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Secretary of State for Trade and Industry

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30 July 1986

The Rt Hon John Moore MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
LONDON,  
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NBPN

Jean John

#### ENGINES FOR BRITISH AIRWAYS 747-400s

Thank you for sending me a copy of your minute of 30 July to the Prime Minister.

I am content with your proposals for handling the matter, involving a delay in BA's final consideration of the engine choice. It is however important to resolve this matter quickly, from Rolls-Royce's point of view as well as BA.

So far as BA's preliminary evaluation is concerned, I would make two points at this stage. First, as you say there are a number of features in BA's technical and operational analysis which are open to debate. These could have a material impact on the commercial evaluation. Second, even on the basis of BA's current evaluation, the financial margin in favour of Rolls-Royce is over £30 million, or nearly 12 per cent, in present value terms. I consider that a substantial advantage.

My principal concern is British Airways' request for a performance bond to the total value of the engine contract. It is not clear what BA's reasons are for seeking such a bond, which would I believe be unprecedented in the aircraft industry. The request seems to imply doubt on BA's part about Rolls-Royce's ability to continue its operations in the private sector. But the Board of Rolls-Royce could not issue a prospectus for privatisation next

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year unless they were sufficiently confident that the business would continue at least over the period within which the BA engines would be delivered; the Government has announced that it will ensure Rolls-Royce has an appropriate capital structure for its operations in the private sector; and Cathay Pacific have recently placed a major order for the engine in question, the D4D, without any such bond. If an overseas airline does not require such a bond, it seems perverse that BA should do so.

There may also be a question in BA's mind whether the D4D project is consistent with the collaboration agreement between Rolls Royce and GE. It is true that there was some concern on this point at a earlier stage. However, Rolls-Royce have a written agreement with GE which permits the continuation of the D4D project in parallel with the CF6-80C2 collaboration.

The implications for Rolls-Royce and the Government of R-R giving a performance bond for the full value of the contract could well be serious. The capital injection required by Rolls-Royce on privatisation would be substantially increased and the granting of the bond, which would have to be disclosed in the prospectus, would be regarded as indicating a lack of confidence in the company's future. Other customers would no doubt seek similar bonds in relation to future contracts with Rolls-Royce. It would therefore be damaging both to Rolls-Royce's commercial future and to the prospects for a successful privatisation.

Rolls-Royce have offered a limited bond calculated to cover BA against what they consider is a reasonable level of risk. I would hope BA and RR can reach agreement on this issue through normal commercial negotiation. But I believe we shall need to probe thoroughly the justification for a performance bond to the full value of the engines, if BA continue to press the case for it. In the meantime, I believe it would be right for you to tell Lord King that the Government has serious reservations about the request and will want to examine the case for it critically.

I look forward to discussing this matter with you tomorrow before your meeting with Lord King.

I am sending copies of this letter to the Prime Minister, the other members of E(A), the Secretary of State for Defence, and the Chief Whip, and to Sir Robert Armstrong.

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*Paul*

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PAUL CHANNON

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