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From the Minister for Trade

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

14 August 1986

WJM

John Moore

CHOICE OF ENGINES FOR BA'S 747-400'S

Thank you for sending Paul Channon a copy of your minute of 13 August to the Prime Minister. I am responding in his absence on leave.

I think he would have wished to record more clearly the misgivings which he has concerning both the guarantee of asset value and the performance bond which have been offered by Rolls-Royce. As you note, both these features carry implications for the capital injection which Rolls-Royce will require at privatisation. But the requirement for a performance bond also carries substantial risks: not just commercial risks (most obviously in respect of RR's future sales negotiations), but also the risk of adversely affecting potential investors' perception of Rolls-Royce if the impression was to be gained that the request for a bond implied a lack of confidence in Rolls-Royce's future. This could have an adverse effect on RR's share price. It must also be said that Samuel Montagu have expressed the view that a performance bond offers little real additional protection to BA, though I believe that Hill Samuel take a different view. However, despite the risks and despite the likely cost to Government implied by Rolls-Royce's offer, Paul Channon concluded that in the circumstances he would not wish to press these misgivings.

You minute touched finally on the subject of public announcements about this order. The terms of discussion about these arrangements will require careful handling to minimise potential damage to Rolls-Royce's position. As far as immediate announcements are concerned, I hope it will be possible to avoid any reference to the

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Rt Hon John Moore MP

August 1986

performance bond, though I agree that if the subject comes up, the response should be along the lines you suggest. In the longer term there will be questions relating to possible disclosure of certain aspects of the contract in both BA's and RR's prospectus and accounts, and I believe it will be essential to have the closest consultations between all concerned to ensure a consistency of approach in a situation where the immediate interests of the parties may be expected to show some divergence.

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

A handwritten signature in black ink, consisting of a stylized 'A' followed by a horizontal line and a downward-pointing arrow.

ALAN CLARK

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CFBS



Treasury Chambers, Parliament Street, SW1P 3AG

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

NSP

14 August 1986

Dear John

Choice of Engines for BA's 747-400s

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I have seen a copy of your minute of 13 August to the Prime Minister.

There are clearly many attractive features in the deal which BA and RR have been able to reach, and I do not dissent from your proposal to approve the investment or, on balance, with your view of the overall outcome. I would, however, like to make some comments on the disadvantages which the proposals involve.

If there were no prospect of BA leaving the public sector, I think we would need to think very carefully indeed about the terms of the lease. Unconventional finance for public sector investment nearly always involves additional costs by comparison with outright purchase. In this case, I understand that those costs may be equivalent to about 6 per cent of the total capital costs involved which amounts to a substantial sum in absolute terms. We therefore need to consider the justification for agreeing to a lease. In my view it would not be enough to point to the advantages to privatisation of having this investment financed off BA's balance sheet. The strong argument is that BA themselves see commercial benefit in the terms of the lease, particularly as regards the flexibility to return aircraft after 5 or 9 years and that point should be added to those mentioned in the last full paragraph of your minute about presentation.

I am of course pleased that Lord King has now firmly accepted that there will be no need for a capital injection into BA. But I am concerned at the prospect of our having to make a larger capital injection into Rolls Royce than we might

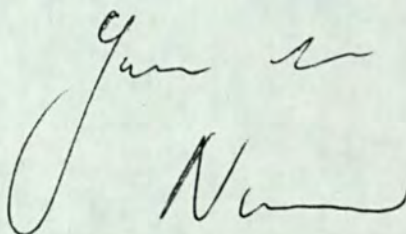
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otherwise have hoped for. - Whilst I can see that the factors you mention might call for some further strengthening of RR's balance sheet on privatisation, my officials will need to look into Samuel Montagu's arguments very fully. I would regard the figures you mention as the absolute maximum I could contemplate and agree to the proposals on that basis.

The performance bond is also a matter of great concern to me. Its very existence might be taken to cast doubt on RR's commercial viability. I am sure that in any immediate announcement of this deal we should avoid mentioning the performance bond, and indeed all the other detailed terms of the deal. I understand that these details will need to be included in both prospectuses when BA and RR are privatised, but it would be wrong to draw any special attention to the bond either now or then. If, despite all this, any questions are asked about the performance bond, we certainly need to make the points you suggest about the importance of the order to BA and the advice they received. We should also say that a similar bond would have been available from other competitors for the order, but I think we should avoid any reference to lack of confidence in RR unless it is necessary for defensive purposes.

