.

4. In the discussions which followed Rolls at first got the impression that the requirement was for civil Speys; but when Sir Kenneth Keith visited China in March 1973 the Chinese Vice-Minister of Foreign Trade told him that they wanted the military version. Further visits defined the requirement more precisely and by the autumn of 1973 it appeared that both sides would be able to sign a document recording Heads of Agreement intended to lead to detailed negotiations.

5. These developments had brought Her Majesty's Government into the picture because of the implications for the control of strategic exports. Ministers decided in June 1973 to authorise Rolls to pursue the negotiations further and a first approach was made to COCOM. The result was not encouraging. There were reservations from Japan, France and Germany and an objection from the US. There were nevertheless grounds for hoping that our allies could be brought to look at the balance of advantage in a different light and in September 1973 Ministers confirmed their decision to allow Rolls to continue to pursue their negotiation because of the likely economic advantages of the deal.

6. At this point the Chinese began to back away and 18 months of false starts and delay began. This covered two distinct periods. The uncertainty began with the Chinese having second thoughts about the wisdom of signing Heads of Agreement indicating a declaration of intent to buy. They put off commenting on Rolls Royce's draft for some weeks. Then came the general election of February 1974, following which the Chinese felt the need for a reaffirmation by the Labour Government of the endorsement given by their predecessors. This was given by Ministers, notably by Lord Goronwy-Roberts on 3 April, 1974, and by you, Sir, on 12 June, 1974, to the Chinese Ambassador in London. The Chinese were then ready to reopen discussions. They made clear however that they would not accept the proposal for a preliminary Heads of Agreement. They suggested the start of negotiations leading to the final signature of contracts. These began in September 1974 and continued with interruptions to February 1975, when Rolls Royce submitted a revised draft contract for the licensing agreement.

7. This was followed by another pause of six months in which it appeared that the Chinese had lost interest. It cannot have been coincidence that this period coincided with the run up to the referendum on our membership of the European Community. It was not until after the referendum result was known that they agreed to the resumption of discussions.

8. The Rolls Royce team led by Mr. Dennis Jackson conducted the final negotiation during the four months from August to December 1975. It was a rough and often depressing period for the team of 10 who lived in the grand but soulless Peking Hotel and carried on continuous negotiation day after day, followed by long hours of consultation and work at night and weekends. The Chinese negotiating tactics involved a remarkable combination of high pressure urgency and time consuming stonewalling. This may have had the psychological

aim of wearing down the resistance of the Rolls Royce team; it probably also reflected the simple fact that the negotiators on the Chinese side were themselves under great pressure. If this in many ways pioneering project which they have negotiated does not work it will be their heads that are on the block in the years to come. Nor can it have been easy for them to get decisions taken quickly by the Government on their side.

9. The major concerns on both the Chinese and British sides came out clearly in the negotiations. The first hurdle was a Chinese attempt to get Rolls to accept full responsibility for the success of the manufacturing project. This showed itself in the argument over the penalty to be applied in the event of failure to produce an engine up to the standards required. The Chinese asserted that a penalty for the failure of substantiation tests was normal practice in contracts for complete plant. It took weeks to get them to accept that this project was quite different and that Rolls could not guarantee the success of a process which was so dependent on the facilities in the engine plant provided by the Chinese and on the skill of Chinese engineers working there. In the end a satisfactory formula was agreed which allowed for a proportion of the price to be withheld until substantiation tests were complete but only if it could be shown that the responsibilities for failure lay with Rolls, e.g. through a mistake in plans or documents supplied.

10. The next long haggle was on the price of the engine licence. The final figure of £41½ million was almost exactly half-way between the starting price of each side. It took six weeks of slogging to achieve this result. Here again Rolls had to bring the Chinese to depart from their normal position. Never before have they paid so great a proportion of the total price simply to buy technology as distinct from plant itself.

11. Price was important not only to Rolls but to Her Majesty's Government who wished to be assured that the economic benefit would be commensurate with the risks involved to our relations with our COCOM allies. Another important element in the same context was the need to get from the Chinese some measure of guarantee against transfer of technology or complete engines to third countries. It can be argued that there is no way of stopping them from doing so if they so wish, once the manufacturing facility is established, but it was still important that we should get some undertaking on the basis of which we could reassure allies and friends. The Chinese proved ready to provide it as far as the technology was concerned, regarding that as a commercial matter between themselves and Rolls Royce. They were not willing to see any reference in the contract to a limitation on their right to dispose of complete engines. In the end hard bargaining persuaded them to provide Rolls with a side letter renouncing the intention of selling or lending the engines to third parties for 10 years. This was not without its loop-holes but it was judged acceptable not least because it could well be nearly 10 years in any case before China has engines available for transfer.

