

SECRET

PRIME MINISTER

ROYAL ORDNANCE

I am sure you are right to be very doubtful about the proposal to sell Royal Ordnance now. (I sat on the fence when you asked me about it after the meeting.)

If the RO sale goes ahead with a non-competitive order for the Seventh Challenger Regiment it will be taken to prove that the Government is determined to privatise regardless of the consequences, and at any cost to its other policies, including greater competition.

Public opinion is already very sceptical about the sale of BGC and water. To sell RO on the present basis would hand the Opposition a tremendous weapon to attack the entire policy.

You will want to look tomorrow at MOD's piece on the consequences of not privatising RO, but unless that is very compelling, my recommendation would be against going ahead. The costs to one of the Government's central policies <sup>otherwise</sup> are likely to outweigh messy consequences for RO.

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~~MBA~~

11 June, 1986.

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PRIME MINISTER

11 June 1986

ROYAL ORDNANCE

The Royal Ordnance (RO) makes ammunition, explosives, small arms and fighting vehicles primarily for the British Army. Last year it had a turnover of some £500m and made a profit after tax of £26m. It employs 17,000 people, although the corporate plan is to reduce this to 12,000.

Historically, the RO has been purely a manufacturer of equipment to MOD orders, the equipment often being developed by MOD research establishments. Preparation for privatisation has necessitated establishing the RO as a more normal commercial concern with an arms-length relationship with MOD procurement, transferring to it intellectual property rights (IPR) and some product development capability. MOD's guiding philosophy has been to try and place the RO as far as possible in a similar position to other MOD suppliers.

This has resulted in the transfer of some IPR to the RO, agreement on continuing access to the MOD's research establishments (on commercial terms) and other similar changes. The MOD has also entered into (effectively) a seven-year agreement with the RO to maintain indigenous capacity in explosives because of its strategic importance. More debateable, MOD has agreed not to give access to its research establishments or other similar assistance to companies wishing to compete with existing RO products. The argument is that historically the research establishments have been a de facto part of the RO plc, and thus such assistance would be equivalent to, say, Vickers research department helping one of its potential competitors.

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Where assistance to the RO clearly exceeds proper commercial comparison is the order for the Seventh Regiment of Challenger tanks. There is a firm military requirement for the 76 tanks but Michael Heseltine decided as the final flotation concession that the RO should be given the order on a non-competitive basis, subject to agreement on price. It is argued that this does not cost the MOD anything because it forestalls redundancies which MOD would have to pay for in the overhead rate of future orders. But unless RO's costs are excessive there must be a good chance they would get the order on a competitive tender, moreover redundancies would still be necessary.

Provided all these arrangements remain in place then Rothschilds view is that, although risky, privatisation is feasible in July. They expect minimum net proceeds of £100m (compared to the book value of assets of some £200m). Having caused significant problems along the way, the RO directors are now prepared to proceed. This is also George Younger's recommendation. The issues are:

1. Is the cost of the concessions likely to be greater than the cost of retaining RO in the public sector? (It is too late to attempt a renegotiation). And
2. Would it be politically wiser to proceed with the sale in the face of criticism over the price and competition or would it better to cancel the sale, certainly until after the election?

On the financial side the real issue is whether the RO with its present management will become more efficient in the private sector than would have been the case had it remained in the public sector. The order for the Seventh Regiment and restriction of competition also shade against the sale.

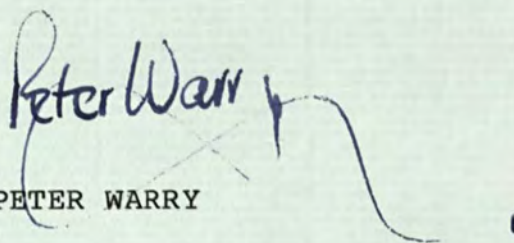


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Vickers would like to buy the Leeds and Nottingham factories which employ some 2,500 of the 17,000 RO staff. If this happens it would reduce indigenous competition and perhaps result in even more redundancies. Although Vickers imply that they would ultimately close the Leeds factory I suspect they would probably end up closing their own factory at Newcastle, because Leeds have superior facilities. However, Vickers are light years ahead of the RO in collaboration deals, sales and marketing and general entrepreneurship and the acquisition by Vickers would probably benefit the UK.

Whichever course is taken will cause political problems. If the flotation proceeds Vickers will scream (but probably not too loudly), the opposition will jeer at the price and everyone will complain that competition has been damaged. On the other hand not to proceed following BL and British Airways would be the third nail in the privatisation coffin in almost as many months, and an unhappy backdrop for British Gas.

On balance the commercial arguments are probably against privatisation and the political ones in favour. It is a difficult choice, but having gone so far, it may be best to carry on with the flotation.

A handwritten signature in blue ink that reads "Peter Warry". The signature is stylized and includes a long, sweeping flourish that extends to the right.

PETER WARRY



PRIME MINISTER

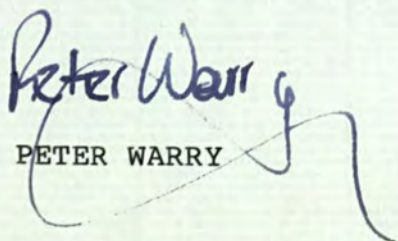
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If the flotation does not proceed it should be possible:

1. To sell the Leeds and Nottingham factories to Vickers - but the competitive tender for the Seventh Regiment Challengers should be delayed as this will obviously form a crucial part in the negotiations. (We would also want to negotiate a similar deal with Vickers on the price of the Fifth and Sixth Regiments to that already negotiated with the RO).
2. ICI and IMI already manage explosive and propellant factories for the RO and it ought to be possible to persuade them to take over ownership on the right terms.
3. It could make sense for companies using RO's propellant output, for example British Aerospace or Vickers to acquire the primary manufacture.
4. Although Enfield has considerable problems it has a product for which the British Army will have a continuing requirement. The potential for improvement could make it an attractive sales prospect.

As has been shown with BL this sort of fragmentation can be successfully thwarted by obdurate management, and it is not worth embarking on this route unless we are also prepared to put in the management that will actually deliver the policies. Without this the RO is all too likely to remain a drain on the public purse, and to fail to make the efficiency improvements that would have been the key justification for its flotation.

  
PETER WARRY