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Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY

1-19 VICTORIA STREET

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13 February 1984

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street  
London SW1

*D Nigel*

ROLLS-ROYCE: PERFORMANCE RELATED BONUS SCHEME

Under the arrangements which Patrick Jenkin and Geoffrey Howe agreed at the beginning of 1982, Rolls-Royce Ltd are required to consult me on the remuneration of the highest paid officer of the company (currently Sir William Duncan), but not on any other executive pay. When Sir William Duncan was appointed, it was agreed and announced in Parliament (20 April, 1983) that a performance-related bonus scheme would be introduced which would allow him to earn a bonus of up to £25,000 on a basic salary of £125,000. Rolls-Royce have now submitted such a scheme for my approval. A copy of the scheme is attached; some further details obtained in correspondence with Rolls-Royce are reflected in what follows.

The scheme is intended to apply to all executive directors and about 20 other senior executives, although it is only in the case of Sir William that our approval is required. It has two elements:

- i a Corporate Performance Element (CPE), which will be the same (as a percentage of salary) for each member of the plan;
- ii a Personal Performance Element (PPE) dependent on personal achievement.

The CPE will be expressed as a percentage of salary in the range  $2\frac{1}{2}$ - $12\frac{1}{2}$ %, and will be determined by reference to the financial duty which we set for the company. The intention is that set levels of achievement above the agreed objective should trigger CPEs within the given range. If these levels of achievement are not met, then clearly the CPE would be zero.

The PPE for each executive will be a number in the range 1-2 which will be determined by personal achievement in relation to job description. Indicative examples prepared by RR's consultants demonstrate that PPEs can be set in a sensible and reasonably objective way. A fixed PPE multiplier may be set for



some executives whose functions do not lend themselves readily to objective setting, including the Chairman, whose PPE will be set at 2.

The PPE and CPE multiply together, so that

$$\text{Bonus} = \text{Salary} \times \text{CPE} \times \text{PPE}$$

and the bonus will thus lie between 0 and 25% of salary. One consequence of this structure is that no bonuses at all will be paid unless the company as a whole surpasses the target we set for it. In Sir William's case a maximum figure of £25,000 would be set. I believe that this is a reasonable basis for a scheme.

I have been assured by the Chairman that the non-executive members of the Board will have a formal and full role to play in the operation of the scheme when the restructuring of the non-executive membership is completed this year. With this clear involvement of the non-executives from 1985 onwards I believe I should give RR the clearance required for the early introduction of the new arrangements.

Unless you or E(NI) colleagues, to whom I am copying this letter, see reason to object, therefore, I propose to approve the scheme (insofar as it applies to Sir William Duncan) with a formal role for the non-executive directors.

A handwritten signature in dark ink, appearing to read 'Norman', with a horizontal line underneath.