12. By 27 November agreement on the price for the licence, on the re-assignment assurances, and on the number of engines to be sold enabled Ministers to decide that the terms were sufficiently satisfactory to justify Rolls signing the contracts. A plan had already been drawn up to provide advance information to our COCOM partners and to other Governments in the Asian and Pacific areas. Because some issues were still outstanding and the date of signature still uncertain this arrangement had to be set up on a contingency basis with the trigger being pulled only when signature was no longer in doubt.

13. In the event another fortnight elapsed before signature and the final stages reflected many of the doubts and delays of the previous three years. On a

number of occasions the bird, apparently safely in the hand, threatened to fly over the nearest bush and out of sight. The main problem at this stage was the price to be paid for the completed engines. This issue had been complicated by the Chinese reducing their requirement from 200 units to 50. The margin of profitability was thus lowered in spite of the satisfactory price for the licence. Inflation in Britain meant that the basic price per unit had had to be raised very sharply from the level first quoted to the Chinese in 1973 and allowance had then still to be made for further escalation up to the delivery dates in 1978-79. The Chinese expressed alarm. By the time of Sir Kenneth Keith's arrival in Peking on 11 December Mr. Jackson had persuaded the Chinese to accept a realistic base price for 1975 but the rate of escalation to be applied was still in dispute. On his arrival Sir Kenneth decided that it would be commercially sensible to go for a quick settlement. Another break over the Christmas and New Year could have left the Chinese with yet another opportunity for second thoughts: even if the break caused no more than delay, the cash-flow loss looked like being greater than the prospective gain from further protracted bargaining. A satisfactory, if modest, escalation formula was thus agreed quickly after his arrival.

14. At this point things seemed settled for signature on December 12 but now problems continued to arise up to the 12th hour. For the civil Speys export licences had been issued with a period of validity long enough to cover the period of actual export. Towards the end of the negotiations the Chinese were told that since the Mark 202 was a military engine the export licences would be valid for only 12 months (the licence would of course be open to renewal to cover in due course the period of export in 1978-79). Strong attempts both by Rolls Royce and myself to convince them that this was normal practice did not succeed in getting them to accept it. I spoke on instructions to the Ministry of Foreign Trade and assured them that a 12 months' licence for equipment of this sort was our normal procedure even with NATO allies. I assured them that they need have no anxiety about the willingness of the British Government to see the delivery of the engines completed. You were, if necessary, prepared to have me confirm this Ministerial declaration of intent in writing. But even this was not enough for them. On the very morning of the day on which signature of the contracts was set for 5 p.m., they revealed their unwillingness to accept anything less than a document authorising export, valid for the whole period of the contract and quotable in the contract. At this point this seemed to be the sole remaining issue. Allies had been informed that signature was imminent, invitations to the celebratory dinner that evening had been issued and the Press were aware of Sir Kenneth's presence in Peking. A decision on how the problem should be overcome had thus to be taken very quickly in order to avoid any impression that the contract was being held up by Her Majesty's Government's unwillingness to give an assurance that the export permit would be valid for the period of the contract. Since the rules affecting validity of Department of Trade export licences could not be broken a solution had to be found in the issue by the Department of Industry of an "export authority" valid for the contract period. In view of the time scale a decision on this solution had to be obtained by telephone from London with unusual urgency.

15. No sooner was this hurdle overcome than a new cause for delay arose. During the checking of the contract the Chinese insisted on a number of insubstantial but time-consuming changes which made it impossible to get the documents prepared for signature in time. We thus had the unusual experience of attending a Chinese dinner that evening for nearly 100 people to celebrate a signing that was yet to take place. Still, all seemed well because both the Chinese and Sir Kenneth Keith in their speeches announced that full agreement on all points had been reached.

