

CONFIDENTIAL

P.01078

PRIME MINISTER

Rolls Royce RB211 - 535 Engine Programme
(E(A)(83)5)

BACKGROUND

This memorandum by the Secretary of State for Trade and Industry, with an accompanying note by officials, seeks approval for launch aid for a development of the Rolls Royce (RR) RB 211 -535 jet engine. ("Launch aid" is Government financial assistance towards the capital costs of an aerospace project, usually recoverable by means of a levy on sales).

2. There are two main versions of the RB 211 engine:

i. The -524 This is intended for large aircraft such as the Lockheed Tristar and the Boeing 747. Both the main American manufacturers - Pratt and Whitney (PW) and General Electric (GE) - have similar engines. The -524 is a poor third in the market: the Tristar programme has been terminated; PW and GE have markedly stronger positions in the 747 market; and the -524 is not well suited to the new wide-bodied twin-engined aircraft (Airbus 300 and 310; Boeing 767).

ii. The -535 This is a smaller derivative of the -524. Its only application at present is powering the Boeing 757, for which the original version of the -535 was "lead engine". The initial US competition came from GE, who subsequently withdrew. But PW entered the competition with a brand new design (the PW 2037). To match the performance guarantees offered on this engine by PW, RR were obliged to produce an improvement of the -535, known as the RB 211 -535 E 4. It is this version which is the subject of E(A)(83)5.

3. RR have applied for £102 million of launch aid, spread over the years 1983 to 1985. The Secretary of State for Trade and Industry, while supporting the

CONFIDENTIAL

CONFIDENTIAL

application in principle, does not ask for a specific figure, but seeks authority to "provide only the minimum figure which will restore RR's cash flow to a level where the company can proceed with both the E 4 and its rationalisation programme". Trade and Industry officials (paragraph 51 of the note by officials) suggest that £89 million should be maximum.

4. The Secretary of State asks that the launch aid he negotiates should be financed from the Contingency Reserve, in other words, that he should not be required to find offsetting savings elsewhere in his programme.

5. Treasury officials oppose any launch aid, on the grounds that the project is not viable. The assessment by officials suggests that the proposed E 4 development will earn at least the 5 per cent real rate of return regarded as the acceptable minimum for public sector projects and should therefore be regarded as viable. However the Treasury argue that, although it is not usual when assessing additions to existing projects to take into account the earlier "sunk costs", it is relevant to look at the -535 programme as a whole. The earlier versions of the -535 engine generated virtually no income and this, in their view, raises the possibility that the investment on the E 4 project could also be lost.

MAIN ISSUES

6. The main issues before the Sub-Committee are as follows:

- i. Should the Government allow RR to continue with the E 4 or require cancellation?
- ii. If the Government allows the project to continue, should it provide launch aid?
- iii. If launch aid is provided, what should be its maximum amount?
- iv. Should the amount eventually agreed be provided from the Contingency Reserve?

Continue or cancel?

7. If Ministers consider that the project is not viable, then the logical course is to require RR to cancel it. The main considerations here are:

- a. the viability of the project; and
- b. the implications of cancellation for RR's strategy.

Viability

8. The assessment in the note by officials suggests that on most plausible scenarios, the E 4 development should earn a satisfactory rate of return. It would therefore usually be accepted as viable. The counter arguments which the Sub-Committee may wish to consider are as follows.

- i. Risk All aerospace projects are risky; and the possibility of significantly less favourable outcomes than those considered in the note by officials cannot be ignored. For example, PW might be able to achieve substantial further technical improvements at low cost; or the Boeing 757 might sell badly. On the other hand, things could go more favourably than assumed. PW might run into serious technical trouble; or new applications for the - 535 might emerge.
- ii. Need for more money later Historical experience suggests strongly that further injections of cash will be needed for the - 535 programme in order to secure further technical advances. This point is discussed at some length in paragraph 15 of the note by officials. On the other hand, if PW spend more money to improve their engine, they will need to recover it through a higher price. RR will then be able to increase their price. It therefore seems reasonable to accept that further money will probably be needed for the - 535 programme, but not to assume a priori that such money cannot secure an economic return.
- iii. Money already lost on the - 535 project It is undeniable that the original - 535 engine has made no money. But that investment is already lost. The case for the additional expenditure on the E 4 project has to be

CONFIDENTIAL

looked at on its own merits. Past experience properly suggests that future sales forecasts should be viewed with considerable scepticism. But after making all proper allowances the report by officials suggests that the additional expenditure on the E 4 project should earn a satisfactory rate of return.

