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PRIME MINISTER

FUTURE OF ROLLS ROYCE

1 We accepted last year (MISC 22 (80)1) Lord McFadzean's broad strategy for Rolls-Royce (RR) on the understanding that it would allow the company to become profitable and that it would dispense with the need for additional public funds, apart from launching costs from time to time, by the end of 1982.

2 We recognised that there were substantial risks and in particular there was always a danger that RR could be severely squeezed. RR is the smallest of the three major aero-engine companies in a market which is uncomfortably small for three competitors. RR's rivals, General Electric (GE) and the Pratt and Whitney (P&W) subsidiary of United Technologies, are much larger and more widely based companies; United Technologies itself is the tenth largest industrial company in the United States. The civil market is dominated by US airlines and US airframe companies while the military market is dominated by American defence procurement. The continuing strength of sterling further underlines the risks. But the technical and marketing success of the RB211-535 engine on the Boeing 757 aircraft suggested that Lord McFadzean's strategy was well worth attempting.

3 The world recession has, however, significantly affected airline orders. RR has unexpectedly found itself competing with a new P&W engine (the PW2037) on the Boeing 757 and has failed to win two major orders from Delta and American Airlines. This and the loss,

again to P&W, of the contract to supply the engines on the Airbus A300s ordered by Saudia has underlined the risks in Lord McFadzean's strategy and in particular the risks of being the smallest of the engine producers in the market. RR needs to respond soon to these developments. A decision will also be required within a few months on whether RR should be permitted to proceed with its Japanese partners on a new engine, the RJ500, which is also likely to meet head-on competition from both the US companies. Inevitably the RJ500 would require more public money and we ought to look at the alternatives before the Government becomes committed.

4 The alternatives are stark. It is likely that a continuation of RR's existing go-it-alone strategy will mean continuing expense for the taxpayer and cut-throat competition with the large US companies. On the other hand, it has always been clear that it would be almost impossible for RR to achieve a gradual and cheap withdrawal from the civil market because, if there were any doubt about RR's long term future in the business, there would be a rapid collapse in customer confidence at great cost to the taxpayer.

5 Events may now, however, have given us a relatively fleeting third option based on some sort of association between P&W and RR that might perhaps be acceptable politically, financially and even to RR itself. The new option arises because, in order to break into the market for the engines for the Boeing 757 aircraft, in which RR had a head start, P&W have given extravagant guarantees about the extent to which their new engine will improve on the fuel

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efficiency of the RB 211-535 engine. If the two companies continue in head-on competition and the RB 211-535 enters service with sufficient fuel economy for the P&W guarantees on the PW 2037 to be called, the cost to P&W would be between $\$\frac{1}{2}$ and $1 billion in respect of contracts taken so far. P&W's commercial strategy appears to be based on the assumption that they can prevent the RB 211-535 (except in its earliest version) from entering airline service, thereby preventing their guarantees being called. P&W are bending every effort to undermine RR's position by, for example, casting doubt upon our willingness as a Government to back RR until the RB 211-535 enters production. No doubt P&W hope to recover the cost of this strategy in the less competitive market which would result from the elimination of RR as a competitor. This is a high risk strategy and the extent of P&W's exposure means that United Technologies may be more willing than previously to agree to terms for an association which we could accept.

6 There is every prospect of continuing competitive battles between the companies, which will ensure that neither company will secure the return on investment it would otherwise expect. Moreover, if RR and its Japanese partners launch the RJ500 engine, this would lock RR into still wider headlong competition with P&W. The costs of RR's go-it-alone course cannot be quantified but on past experience they would be high and the prospects of any return is at best uncertain. I think that in these circumstances it would be right to explore the possibility of an alternative strategy based on an association between RR and P&W.

7 Quite independently, the Department of Industry has been approached

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by Warburgs acting on behalf of P&W with the suggestion that an association with RR might be attractive to P&W. Warburgs have suggested such a link might form a basis for privatisation of RR but their thinking on this point has been only rudimentary so far.

8 There are obvious drawbacks to such a proposal. I have little doubt that RR, and Lord McFadzean in particular, would strenuously oppose a deal; they would see it as the end to their independence and would expect P&W to be the senior partner. There is the significant UK defence interest to be taken into account. There is also no assurance that a reasonable deal can be struck. To have any chance of success we would need to convince P&W, and their parent company, United Technologies, that, in the absence of a reasonable deal, the Government would back RR to the hilt in their competitive strategy and that the RB 211-535 will indeed go into service with sufficient fuel efficiency for the P&W guarantees for their PW2037 engine to be called (but we are in effect committed to such expenditure already). It is also a course which involves a major risk, since P&W could leak it to RR's customers as part of their strategy of destroying confidence in RR's future; indeed P&W may have approached Warburgs with precisely this idea in mind. There are also severe doubts as to whether RR could in practice secure a stake in any new company which would be politically acceptable without huge costs to the UK taxpayer. I am clear, however, that, if we do not take this chance, we shall be locked into a continuing competitive battle between RR and their American rivals which is unlikely to show us a good return

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on investment and which could in the end force RR out of the civil aerospace market at high cost financially and politically. I am sure, therefore, that we should at least try to examine the idea seriously.