16. They spoke too soon, as we assembled on the following afternoon for the signing ceremony yet another melodrama was caused when the negotiators on both sides reported that they could not agree on the exact application of the formula for the escalation of the price for engines and in consequence a vital page of the contract was still incomplete. This difficulty proved in the main to arise from a misunderstanding and poor interpretation but it had still to be resolved by a last-minute bargaining session in Sir Kenneth Keith's hotel room. In consequence the second celebratory banquet at which Rolls Royce were the hosts had, rather incongruously, also to be held, before rather than after the signing ceremony itself. It was with great relief that at 9.00 p.m. that night we saw Sir Kenneth Keith and the General Manager of Techimport write their names on the voluminous contract documents.

17. I have recorded the ups and downs of the negotiations in some detail in part because they illustrate the very difficult task faced by British commercial negotiators here. The rewards are high but the going is hard. The issues raised also reflect fundamental Chinese concerns which we will have to take into account if we are going to continue to be successful in obtaining further major contracts of this kind.

18. The first thing which emerged was the difficulty of the decision for the Chinese. Profoundly conscious of being left in the lurch by the Russians in the earlier '60s they had to decide whether to put the modernisation of a crucial part of their aircraft industry into the hands of a foreign company. This was a much bigger decision than those taken in the early '70s when they recommenced major imports of plant from Japan, the US and Europe. The defence and security of China were at stake.

19. It was almost certainly the realisation that aero-engine technology is among the most difficult to develop and that China could not catch up within the time scale set by her need to improve her defences which led to the decision to seek help abroad. This was only part of the problem. It will be evident from what I have written above that throughout the three years of the negotiation the Chinese looked for constant reassurance that the UK would prove a reliable and viable partner in the venture and that Her Majesty's Government on their side would give full assurance that the export contracts could be fulfilled. After their experience with the Russians reliability of supply is a vital issue for the Chinese and I have no doubt that if at any point Her Majesty's Government had appeared in the least hesitant to come forward with full and immediate assurance the Chinese would even at the last moment, nervously back away and look elsewhere.

20. The significance of the Chinese Government's decision to go ahead goes beyond the field of trade and industry. It indicates that they see no clash of interest with Her Majesty's Government over the next five years. Providing the project succeeds the position of those in China who take a pragmatic view of economic development and the value of good political and trade relations with the West will have been strengthened.

21. Making the Spey deal work will not be an easy task. Rolls engineers have no illusions that their Chinese counterparts are yet qualified to tackle a task of this sophistication. They are nevertheless determined that it shall not fail through any fault of theirs. We too have every interest in their succeeding because, following the example of Hawker Siddeley with their Tridents, Rolls have now won for the UK the inside track in China in the competition of aero-space sales.

22. This brings me to the problem of the future. The decision to sell aero engine technology to China was a logical one. China's position is very different

from that of the Soviet Union: not merely is she geographically remote from Europe but she is well behind the West and the Soviet Union in the development of her air force. The deal thus presents no threat to our strategic interests and given the vast preponderance of Soviet might in no way upsets the military balance there. In consequence it led to no outcry from our allies whose anxieties were more concerned with COCOM procedures than with fears of damage to the strategic interests of the West or of our friends in Asia. The question now is whether we and our Western allies will think it prudent to go further down the same road. If the Chinese, having succeeded in this deal show an interest in further purchases in the West of technology and equipment for their armed forces, we and our allies will have to decide whether to agree. That will call for some careful calculation of the strategic balance in Asia, the effect on the Sino/Soviet dispute, and on whether it would be in our interests, within limits at least, to help China to build up her strength in order to off-set in some degree increasing Soviet power. These questions go wider than this despatch but I have no doubt that we will need to consider them carefully in the coming year.

23. Finally I should pay tribute to the Rolls team who won these contracts and in particular to Sir Stanley Hooker, and to Mr. Dennis Jackson who carried the burden of the negotiations in circumstances where many would have given up in despair. I should also like to pay tribute to my Commercial Department as a whole for the unstinting help which they provided to the Rolls team throughout the long negotiations. And finally, a tribute to my Communicators who willingly took on the handling of almost all of Rolls' highly complex traffic. It will give some idea of the scale of their assistance if I add that 40 per cent of the telegram traffic of this Embassy during the last quarter was carried on behalf of Rolls.

24. I am sending copies of this despatch to the Department of Trade and the Department of Industry, to the Ministry of Defence and to Her Majesty's Representatives at Washington, Moscow, New Delhi, Paris, UKDEL NATO, Tokyo, Kuala Lumpur, Singapore, Canberra, Wellington and to the Governor of Hong Kong and the Senior British Trade Commissioner, Hong Kong.

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