Strategy

9. The effect of cancelling the E 4 would almost certainly be that RR would pull out of the market for large civil aero-engines. As noted earlier, the prospects for the - 524 version of the RB 211 are poor; and the original version of the - 535 would not sell in competition against the PW 2037. RR should be able to make a living in other sectors of the engine market, though no doubt on a significantly smaller scale than now. But the Sub-Committee will wish to assess the effects on RR's commercial standing if they pulled out of a competition in which they have only one opponent and a strong position as suppliers of the lead engine.

Launch aid

10. If the Sub-Committee decides that it would not be right to require RR to cancel, the question of launch aid arises. The Treasury argue that it is a proper posture for the Government to put the onus of continuing with the project on RR who would then have to try and accommodate it within their cash limits and financial targets by reducing or postponing lower priority activities.

11. By common consent however the E 4 project is vital to the future of RR, which is wholly owned by the Government. If it succeeds the company will have maintained its position as a major producer of civil aero-engines. If it fails the company will be in serious trouble. To allow the project to continue without providing adequate resources would seem to be the worst of all worlds.

12. It could be argued that there is a case for at least delaying a decision until the new Chairman and Chief Executive, Sir William Duncan, has been able to reassess RR's product strategy. RR have gone ahead with the E 4, even though there has been no answer to their request for launch aid since February 1982; and it is most improbable that they would stop now. If they have no assurance of



CONFIDENTIAL

launch aid, they may be more likely to take a realistic and rigorous view of other priorities. Against that, it may be argued that RR have already been subjected to serious delay and that it would be wrong to ask them to continue against a background of financial uncertainty.

13. A possible compromise, if the Sub-Committee favours giving launch aid, might be to tell RR that the Government is in principle willing to give aid but will not decide the amount until it has been able to review the company's prospects on the basis of the review of product strategy to be completed in the autumn.

Amount

14. If the Sub-Committee agrees that launch aid should be given, but regards a general assurance to that effect as insufficient, it will be necessary to give the Secretary of State for Trade and Industry negotiating guidelines. You will not wish the Sub-Committee to discuss the detailed figuring. But it might be as well to establish the general basis for the negotiations.

15. In effect, the Secretary of State for Trade and Industry wishes to negotiate with RR as if it were a private sector company, with a view to giving the minimum amount of launch aid consistent with a prudent commercial approach to cash flow and balance sheet ratios. At official level, the Treasury have argued on occasion for a radically different approach: bridging the gap between agreed capital requirements and internal resources, as if RR were a nationalised industry. This would mean a significant change in policy towards RR, which has so far been regarded as eligible for assistance on the same footing as a private sector aerospace undertaking. It might also be difficult to reconcile with the aim of privatisation.

Contingency Reserve

16. The Secretary of State for Trade and Industry proposes that whatever launch aid may eventually be agreed should be found from the Contingency Reserve - that is, that he should not be required to find any offsetting savings from within the rest of his public expenditure programme. The Treasury argue that any expenditure should be accommodated within the Department's existing baseline. You will probably wish to ask the Secretary of State to resolve this with the Chief Secretary, Treasury as part of the bilateral discussions agreed by the Cabinet for the next stage of the Public Expenditure Survey.

CONFIDENTIAL

Community implications

17. Because launch aid is repayable, the Government does not regard it as a State aid or notifiable as such to the Commission. Neither we nor our other European partners usually notify assistance for aerospace projects.

HANDLING

18. You will wish to ask the Secretary of State for Trade and Industry to introduce his memorandum and the Chief Secretary, Treasury to reply. The Foreign and Commonwealth Secretary can advise on the international implications of a decision to cancel the E 4. The Secretary of State for Defence will have views both on the technical aspects of the programme and the effects of cancellation on RR's military business. The CPRS have been active in investigating the programme; and Mr Sparrow will be able to advise the Sub-Committee both from that standpoint and as the Chairman of the Official Group on Rolls Royce (MISC 25). The Attorney General has been invited to deal with any legal points.

CONCLUSIONS

19. You will wish the Sub-Committee to reach conclusions on the following.

i. Should the Government allow Rolls Royce to continue to develop the RB 211 - 535 E 4, or require cancellation?

ii. If it does not require cancellation, should it be prepared in principle, to offer launch aid?

iii. If so, is it willing to allow the Secretary of State for Trade and Industry now to negotiate an amount of launch aid? Within what limits? Or should a decision on the amount wait until Sir William Duncan has completed his review of strategy?

iv. Should any launch aid for the E 4 be a charge on the Contingency Reserve as proposed in E(A)(83)5? Or should this be pursued by the Secretary of State for Trade and Industry and the Chief Secretary, Treasury, in their bilateral public expenditure discussions.

P L GREGSON

26 July 1983

CONFIDENTIAL