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CONFIDENTIAL

23 June 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London SW1

NBN

Dear John

ENGINES FOR BRITISH AIRWAYS BOEING 747-400s

Thank you for sending me a copy of your minute of 11 June to the Prime Minister. I have also seen the response from No 10 to your Private Secretary and Norman Tebbit's letter of 16 June.

I understand that our officials met last week to put in hand the report the Prime Minister has asked for.

I agree with Norman Tebbit that this is an issue of very great potential sensitivity. Your minute sets out very fairly the importance of this order to Rolls-Royce; and my hope remains that BA will conclude that they wish to buy Rolls-Royce engines. If they conclude otherwise we will be faced with difficult decisions, and I am sure we will need a collective discussion of the issue.

I am copying this letter to the Prime Minister, members of E(A), to John Wakeham and to Sir Robert Armstrong.

Yours,

PAUL CHANNON

Paul

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BOARD OF TRADE
BICENTENARY





Chancellor of the Duchy of Lancaster

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CLG

CABINET OFFICE,
WHITEHALL, LONDON SW1A 2AS

Tel No: 233 3299
7471

16 June 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

Prime Minister ²
To note that Mr Tebbit
is also concerned, (I had
already made all these
points on your behalf.)

mb

DLF
16/6.

D. John.

ENGINES FOR BRITISH AIRWAYS 747-400s

Thank you for the copy of your minute of 11 June. I have also seen Mr Norgrove's letter of 12 June to your private secretary in response.

I welcome the Prime Minister's view that Departments should consider this urgently, including from the point of view of Government as owner of both BA and Rolls Royce.

You say in your minute that GE would appear to be willing to offer particularly attractive terms for the prestige of becoming a BA supplier. It goes, of course, far beyond prestige. This order would have a substantial market impact, particularly in the damage it could do Rolls Royce in seeking other orders. We therefore need to be very sure of the circumstances leading up to this decision.

As regards the financing, it would not be understood if we allowed BA to take advantage of a method of financing this deal which, at the same time, by virtue of the restrictions on public sector companies, was not available to Rolls-Royce. It would be said, with some justification, that we had allowed the national interest to be lost sight of. I hope that we can investigate fully this aspect of the deal and see that Rolls-Royce is not hampered by its public sector status.

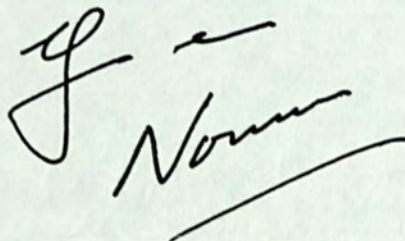
I agree that a decision that either overrides BA's commercial judgement or loses Rolls Royce the order will be difficult to present. There is therefore every reason to be active now in considering the deal, so that these unpalatable choices may be avoided.

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CONFIDENTIAL

I would welcome the opportunity for a discussion between colleagues as soon as officials have completed the work sought in Mr Norgrove's letter.

I am sending a copy of this letter to the Prime Minister, members of E(A), to John Wakeham, and to Sir Robert Armstrong.

A handwritten signature in black ink, appearing to read 'Norman Tebbit', with a long horizontal flourish underneath.

NORMAN TEBBIT

AEROSPACE

BA

PTS





10 DOWNING STREET

From the Private Secretary

12 June 1986

ENGINES FOR BRITISH AIRWAYS BOEING 747 - 400s

The Prime Minister was grateful for your Secretary of State's minute of 11 June about the competition to sell engines to British Airways.

The Prime Minister agrees with Mr. Moore that BA should be free to put proposals based on an objective assessment of the relative merits of the quotations from Rolls Royce and GE. However, the Prime Minister has asked that the Departments of Transport and Trade and Industry, with the Treasury, should consider urgently the financial and other aspects of the deal from the point of view of the Government as owner of both BA and Rolls Royce, and prepare a report. The ability of Rolls Royce to match the financial terms offered by GE should also be considered, bearing in mind that its room for manoeuvre may be reduced by its position as a company in public ownership.