NORMAN TEBBIT

13 APR 1984

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STAFF IN CONFIDENCE

PERFORMANCE RELATED BONUS FOR SENIOR EXECUTIVES

1. The objective of the bonus plan is to improve corporate performance and therefore only those senior executives whose personal contribution has, or should have, a direct affect on corporate policy or results will be included.
2. At the level of management to be covered, the basic salaries should be such as to compensate fully for good performance. These basic salaries are assumed to be at the appropriate levels in relation to the market place. The performance related element will therefore apply only to the achievement of significantly better than satisfactory results. The quantum of benefit will itself be significant for such performance, with a ceiling. Any bonus payment will be at least 5% of base pay and the ceiling will be 25%.
3. The coverage is to be the Chairman, other executive Board members (currently six) plus a maximum of twenty other senior executives who report direct to Board members and are closely associated with the policies and actions of those Board members. (Executive positions likely to be covered are annexed).
4. The bonus will be comprised of two elements:
  - i) a Corporate Performance Element (CPE) - constant in salary percentage terms for all members of the plan;
  - ii) a Personal Performance Element (PPE) - dependent upon personal achievement measured by clearly identified factors related to the executive's personal job function.
5. The CPE will be related to how well the Company itself performs in relation to objectives set for it. Agreement between the Company and HMG of a financial duty based on a simple percentage of average net operating assets and a percentage return on net operating assets would offer a simple and appropriate method of assessing performance. Alternatively, if other measures of overall Company performance are agreed with HMG these would be the basis. The concept of quantification of CPE would be for each level of achievement above the agreed financial duty objective to trigger a CPE salary percentage in the range of 2½% to 12½%.
6. The PPE would then be based upon a single or multi factor measurement of personal achievement and would represent a multiplier in the range of 1 to 2. When determined, this multiplier would be applied to the CPE percentage to establish the actual percentage of base pay as a total bonus for each executive. All executives would receive the formula produced CPE percentage which itself would never be less than 50% of the executive's total bonus: it may in fact be appropriate in the initial period of the plan for the CPE percentage to be a higher proportion, say 75%, of the total bonus.

7. In the case of the Chairman, as his performance can only be assessed for this purpose by reference to total corporate performance, his PPE multiplier will be fixed at 2. His personal total bonus range would therefore be 5% to 25%, dependent upon the CPE percentage.
8. A similar fixed PPE multiplier will be appropriate to other executives whose job functions do not lend themselves readily to objective setting. Such cases do not need to have a fixed multiplier of 2, but could be in the range of 1 to 2 according to seniority. The recent reorganisation of management structure will, however, enable appropriate personal objectives to be set and thus the establishment of a personal performance formula to determine individual PPE multipliers. The criteria upon which such objective setting is based will include profit achievement, loss control, productivity, cash control, manpower objectives within the various cost centres and for which the individual executives are responsible.
9. The Chairman will be responsible for setting the formula by which the CPE percentage is determined as soon as the financial duty for the year in question is agreed with the Department of Trade and Industry. The PPE objective setting will involve each executive personally, principally between the person to whom an individual reports and that individual. All proposed PPE formulae will be reviewed by the Chairman in consultation as appropriate, before being agreed.
10. The plan will relate to the financial year commencing 1st January 1984. Its implementation will take place during the first quarter of 1984. The details of its coverage beyond the Board will be confidential.

2nd January 1984

EXAMPLES OF LIKELY COVERAGE OF BONUS PLAN

All executive members of the Board

Operations Director - Civil Engine Group

Commercial Director - Civil Engine Group

Operations Director - Military Engine Group

Marketing Director - Military Engine Group

Director of Design - Corporate Engineering Group

Director of Advanced Technology - Corporate Engineering Group

Director of Purchasing - Supply Group

Director of Manufacturing Technology - Supply Group

Director of Manufacturing Operations - Supply Group

Company Treasurer - Finance

Director of Repair and Overhaul

Director of Corporate Strategy

Director of Personnel

Company Secretary

Director of New Business - Corporate Engineering Group

Director Industrial and Marine Group

Director of Engineering - Civil Engine Group

Director of Systems and Computing

ECNO



NIBPM AD 9/3

Treasury Chambers, Parliament Street, SW1P 3AG  
 01-233 3000

8 March 1984

The Rt Hon Norman Tebbit MP  
 Secretary of State for Trade and Industry  
 Department of Trade and Industry  
 1-19 Victoria Street  
 LONDON SW1

*John Norman*

ROLLS-ROYCE: PERFORMANCE RELATED BONUS SCHEME

You wrote to me on 13 February, with details of Rolls-Royce's proposals for a performance related bonus scheme. You will subsequently have seen Nick Ridley's letter of 28 February raising some more general points on which I shall be replying separately.

*will require  
 14 required*

I welcome the introduction of an incentive element into the pay of the company's senior staff, and I have no objection to the scheme's basic structure which relates the bonus to both company and individual performance. However, I am doubtful about one important detail. Setting the PPE indicator base at one would enable an executive whose individual performance was sub-standard nonetheless to get a bonus related to the company's overall performance. This problem could be overcome if the PPE base were set at zero; an executive who had not performed well would then get no bonus at all.

