



10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 June 1986

Thank you for copying to the Prime Minister your letter of today to Mr. Channon about the British Airways engines order. The Prime Minister is following this closely and I shall bring your letter to her attention.

(David Norgrove)

Sir Francis Tombs.

15/6

Mr. Noyce

You will wish to note the contents of this minute, which we discussed briefly this morning.

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CDP
for para 6,

From: A J WIGGINS
13 June 1986

[Signature]
18/6/86.

MR UNWIN

cc Mr Stark
Mr Roberts
Dr Walker

DW
19/6

ISSUES RELATING TO PRIVATISATION OF BRITISH AIRWAYS

You and Mr Stark asked me separately when Ministers were likely to be asked to decide on the choice of engine for BA's Boeing 747-400s. I have discussed the whole range of inter-related issues arising on the BA privatisation with Mr Holmes, Department of Transport.

2. The position on the choice of engine is generally covered in the Transport Secretary's minute of 11 June to the Prime Minister. BA are currently investigating the technical and financial implications of the offers by GE and RR. The first indications are that GE have the edge on economy and maintenance costs, although neither engine yet exists and all such claims will need careful evaluation in the light of the two companies' past performance. Cathay Pacific told the Department of Transport that they had chosen the RR engine because there was very little difference between it and the GE rival; the Department suspect that CP are influenced by the fact that their Hong Kong depot has ~~only~~ ever serviced RR engines. So far as the Government are concerned, Ministers will need to take into account not only the direct financial impact on BA but also the prospective importance to RR of manufacture of their engine in the 1990s. If it appears that the world market for this engine is always likely to be very restricted, even if the BA order could be secured, RR might in the end be well advised to settle for a substantial sub-contract share of GE work - it would be open to them to seek a share of the benefits of other orders than that placed by BA.



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3. A further complicating factor is the impact on BA's privatisation balance sheet. Boeing's original position was that they were only interested in selling these aircraft, not leasing them. More recently it appears that they may be willing to lease them to BA, provided BA at the same time convert some existing operational leases into finance leases. GE are very anxious to secure BA as a customer for the first time, and have apparently offered to arrange for BA to have both aircraft and engines on an operational lease through a financial affiliate. The Department of Transport think this would help them to resist BA's demand for a cash injection to strengthen their balance sheet before privatisation; BA's position appears to be that they will need the cash injection in any event, since analysts will adjust whatever balance sheet is presented to take account of major leases. From BA's standpoint an operational lease has the advantage over both outright purchase and a finance lease in that the airline has flexibility to adjust the size of its fleet without suffering severe financial penalties. No doubt BA's intention is that they should have both operational lease terms and the cash injection, with the Government losing out both through the cash provided to BA and through the reduction in the value of RR (assuming they cannot meet the operational lease terms). BA have told the Department of Transport that RR's financial terms are so complicated that they will take some weeks to elucidate.

4. The Department of Transport envisage that BA will complete their study of the alternative proposals in the earlier part of July, so enabling Ministers to take a view on this investment before the summer holiday. This would point to an E(A) discussion around 20 July.

5. Ministers will also need to consider in July the timing of the BA privatisation. Further interdepartmental work organised by the Department of Transport has failed to find a new way of separating the contingent anti-trust liabilities from the company to be privatised, leaving a Government indemnity (which Ministers have all along resisted) as the only practical approach to this objective. However, one of the two outstanding anti-trust suits against BA has already been dismissed (although there is the possibility of an appeal), and a hearing is expected on the other case in the course of this month. As a result



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of these developments, the estimate of BA's maximum liability in the event of further litigation in relation to Laker is likely to be reduced substantially below the estimates given a few months ago, so that it may become easier to tackle the issue head-on in the initial Prospectus. There is thus some prospect that this obstacle to privatisation will have been dismantled sufficiently for the sale of the airline to go ahead next January. The Department of Transport expect to put a paper to MISC 112 in the course of July; this would then enable preparations to go ahead for a January flotation, leaving a final decision on this to be taken in September.