I am copying this letter to the Private Secretaries to the members of E(A), to Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport

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PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS BOEING 747s

The Transport Secretary does not intend to raise this at Cabinet tomorrow unless others do so.

He concludes that BA should be free to put proposals to him based on an objective assessment of the relative merits of the two quotations. The line he proposes runs strictly in accordance with the line you took in the House on Tuesday.

I wonder though whether this is not too purist and also whether as a new Minister John Moore is following too rigidly your position elaborated on the spot in answer to Mr Kinnock.

This decision is too important for the Department of Transport to sit back passively and wait for BA to make their proposals. The Government also has some responsibility to Rolls Royce because public ownership may inhibit its ability to offer special financing deals in the way GE can. It may be possible to help Rolls Royce (if at some cost) without infringing the position that BA should be free to make its own recommendation.

The options should be explored, whatever the final decision.

Agree the line proposed by Mr Moore, but invite DTI, Treasury and Transport to consider urgently the financial aspects of this deal, and particularly the position of Rolls Royce in seeking to match GE, bearing in mind that the Government owns both BA and Rolls Royce?

Yes not

DLW

David Norgrove

11 June 1986

MJ2CAY

Aerospace - pt 5.

Future & Structure of BAHK Airways

ENGINEER FOR BRITISH AIRWAYS BOEING 747

*cejh*

PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS BOEING 747 - 400s

I thought you would find it helpful if I explained the background to the story which appeared in the 10 June edition of the Guardian that British Airways were contemplating buying American General Electric in preference to Rolls Royce engines to power future B747s.

BA's Investment Plans

BA believe that they need to acquire 16 of the Boeing 747 - 400 series quickly, to replace the oldest 747s in their fleet which have suffered structural cracking problems and are expensive to maintain. The current average age of these aircraft is just under 14 years. The new version of the 747 would also have greater range and capacity which BA believe is necessary to match their competitors.

They have therefore bought options, which simply reserve a place in the production line, on 16 Boeing 747 - 400 aircraft. The cost of the options was \$6.4m (\$400,000 each) which is refundable. A decision on whether to exercise the first 3 options has to be taken by January 1987, with the remainder exercised in 3 successive batches at 12 monthly intervals. As part of their evaluation BA invited the 3 engine manufacturers (Pratt and Whitney, General Electric and Rolls Royce) to submit quotations by the end of May. They are still in discussion with General Electric and Rolls Royce. Pratt and Whitney, however, have declined to tender.

Government Powers

Under the Memorandum of Understanding with the company and the Articles of Association all investment in new aircraft has to come to me for approval.

Financial Terms

BA have not yet received firm financing proposals from either contender. They think it likely, however, that General Electric will be able to arrange for the aircraft to be supplied on an operating lease. This would enable BA to surrender the aircraft virtually without penalty after 5 years and after 9 years. After 5 or 9 years BA could convert the leases to a full finance lease to cover the remaining book life of the aircraft. Alternatively, after 9 years BA may be able to exchange these aircraft for a later version of the 747.

Rolls Royce have a 25% work share commitment in the General Electric engine, and General Electric have assured BA that they would be willing to negotiate an increase in the Rolls Royce share up to 33% including assembly. General Electric are not at present a BA supplier, and appear to be willing to offer particularly attractive terms for the prestige of becoming one.

BA have given Rolls Royce as much detail as they properly can about the likely General Electric financing package, to see whether Rolls Royce can match it. Other things being equal, BA would like to stick with Rolls Royce as a supplier. Privately, however, BA doubt whether Rolls Royce will be able to match these terms. While the aircraft are on operating lease the engine and airframe manufacturers have to carry the residual value on their balance sheets. The full value of the order for the 16 completed aircraft would be about £1.5bn, of which the engines (80 and initial spares) would account for about £400m.