I am sending copies of this to the recipients of your minute.

A handwritten signature in dark ink, appearing to read 'Norman Lamont', written in a cursive style.

NORMAN LAMONT

AEROSPACE ; Future of BA Pt. 5

PM's agreement conveyed to
DTI by TF 14-8-86

Duty
Clear
"PW

15
14/8

PRIME MINISTER

CHOICE OF ENGINES FOR BA'S 747-400s

I can now report that I have considered BA's investment case for 16 Boeing 747-400s and have concluded that all 16 should be approved; that BA and RR have reached agreement on the two points which were outstanding when I reported on 30 July; that on the basis of that agreement BA's management have now concluded that they should recommend that RR rather than GE engines should be ordered; that Paul Channon has considered the implications of the terms agreed for the privatisation of RR and has concluded that they are acceptable even though they may necessitate some increase in the capital injection which RR will require on flotation. Subject to your views and those of colleagues I would now propose to approve BA's proposal to acquire 16 Rolls Royce powered Boeing 747-400s on operating lease for delivery in 1989 and 1990. The proposal would also enable BA to acquire options on a further 12 of these aircraft but that would involve no commitment now or in the near future to exercising those options.

My officials have examined the investment appraisal with Treasury officials and they have concluded that the case for the investment is sound. You will recall that one of the outstanding problems between BA and RR was the terms on which exposure should be shared between them on any shortfall in the resale value of the aircraft compared with the unexpired portion of the lease, if the aircraft were turned back at 5 or 9 years. Further negotiation between BA and RR has produced terms which are mutually acceptable to the two companies, and which compare satisfactorily with the terms on offer from General Electric. The other outstanding problem, BA's request for a performance bond has also been resolved on terms acceptable both to BA and Rolls Royce.

I understand that Paul Channon has considered the implications of RR's offer for that company's privatisation, and that Samuel Montagu, DTI's merchant bank advisers on RR have advised that the guarantee of asset value given at the turnback points under the lease would create identifiable contingent liabilities which could require an additional capital injection for RR at privatisation - a figure in the range £20-40m has been suggested. I should however mention that BA believe that these contingent liabilities can be dealt with adequately by a note in their accounts, and that no strengthening of their balance sheet will be needed for the equivalent asset guarantee which they will provide.

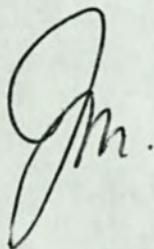
Samuel Montagu believe that the offer of the performance bond carries potential commercial risks for RR and that this too could lead to a requirement for additional capital at privatisation - a figure of up to £30m has been suggested for this element. Despite the risks and despite the likely cost to Government in terms of additional capital requirements for RR, I understand Paul Channon has concluded that it would be appropriate to proceed with the agreement.

I would also conclude that an increase in the capital injection which RR may require has been accepted. There are no better options: losing the order to GE would be more damaging to RR; insisting that BA accept an outright purchase rather than a lease would necessitate an injection to BA on flotation which would be far larger than the likely increase in the already planned injection to RR. As it is Lord King has accepted that with these financing agreements BA will need no capital injection or flotation.

Overall, I believe this represents a satisfactory outcome for the Government, and unless I have heard to the contrary by 10.00 am on 15 August I shall assume that you and other colleagues are content. I believe that the decision has to be taken quickly, because both engine manufacturers are pressing for an answer and the decision is likely to leak in any case if there is a delay.

The main public announcement must be for BA and RR to make. The deal is a commercial one freely negotiated between the two companies, and it is essential to the successful privatisation of both that a contrary impression should not be given. I would, however, propose to explain simultaneously with the companies' announcement that I have given BA investment approval for the order and to welcome it as good news for the future both of BA and of Rolls Royce. If asked about the performance bond, my Department and the DTI can make it clear that BA were advised to take this step, in view of the importance of the order to BA's business. But it implied no lack of confidence in RR's ability to complete the order or to trade profitably as a result of it.

