



bc BG

SRW
(45)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

31 July 1986

Dear Richard,

ENGINES FOR BRITISH AIRWAYS 747-400s

The Prime Minister was grateful for your Secretary of State's minute of 30 July which described the position reached so far on the choice of engines for British Airways 747-400s and has noted his conclusion that it is in everybody's interests that commercial logic and the Government's interests as owner of both companies should point in the same direction.

I am sending a copy of this letter to the Private Secretaries to members of E(A), Murdo Maclean and Michael Stark.

Yours,
David

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport.

BM



10 DOWNING STREET

Prime Minister ²

The Chancellor is very
concerned at the idea
that RR should be required
to put up a full performance
bond, He has taken this
up with John Rose.

RRW

3.1/7

RRW

b.c. Mr. Norgrove No 10 ^{CCB}

CONFIDENTIAL

Commercial in Confidence

DR WALKER

cc Mr Unwin (o.r.)

W
1/8

Engines for British Airways 747-400s

The Transport Secretary has now sent an ^{attached} interim report to the Prime Minister and other colleagues (his minute of 30 July) on the current position. This makes clear that the economic balance is in favour of placing the order with Rolls Royce rather than GE, subject to the outstanding points about a ninth-year 'window' under which BA could dispose of the aircraft, and about BA's demand for a performance bond from RR.

2. It emerged at Mr Holmes' meeting yesterday that the demand for a performance bond could be a serious problem. The idea seems to have come from Lazards, who were involved in the MOD demand for performance bonds in respect of ships to be constructed at the warship yards privatised by management buy-out. BA's argument is that RR have gone bust once, and that their order for the D4D engine is equivalent to RR's entire net worth on their balance sheet. It would be very damaging to BA's business if the engines were not delivered on time, and BA found itself without the aircraft it needed to continue profitable operations. Since it is very hard to define the assumptions necessary to quantify the losses, BA are simply asking for a performance bond for the entire value of the contract, which they would collect immediately if RR failed to perform. BA further argue that, having once made the demand, they cannot simply withdraw it; the matter is bound to become public, and would have to be dealt with within the Prospectus. BA see no need to make a comparable demand of GE, although they have now done so in the cause of 'fairness'; they say that they are satisfied that GE is a large enough company for there to be no risk of it going out of business - and the engine in question is already in service, rather than still under development.

3. It would be a very serious matter for RR to give a performance bond of the

CONFIDENTIAL

Commercial in Confidence

kind demanded by BA. The banks who provided the bond would probably demand some preferential position among RR's creditors, and this would react back on the company's ability to borrow, and so on the privatisation balance sheet. As the DTI see it, RR would have to be allowed to retain more of the proceeds from the share issue, so as to reduce the gearing of the company; this would obviously reduce the Government's proceeds from the privatisation. Moreover, the existence of the performance bond could not be concealed; it would have to be declared to investors, and if BA felt they had to have it, no doubt all RR's other customers would demand equal treatment. RR have not previously given such bonds to any customers, and this would put them at a serious disadvantage in relation to their competitors in the world market. DTI do not quite say that privatisation could not go ahead if RR complied with BA's demand, but at the very least the issue would raise a major doubt about privatisation.

4. As the Transport Secretary says, the only satisfactory way of resolving this issue is for BA and RR to come to a freely negotiated commercial agreement. Despite the claim in his minute that the choice for BA between RR and GE is fairly evenly balanced, it seems that - the performance bond apart - the economic assessment points clearly to RR (by £35 million on BA's owning biased figures, and up to £100 million on reasonable alternative assumptions). Department of Transport officials believe that BA top management are genuine in wanting to go to RR unless economic considerations point clearly in the other direction, and that they are not using the performance bond question simply as a means of shutting RR out. RR have offered a restricted performance bond assessed by reference to the extra costs BA could incur in the unlikely event that RR were the sole cause of late delivery of aircraft - RR's estimate of this is about £50 million, as against the total value of the contract of £400 million. RR point out that BA would in any event have the normal contractual remedies available to them if they suffered losses as a result of RR's failure to perform. But there has been no meeting of minds between the two companies; Lord King has been reluctant to meet Sir Francis Toombs, indicating that he thought the issue was one which should be settled by accountants. In practice it seems unlikely that this would happen unless both chairmen gave instructions that an accommodation was to be reached. DTI consider that BA greatly

CONFIDENTIAL

Commercial in Confidence

exaggerate the risks to, which they would be subject; the further development work RR need to do to prove the D4D version of the RB 211 engine is quite modest; RR's expectation of good profits from it (which is reflected in the concessions they have offered to secure the order) depends on exploiting much development work already done, and equipment already in place.

5. Mr Moore is to see Lord King today. Attempts were being made to arrange a meeting before hand between Transport, DTI and Treasury Ministers to consider what should be said to Lord King. It would clearly be very unfortunate for the privatisation of RR if BA were either to persist in the demand for the performance bond, or to take the position that the problem could only be avoided by giving the order to GE. RR's failure to win the order from its principal civil customer would undoubtedly be a major blow to flotation. The Government's proceeds from each privatisation are currently put at about £700 million. It would be very unsatisfactory if, in order to boost the proceeds from one of the privatisations by a relatively small amount, the value of the other company was very substantially reduced, or its privatisation frustrated.

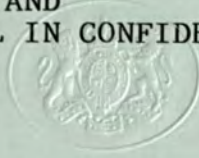
JW

A J WIGGINS

Economic Secretariat.

31 July 1986.





CEB

Prime Minister 2

A cautious minute.

