

D. R.
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²
PRIME MINISTER

BA: ROLLS ROYCE

This is not likely to be ready for a decision before September.

There is still some way to go, but it looks as though Rolls Royce are a nose in front at present. Their financing package broadly equals that on offer from GF, and they can apparently offer better terms on spares.

DNS

mt

David Norgrove

29 July 1986

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CABINET OFFICE

pa

With the compliments of

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343/7

cc. Dr Walker

Mr Wiggins

Cc/BG

Mr Noyne (for info).

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Many thanks.
Given this or one
or two other
outstanding issues,
we had better start
enmarking some E(A)
dates in September.

MR UNWIN

cc Dr Walker

Engines for BA 747-400s

JW
29/v.

As I mentioned to you, it now appears unlikely that this issue can be taken by E(A) before the holidays.

2. The problem arises because of the strange way in which BA do business with the Department of Transport. The expectation is that BA will need replacements for their oldest 747s if their business is to retain its present shape in the 1990s. The only replacement now on the horizon is the 400 series, for which General Electric and Rolls Royce have contending engines. BA have taken the line that they cannot submit their case to the Department of Transport for investment approval until they have made their choice between the two engines; but the Department of Transport cannot confirm the choice of engines until they have considered the investment case. There seems now to be a fair prospect that the necessary studies can be carried through during August, so that the issue will be ready for E(A) in the early part of September.

3. The Prime Minister was worried that public sector constraints, or the requirements of privatisation, might result in the order going to GE in circumstances which were damaging to the overall national interest, taking account of the position of Rolls Royce as well as of BA. Further work suggests that BA are not behaving markedly differently from other airlines in seeking to acquire new aircraft on an operating lease, i.e. off balance sheet, and with relatively flexible terms for ending the lease without heavy responsibility for capital losses if the air travel market does not justify the retention of the aircraft, or if other, better aircraft should become available. Rolls Royce have

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arranged terms for the operating lease of the aircraft with their engines which appear to be fully competitive with those offered by GE for the aircraft with their engines. Given this development, the choice should in the end now be made on purely economic grounds without a special balance sheet constraint.

4. Rolls Royce as sub-contractors have a 25 per cent share in the work on the GE engine, but this is not a genuine collaborative arrangement, and they do not share in the profits. The DTI have considered whether, rather than match GE's terms on the financing of the new aircraft, Rolls Royce would be better advised in effect to abandon their engine and concentrate on developing a more satisfactory relationship with GE. The DTI's provisional conclusion is that it would be better for the company to undertake 100 per cent of the work on supplying their own engines on whatever terms were necessary to secure the order than to rely on work as a sub-contractor for GE. The Rolls Royce engine apparently incorporates many well-proven parts, so that it should be capable of earning good profits; because of this Rolls Royce have offered a substantial discount on other spares which they will be supplying to BA, and this factor seems likely to be sufficient to secure them the contract. From the standpoint of the privatisation of Rolls Royce, the DTI are clear that they are better off securing the order on the terms offered than having to relay on Sub-contract work for GE.

5. Assuming that the BA Management accept the logic of the economic case in favour of Rolls Royce (which appears to be robust enough to withstand a good many biases in favour of GE), work will go ahead immediately on the necessary investment appraisal, with a view to a final decision early in September. Provided this timetable can be adhered to, there should be no difficulty with either privatisation.

JW

A J WIGGINS

Economic Secretariat.

28 July 1986.