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



JOHN MOORE

13 August 1986

FOLLOWING IS A MINUTE FROM JOHN MOORE ABOUT THE CHOICE OF ENGINES FOR BRITISH AIRWAYS. AS YOU WILL SEE HE IS NOW PROPOSING TO APPROVE BA'S PROPOSAL TO ACQUIRE 16 ROLLS ROYCE POWERED BOEING 747S FOR DELIVERY IN 1989 AND 1990. I UNDERSTAND THAT THE TREASURY ARE RECOMMENDING TO THE FINANCIAL SECRETARY THAT HE ACCEPTS THE PROPOSAL. DO YOU AGREE WITH WHAT JOHN MOORE PROPOSES SUBJECT TO COLLEAGUES? A DECISION IS NEEDED BY TOMORROW MORNING.

I CAN NOW REPORT THAT I HAVE CONSIDERED BA'S INVESTMENT CASE FOR 16 BOEING 747-400S AND HAVE CONCLUDED THAT ALL 16 SHOULD BE APPROVED SEMI COLON THAT BA AND RR HAVE REACHED AGREEMENT ON THE TWO POINTS WHICH WERE OUTSTANDING WHEN I REPORTED ON 30 JULY SEMI COLON THAT ON THE BASIS OF THAT AGREEMENT BA'S MANAGEMENT HAVE NOW CONCLUDED THAT THEY SHOULD RECOMMEND THAT RR RATHER THAN GE ENGINES SHOULD BE ORDERED SEMI COLON THAT PAUL CHANNON HAS CONSIDERED THE IMPLICATIONS OF THE TERMS AGREED FOR THE PRIVATISATION OF RR AND HAS CONCLUDED THAT THEY ARE ACCEPTABLE EVEN THOUGH THEY MAY NECESSITATE SOME INCREASE IN THE CAPITAL INJECTION WHICH RR WILL REQUIRE ON FLOTATION. SUBJECT TO YOUR VIEWS AND THOSE OF COLLEAGUES I WOULD NOW PROPOSE TO APPROVE BA'S PROPOSAL TO ACQUIRE 16 ROLLS ROYCE POWERED BOEING 747-400S ON OPERATING LEASE FOR DELIVERY IN 1989 AND 1990. THE PROPOSAL WOULD ALSO ENABLE BA *mm*

TO ACQUIRE OPTIONS ON A FURTHER 12 OF THESE AIRCRAFT BUT THAT WOULD INVOLVE NO COMMITMENT NOW OR IN THE NEAR FUTURE TO EXERCISING THOSE OPTIONS.

MY OFFICIALS HAVE EXAMINED THE INVESTMENT APPRAISAL WITH TREASURY OFFICIALS AND THEY HAVE CONCLUDED THAT THE CASE FOR THE INVESTMENT IS SOUND. YOU WILL RECALL THAT ONE OF THE OUTSTANDING PROBLEMS BETWEEN BA AND RR WAS THE TERMS ON WHICH EXPOSURE SHOULD BE SHARED BETWEEN THEM ON ANY SHORTFALL IN THE RESALE VALUE OF THE AIRCRAFT COMPARED WITH THE UNEXPIRED PORTION OF THE LEASE, IF THE AIRCRAFT WERE TURNED BACK AT 5 OR 9 YEARS. FURTHER NEGOTIATION BETWEEN BA AND RR HAS PRODUCED TERMS WHICH ARE MUTUALLY ACCEPTABLE TO THE TWO COMPANIES, AND WHICH COMPARE SATISFACTORILY WITH THE TERMS ON OFFER FROM GENERAL ELECTRIC. THE OTHER OUTSTANDING PROBLEM, BA'S REQUEST FOR A PERFORMANCE BOND HAS ALSO BEEN RESOLVED ON TERMS ACCEPTABLE BOTH TO BA AND ROLLS ROYCE.

I UNDERSTAND THAT PAUL CHANNON HAS CONSIDERED THE IMPLICATIONS OF RR'S OFFER FOR THAT COMPANY'S PRIVATISATION, AND THAT SAMUEL MONTAGU, DTI'S MERCHANT BANK ADVISERS ON RR HAVE ADVISED THAT THE GUARANTEE OF ASSET VALUE GIVEN AT THE TURNBACK POINTS UNDER THE LEASE WOULD CREATE IDENTIFIABLE CONTINGENT LIABILITIES WHICH COULD REQUIRE AN ADDITIONAL CAPITAL INJECTION FOR RR AT PRIVATISATION - A FIGURE IN THE RANGE £20-40M HAS BEEN SUGGESTED. I SHOULD HOWEVER MENTION THAT BA BELIEVE THAT THESE CONTINGENT LIABILITIES CAN BE DEALT WITH ADEQUATELY BY A NOTE IN THEIR ACCOUNTS, AND THAT NO STRENGTHENING OF THEIR BALANCE SHEET WILL BE NEEDED FOR THE EQUIVALENT ASSET GUARANTEE WHICH THEY WILL PROVIDE.