*Any ...
by ...
DRS
30/7*

PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS 747-400S

In my minute of 25 June, I explained that both Rolls Royce (RR) and General Electric (GE) were making new offers in the bid to provide the engines for British Airways' next generation of Boeing 747, and that Pratt and Whitney had also made a late request to bid. My Private Secretary subsequently explained that both RR and GE had asked for longer in which to complete the terms of their offers. I thought that you and colleagues would find it helpful to have a further report now on where matters stand.

BA's management are still considering a comparison of the offers, and some matters are still being explored. The key elements of the analysis are as follows.

Technical Evaluation

BA have now completed their technical evaluation of the three offers. They quickly discarded the Pratt and Whitney offer. It was substantially less attractive commercially, and offered no compensating operational advantages. On purely technical grounds, BA's engineers believe that while the RR engine would do the job adequately, the GE engine would do a better one. However, some of the judgements made by BA's engineers have been questioned by the Government's own technical experts in the Ministry of Defence, and they are exploring these questions further with BA.

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

Commercial Evaluation

Both GE and RR have offered a complex package of concessions associated with this order. In GE's case the concessions relate mainly to tooling up costs and to free spare parts which would assist BA both in the servicing of the engines bought for the 747 and any future BA aircraft types using the GE engine, and to compete for third party engine overhaul work. In RR's case the concessions relate to modification work and discounts on spare parts on other variants of the engine already in service in BA's fleet. When these factors are taken into account the balance of advantage in BA's evaluation swings in favour of RR. Our probing of technical questions may improve RR's margin, but it is at present relatively small for so large a project and sensitive to many of the assumptions made.

Financing Terms

Both GE and RR have arranged for the aircraft acquisition to be by means of operating leases which would not appear on BA's balance sheet (or RR's). In both cases, BA would have the option to surrender the aircraft after 5 years and after 9 years. The second "window" is particularly important, because, in addition to the greater flexibility, it will give BA the opportunity to exchange relatively easily the 747-400 for a successor version if by that time the state of technology has developed further. However, in the event that BA do surrender the aircraft at 5 or 9 years and they are then sold for a price equivalent to less than the unexpired portion of the lease, the various parties to the agreement have to make good the difference to the organisations providing the finance in a predetermined order and proportion. In all cases, BA would have to meet the first layer of liability, but

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

in this respect the GE offer is slightly more attractive to BA at the 5 year point, and substantially more attractive to BA at 9 years. BA have asked RR to think again about this aspect of the offer, but as yet have not had a response.

Performance Bond

On the advice of their merchant bankers, BA have judged it prudent to ask RR for a performance bond, as a safeguard against non-delivery or non-certification of the engines. This investment by BA is expected to earn about 40% of their revenue. The order, at some £400m, is a very substantial one for RR in respect of its order book and current net worth. In these circumstances, and given the forthcoming privatisation of RR, my merchant bankers, Hill Samuel, advise that it is reasonable for BA to have asked for a bond to the value of the contract price. The bond so far offered by RR falls a long way short of this. BA have also asked GE for a performance bond, though given their very much greater net worth and order book they would not have judged it necessary in other circumstances to do so, and would not expect GE to have any difficulty in providing one.

Overall Investment Decision

I had hoped that it would prove possible to resolve the engine choice in advance of the overall decision on the size and timing of the order for new aircraft. However, both manufacturers have made their bids in relation to an order for 16 aircraft and there can be no certainty that the terms would remain the same for a smaller order. I do not think therefore that we can reach a decision on the choice of engine until BA have satisfied me that, on the basis of the normal tests

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

applied by Government to investment appraisals, the case for investment in 16 aircraft is justified. This will involve a complex evaluation of alternatives, and BA will not be able to complete this work until the middle of August.

Next Steps

If the BA Board were to come to a decision at their meeting on 1 August on the engine choice, I fear that the news would quickly leak and that we would also find ourselves boxed into giving approval for 16 aircraft irrespective of the strength of the case, because it would then be argued by BA and the manufacturers that the full order was needed to secure the terms on offer for the engine. The issues on the engine choice are in any case finely balanced, and I think it is essential to discuss the position further with Lord King before the Board next meets. I had a preliminary meeting yesterday at which he warned me about the problem on the performance bond, and I shall be seeing him again on 31 July.

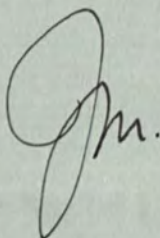
At our meeting I shall say to him that since the terms offered by the engine manufacturers have been based on an order for 16 aircraft, I want first to be satisfied that an order of that size is justified before the Board considers the question of the choice of engine, but I would not object if the Board wished to take their own decision that the order should be for 16 aircraft and not some other number before putting their full evaluation to me. I shall make it clear to Lord King that this issue must be resolved before we take a decision in September on the timing of BA privatisation. I shall also impress upon him the desirability of using the time available to iron out any remaining difficulties over financing terms.

CONFIDENTIAL
AND
COMMERCIAL IN CONFIDENCE

In my view, the best outcome would be if the BA Board were freely to be able to conclude that the company's commercial interest lay in ordering from RR. I understand that this order is important to RR, and that the consequences for RR's privatisation could be serious if they do not win it.

I am sure that the importance the Government attaches to the successful flotation of RR will not be lost on Lord King. But equally, the Board of BA have a duty to safeguard the company's commercial interests, and for me to require them to act in any other way on so major a decision would be very damaging for BA's privatisation prospects. It is therefore in everybody's interests that commercial logic and the Government's interests as owner of both companies should point in the same direction.

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



JOHN MOORE
30 July 1986

BA : Aerospace Pt 5.

