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P 02098

PRIME MINISTER

FLOTATION OF ROYAL ORDNANCE plc
(Ad Hoc Meeting at 4.15 pm on Wednesday, 11 June)

CONCLUSIONS

1. You will wish the meeting to decide:
 - a. whether the flotation of Royal Ordnance (RO) plc should proceed on 16 July on the lines proposed by the Defence Secretary;
 - b. if not, whether further work should be put in hand with a view to eventual privatisation, and what that further work should be.

BACKGROUND

2. Until January 1985 Royal Ordnance (RO) operated as a Trading Fund. Major changes in its management methods, financial control systems etc are now in train to change it into a fully fledged plc prior to privatisation. This is scheduled for next month, and all planning has been geared to that objective. The Defence Secretary still thinks it right to stick to that (his view is confirmed in Lord Trefgarne's curiously half hearted minute to you of 10 June), and the Chancellor is likely to support him. There are, however, two worrying sets of counter considerations. First, whether a flotation (by institutional placement) on this

timescale is still commercially feasible. Second, whether the powerful protests of Vickers against the placing of a non-competitive order with RO for 76 Challenger tanks (to form a 7th BAOR Regiment) can prudently be ignored. MOD and the Treasury regard this as an absolutely necessary condition of a successful flotation; and the order was promised to RO by the former Defence Secretary, Mr Heseltine. But the Trade and Industry Secretary is strongly opposed to such non competitive procurement, and is concerned about the consequences for Vickers.

MAIN ISSUES

3. The main arguments for and against flotation may be summarised as follows:-

(a) Arguments for Flotation:

i. Net proceeds:

Do we?
Rothschilds (the advisers to the MOD) believe £100 million should be obtainable, and we need the money;

ii. Commercial Viability

RO is badly managed and a liability to the MOD. They believe flotation will help achieve market disciplines and give RO the flexibility to recruit better management, as well as getting it off their hands;

iii. Timetable

If RO is not floated in July, privatisation may well not be possible in this Parliament. All the other possible slots have already been allocated. Another postponement (following British Airways) would be a set back to the Government's

privatisation programme.

(b) Arguments against flotation:

i. Flotation Premature

Rothschilds have advised the MOD that, in commercial terms, flotation this year is premature and that the logistics of the operation may jeopardise it.. For this reason, if the flotation goes ahead, they favour a "low-key flotation", with some 75 per cent of the shares placed firmly with institutions, leaving only the remaining 25 per cent for public subscription;

ii. Management

On the Defence Secretary's own admission, the new RO Chairman, Bryan Basset is ineffective, while the new Chief Executive, Roger Pinnington, appears to question RO's readiness for privatisation and to doubt whether flotation is the best way to achieve this objective. Although the RO Board are committed to flotation, this is hardly an encouraging basis for a successful operation;

iii. Competition policy and Vickers

As already indicated, precondition for flotation is the award to RO plc on a non-competitive basis, of an order for 76 CHALLENGER tanks to ensure the future of RO's factory in Leeds until the end of 1989. This would be contrary to the Government's competition policy; and it would have an adverse impact on the tank manufacturing facility of Vickers Defence Systems in Newcastle, who contend they can provide CHALLENGER tanks at a more competitive price than RO plc. Vickers claim that if they do not get the order they will lose their

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credibility in overseas markets and jobs may have to go in Newcastle. Thus, if the contract is awarded to RO and flotation goes ahead, Vickers may well seek compensation in the form of an MoD order of £20 m for the conversion of a further 16 Chieftain bridge-layers and for some 60 AVRE (armoured vehicle recovery equipment) conversions, with all future armoured fighting vehicle contracts open to tender.

(iv) Rationalisation of the armoured fighting vehicle industry

There is already overcapacity. The armoured fighting vehicle market is insufficient to sustain the 4 current UK manufacturers - RO plc, Vickers, Alvis (Coventry) and GKN-Sankey. There is therefore a case for rationalisation of the industry before the privatisation of RO. Vickers have already indicated a wish "to enter into serious negotiations to purchase from the MoD certain assets of RO plc represented by the plants at Leeds and Nottingham" (on the assumption that the CHALLENGER order would be negotiated with the new combined organisation). Although this may be to some extent a 'spoiling tactic', it is surely worth considering further.

Vickers have written to you. Correspondence below.

v. Implications for other privatisations

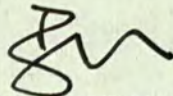
Difficulties with Vickers apart, the RO flotation could be criticised if it only yielded net proceeds of £100 million, when the book value of the assets transferred to RO plc in January 1985 was £206 million. There is also a risk that any row about the privatisation could cast a shadow over the impending BGC privatisation and the privatisation programme as a whole.

COMMENT

4. The case is far from clear cut. It would obviously be a pity to miss this (probably non repeatable) opportunity for getting RO into the private sector by a flotation, although the expected receipts are small in relation to the privatisation programme overall. There is also a risk of political criticism if yet another privatisation is postponed. But you will want to weigh up very carefully the risks of proceeding. The case set out in Lord Trefgarne's minute is hardly reassuring on any count; and if Vickers decided to play it rough (you will want to question Mr Channon on this) there could be the makings of another nasty and embarrassing row (with familiar ingredients - DTI and MOD in dispute over a medium sized defence contractor). There is also a serious point about the need to rationalise the industry, to which the possibility of a Vickers' take over of certain RO assets is relevant. So far as I can see from the papers made available to the Cabinet Office, Vickers and the DTI have been putting this point and the problem of the Challenger order to MOD for some months, but have not so far been given any very reasoned reply.

HANDLING

5. You will wish to invite the Secretary of State for Defence and the Minister of State for Defence Procurement to put the case for flotation of RO in July. The Secretary of State for Trade and Industry will wish to respond. The Chancellor of the Exchequer and the Financial Secretary, Treasury will have views on the implications for the privatisation programme and for competition. The Lord President of the Council and the - Chancellor of the Duchy of Lancaster may wish to comment more generally.


J B UNWIN

10 June 1986
Cabinet Office