6. There remains the issue of US/UK airline capacity. Negotiations with the US have not gone well, although working level discussions are actually going on this week. A further formal negotiating session is scheduled for 21 July, prior to the expiry of the Bermuda 2 arrangements on 23 July. Mr Moore has given clear private indications to the US Administration that the UK must be assured of a reasonable share in the traffic. It may be necessary for the Prime Minister to intervene with President Reagan. Mr Holmes intends that Mr Moore should circulate a paper to MISC 112 next week on the future conduct of these negotiations with the US; it is not clear whether a discussion will be required, but there may be a need for a meeting around the end of the month. If new arrangements cannot be concluded with the US, the implications of the uncertainty will need to be described clearly in the privatisation Prospectus.

7. The final question on privatisation is the commercial outlook for BA, and its effect on the balance sheet. The hope had been that good profits in 1986 would improve the debt-equity ratio to 30:70, but the fall-off in North Atlantic traffic had suggested that the ratio would be 46:54 (with obvious implications for the size of any pre-privatisation capital injection). However, North Atlantic traffic is now said to be improving again, so that the outlook may be somewhat better.

JW

A J Wiggins
Economic Secretariat
16 June, 1986

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COMMISSION





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Chairman's Office

BY HAND

Prime Minister 2

Departments are working
urgently on this issue, though
even DTI think this letter

The Rt. Hon. Margaret Thatcher, MP.,
The Prime Minister,
10, Downing Street,
London, SW1.

13th June, 1986

mf

is exaggerated.

DHS
13/6.

Dear Prime Minister,

The order for engines for British Airways' intended fleet of 747-400 airliners is of such great importance that I am enclosing, in the interests of speed, a copy of my letter of today's date to Mr. Paul Channon. ...

Yours sincerely,

Francis Tombs

Sir Francis Tombs

Encl:



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BY HAND

Chairman's Office

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The Rt. Hon. Paul Channon, MP.,
Secretary of State for Trade & Industry,
Department of Trade & Industry,
1, Victoria Street, London, SW1.

13th June, 1986

Dear Secretary of State,

Events of the past few days lead me to fear that British Airways have proceeded much further towards a commitment to buy G/E engines for their new fleet of Boeing 747-400 aircraft than we had understood to be the case.

There are indications that they may have moved towards this conclusion prior to submission of final bids from the three competitors, discussions on which are only just beginning.

If my fears are correct, it is clear that your Department is not aware of such developments, since we have had no recent approaches from you or your officials.

In such circumstances, it is of the utmost importance that you should understand the following points:-

1. We understand and sympathise with BA's need to obtain off-Balance Sheet financing for the aircraft. There is no difficulty in this being done by BA or by us, but there may be some problems of residual guarantees for turn-round options or of financial rates. No discussions have yet taken place between us and BA on these points, but I believe they are capable of solution.
2. Our 524D4D engine is fully competitive with G/E and P&W engines. This is demonstrated by the fact that Boeing offer all three engines on the 400 series as well as earlier marques and, more particularly, by Cathay-Pacific's selection of the D4D engine for their recent purchase of 747-400 airliners.

/ 2 ...

3. Any suggestion that our work-sharing arrangements with G/E on the CF680C engine would provide a satisfactory alternative to the selection of our engine would be incorrect, as would any suggestion that our work-share could be increased beyond the envisaged 25%. We are already having difficulty in obtaining as much as 25% of work, and see no prospect of an increase.
4. A decision to buy G/E engines would have the following effects:-
 - (a) it would result in the loss of about 20,000 man-years of work divided roughly equally between Rolls-Royce and its suppliers,
 - (b) it would have a serious effect on the credibility of Rolls-Royce in general and, in particular, on our capacity to win orders for the 524D4D engine,
 - (c) it would have a serious effect on investors' perceptions for Rolls-Royce and, therefore, our ability to privatise.

These are, indeed, serious matters - so much so that I must ask for an urgent meeting with you to discuss them.

I have copied this letter to the Prime Minister.

Yours sincerely,

Francis Tombs

Sir Francis Tombs