BA's Preliminary Assessment of Quotations

To acquire the aircraft on an operating lease would have considerable attractions for BA:

- it would provide flexibility in fleet management, since BA could respond to changed market conditions by returning the aircraft to the manufacturer or replacing them with a different model



- until the conversion to full finance lease, the aircraft acquired in this way would not be capitalised in BA's balance sheet or for purposes of the PSBR
- this in turn would take most of the substance out of BA's claim that their balance sheet gearing is too high and that they would need a capital injection on flotation essentially in order to complete their fleet modernisation programme. Politically, I would find it very damaging to agree to a capital injection, particularly now, because BA's competitors have suffered more than BA from the recent fall in international traffic. They would claim that an injection would amount to a subsidy to get the airline off to a good start in the private sector. I shall in any case find it difficult to resist BA's arguments, because their business has suffered too, and they are no longer projecting any improvement in gearing in the current financial year.

BA's preliminary view of the technical merits of the proposals is that the General Electric engine may be preferable, having greater thrust, better fuel economy, lower maintenance costs and more stretch. They think too that it may prove more adaptable to use with other future aircraft types, including in particular the Airbus A330 which BA look upon favourably. However, they have not reached a final view on the technical merits, and the Rolls Royce engine appears to be broadly competitive; the same engine has recently won an important launch order from Cathay Pacific.

Implications for Rolls Royce

If Rolls Royce were to lose this order the commercial effects, and the impact on privatisation, could be serious. Rolls Royce have recently launched this version of the D4 engine (the D4D) and I understand that the revenue forecast to be generated from it is an important element in their cash flow from 1988 onwards. BA is a major customer and failure to win this order with the national flag carrier when the engine had only just been launched would have a damaging effect on the viability of the project,



with knock on effects for companies such as Lucas who supply important components. More generally the loss of this major order would inevitably attract adverse publicity - indeed the mere possibility already has. This could have a depressing effect on the market's view of Rolls Royce and hence on sale proceeds either by reducing the price, or by increasing the size of the capital injection which will be needed.

Employment Implications

Preliminary inquiries suggest that the number of Rolls Royce jobs affected by the loss of this order may not in the short term be very large, though if the D4D project itself were to be called into question the employment effects could be more serious. The impact on supplying companies could also be serious though at this stage it is not possible to quantify.

Public Presentation

The decision if it either overrides BA's commercial judgement or results in Rolls Royce losing the order will be difficult to handle. I think that, whatever the outcome, if the technical and commercial arguments are clear, we should have a defensible case to make. But the consequences for the balance sheet of either BA or Rolls Royce, and the effects on the sale proceeds realised by the Government, will be a difficult calculation which is likely to require careful presentation.

Conclusions

I firmly believe that we should leave BA free to put proposals to me based on an objective assessment of the relative merits of the two quotations, and not try to influence their decision in advance. I appreciate that if Rolls Royce do not win this order they are unlikely to win many others for this engine type, and that could have serious implications for privatisation. But the implications would be equally serious if Rolls Royce could not win this order on the merits of their proposal and would



contradict our belief that such companies should be able to withstand the forces of competition. If we oblige BA to act against their commercial judgement that too would have important consequences, not only for the balance sheet and the outcry any capital injection would provoke, but also for the sale proceeds if we had committed the directors to an investment option, spanning several years' expenditure and a 15-20 year asset life, which they believed was wrong.

I understand that BA should be ready with an investment submission for me by about the middle of July. Meanwhile, no action is called for on the part of the Government, but I shall of course consult you and other colleagues if BA decide to favour the General Electric option.

I am copying this minute to the member of E(A), to the Chief Whip, and to Sir Robert Armstrong.

R. A. Allan.
(Private Secretary)

for JOHN MOORE

11 June 1986

(approved by the Secretary of State
and signed in his absence.)