SAMUEL MONTAGU BELIEVE THAT THE OFFER OF THE PERFORMANCE BOND CARRIES POTENTIAL COMMERCIAL RISKS FOR RR AND THAT THIS TOO COULD LEAD TO A REQUIREMENT FOR ADDITIONAL CAPITAL AT PRIVATISATION - A FIGURE OF UP TO £30M HAS BEEN SUGGESTED FOR THIS ELEMENT. DESPITE THE RISKS AND DESPITE THE LIKELY COST TO GOVERNMENT IN TERMS OF ADDITIONAL CAPITAL REQUIREMENTS FOR RR, I UNDERSTAND PAUL CHANNON HAS CONCLUDED THAT IT WOULD BE APPROPRIATE TO PROCEED WITH THE AGREEMENT.

I WOULD ALSO CONCLUDE THAT AN INCREASE IN THE CAPITAL INJECTION WHICH RR MAY REQUIRE HAS BEEN ACCEPTED. THERE ARE NO BETTER OPTIONS COLON LOSING THE ORDER TO GE WOULD BE MORE DAMAGING TO RR SEMI COLON INSISTING THAT BA ACCEPT AN OUTRIGHT PURCHASE RATHER THAN A LEASE WOULD NECESSITATE AN INJECTION TO BA ON FLOTATION WHICH WOULD NBE FAR LARGER THAN THE LIKELY INCREASE IN THE ALREADY PLANNED INJECTION TO RR. AS IT IS LORD KING HAS ACCEPTED THAT WITH THESE FINANCING AGREEMENTS BA WILL NEED NO CAPITAL INJECTION OR FLOTATION.

OVERALL, I BELIEVE THIS REPRESENTS A SATISFACTORY OUTCOME FOR THE GOVERNMENT, AND UNLESS I HAVE HEARD TO THE CONTRARY BY 10.00 AM ON 15 AUGUST I SHALL ASSUME THAT YOU AND OTHER COLLEAGUES ARE CONTENT. I BELIEVE THAT THE DECISION HAS TO BE TAKEN QUICKLY, BECAUSE BOTH ENGINE MANUFACTURERS ARE PRESSING FOR AN ANSWER AND THE DECISION IS LIKELY TO LEAK IN ANY CASE IF THERE IS A DELAY.

THE MAIN PUBLIC ANNOUNCEMENT MUST BE FOR BA AND RR TO MAKE. THE DEAL IS A COMMERCIAL ONE FREELY NEGOTIATED BETWEEN THE TWO COMPANIES, AND IT IS ESSENTIAL TO THE SUCCESSFUL PRIVATISATION OF BOTH THAT A CONTRARY IMPRESSION SHOULD NOT BE GIVEN. I WOULD, HOWEVER, PROPOSE TO EXPLAIN SIMULTANEOUSLY WITH THE COMPANIES' ANNOUNCEMENT THAT I HAVE GIVEN BA INVESTMENT APPROVAL FOR THE ORDER AND TO WELCOME IT AS GOOD NEWS FOR THE FUTURE BOTH OF BA AND OF ROLLS ROYCE. IF ASKED ABOUT THE PERFORMANCE BOND, MY DEPARTMENT AND THE DTI CAN MAKE IT CLEAR THAT BA WERE ADVISED TO TAKE THIS STEP, IN VIEW OF THE IMPORTANCE OF THE ORDER TO BA'S BUSINESS. BUT IT IMPLIED NO LACK OF CONFIDENCE IN RR'S ABILITY TO COMPLETE THE ORDER OR TO TRADE PROFITABLY AS A RESULT OF IT.

I AM COPYING THIS MINUTE TO THE MEMBERS OF E(A) AND TO SIR ROBERT ARMSTRONG.

ENDS



PRIME MINISTER

CHOICE OF ENGINES FOR BA'S 747-400s

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

A handwritten signature in blue ink, appearing to be 'Jm.', is written above the typed name.

JOHN MOORE

13 August 1986