9 I have arranged to see Lord McFadzean on 23 February when I propose to put the idea to him. In all the circumstances, however, I would expect him to need considerable persuasion to approach the issues constructively. When Norman Tebbit and I meet you on Wednesday, I shall want to explore with you how far we should press this idea.

10 I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Defence, to Sir Robert Armstrong and Robin Ibbs.

KJ

K J
17 February 1981

Department of Industry
Ashdown House
123 Victoria Street

17 FEB 1981

For Mark 2 meeting

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MR LANKESTER

FUTURE OF ROLLS ROYCE

You asked for a quick reation to Sir Keith Joseph's minute of 17 February to the Prime Minister about Rolls Royce. This note has been discussed and agreed with Robin Ibbs.

2. The Secretary of State reports that Rolls Royce are now locked in a fierce competitive battle with Pratt & Whitney (P&W) which is adding substantially to the risks and financial pressures which they already faced. This competition is reflected not only in lost orders which Rolls Royce had a good expectation of achieving, but also in heavy guarantees given by P&W to their customers that their engines will be more fuel-efficient than the Rolls Royce alternatives. P&W's exposure on this account is believed to lie between $\frac{1}{2}$ billion dollars and a billion dollars in respect of contracts so far taken. In the midst of this situation the Department of Industry has been approached by Warburgs, acting on behalf of P&W, with the suggestion that an association with Rolls Royce might be attractive to the American company - though with no indication whatever of what form such an association might take. Sir Keith Joseph has little doubt that Rolls Royce, and Lord McFadzean in particular, would strenuously oppose such a deal - not least because previous experience of co-operation between Rolls Royce and P&W has not been happy. And indeed there is a suspicion that the approach is only being made since such talks could assist P&W in destroying confidence in Rolls Royce's future.

3. Nevertheless, Sir Keith Joseph sees the possibility of an association between the two companies as a possible alternative to either continuing and substantial Government support or to the possible competitive defeat of Rolls Royce driving them from the civil aerospace market. He is due to meet Lord McFadzean on 23 February and, subject to your views, would propose to float the idea of an association with P&W. But before doing so he would like guidance on how far he should go in pressing Rolls Royce to adopt a constructive response to the P&W approach.

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4. There are difficult issues of judgement here. On the one hand, collaboration could reduce the vulnerability of public funds either to supporting Rolls Royce in the competitive battle or to the costs of substantial rundown if the battle is lost or conceded. On the other hand, the politics of appearing to deliver Rolls Royce, and its industrial expertise, into the hands of an American competitor are not easy. Nor can we be certain, in the present state of knowledge, who would win the competitive battle, bearing in mind both P&W's exposure to their guarantees and technical uncertainty about whether Rolls Royce or P&W have chosen the best long-term route to successful engines.

5. There is also the danger that exploratory talks, however delicately conducted, might slip over imperceptibly into real negotiations. If this were to happen it would be essential that Rolls Royce had worked out in advance a clear idea of what the options were for them - sale to P&W, merger with P&W, joint ventures on particular projects and so on - and related questions like the vulnerability of any deal to American anti-trust regulations. It is less easy for the Government to be clear about its reaction to particular proposals before their shape has become apparent. But this too would have to be established before any commitments were made.

6. In short, it is difficult to fault Sir Keith Joseph's recommendation that, given the approach from Warburgs, there should be some direct contact between Rolls Royce and P&W. On the other hand, it would also seem essential that before such talks take place (particularly if they involve Lord McFadzean himself) Rolls Royce should clarify their minds as to what is on and what is not on, both from their point of view and from that of Ministers. In other words it may be right to urge Lord McFadzean to talk to P&W; but it would be very important to remain totally uncommitted until Rolls Royce had assessed the merits of whatever P&W had put forward and he had cleared his lines with Ministers.

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Cabinet Office
18 February 1981

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PRIME MINISTER

c.c. Mr. Whitmore
Mr. Lankester

The Secretary of State for Industry and Mr. Tebbit would like to come to see you for fifteen minutes next week, to discuss a meeting they are having on Monday 23 February with Lord McFadzean to discuss the future policy for Rolls Royce.

CAROLINE STEPHENS

11 February 1981