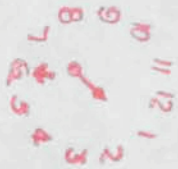
I appreciate that the company are only formally obliged to consult you about Sir Willian Duncan's pay and that this element of the scheme would not apply to him. Nevertheless, I think the point is still worth making to Rolls-Royce and I hope you will be able to persuade them to amend the scheme as I have suggested.

Copies of this letter go to the other members of E(NI) and to Sir Robert Armstrong.

*John Norman*  
*Nigel Lawson*

NIGEL LAWSON

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9  
MAY 1984





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JU24

Secretary of State for Trade and Industry

26 March 1984

APPOINTMENTS IN CONFIDENCE

NBPM

AT 26/3

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
Treasury Chambers  
Parliament Street  
London SW1P 3AG

*D. Nigel,*

ROLLS-ROYCE: PERFORMANCE RELATED BONUS SCHEME

Thank you for your letter of 8 March on this subject. The point you make about the possibility of a bonus for an executive whose performance is sub-standard is one which my officials had already raised with the company. Sir William Duncan's view is that if people fall short of satisfactory performance it is their basic salaries or their jobs themselves which should be adjusted. While you may not regard this as a complete rebuttal of your point, it does indicate that Rolls-Royce have thought about the issue which is, as you say, one on which they are not formally obliged to consult us. In addition, I understand that for 1984 only the corporate element of the scheme will operate, i.e all personal performance elements will be set as 1, so that the maximum bonus possible will be 12½% of salary. I understand that this results at least partly from the difficulty of establishing criteria for evaluating individual performance while the new company organisation is still settling down.

2 In view of all these factors, I intend to write to Sir William along the lines of the attached draft. I should be glad to know if you are content with this.

3 I am copying this letter to the other members of E(NI) and to Sir Robert Armstrong.

*Norman Tebbit*

NORMAN TEBBIT

JU25

DRAFT LETTER TO

Sir William Duncan CBE  
Rolls-Royce Limited  
65 Buckingham Gate  
London SW1E 6AT

APPOINTMENTS IN CONFIDENCE

PERFORMANCE RELATED BONUS SCHEME

Mr Warrington wrote to my officials on 3 January 1984 and subsequently on 11 January about the proposed performance related bonus scheme. I am replying, since this is a subject in which I have taken a personal interest.

I am happy to approve the scheme insofar as it applies to your own salary, and I note your intention to apply it also to certain senior staff. There is, however, one point which has emerged in our consideration of the scheme. This is that under the scheme as currently proposed an executive whose individual performance was less than satisfactory could still receive a bonus related to the company's overall performance. I know that you feel that the way to cope with unsatisfactory performance is not primarily through the bonus scheme, and also that only the corporate element of the scheme will operate in 1984. Nevertheless, I should be grateful if you could look again at this point in determining the future development of the scheme.

NORMAN TEBBIT

Ind Pol. : Future of RR : P22

26 Nov 1984





STAFF IN CONFIDENCE

ANNEX C.

## ROLLS-ROYCE LIMITED

65 Buckingham Gate, London SW1E 6AT, England  
Telex: 918091  
Telephone: 01-222 9020

11th January 1984

P.J. Casey Esq.,  
Department of Trade & Industry,  
Ashdown House,  
123 Victoria Street,  
London SW1E 6RB.

*9 11/1*  
Dear Peter,

### Performance Related Bonus Scheme

Reference your letter of 9th January, I hope the comments below clarify matters.

First, as I indicated, the PPEs have yet to be finalised and will vary from post to post. However, I think the appendix to this letter, which was part of the consultant's report on the scheme, indicates the sort of approach (we believe the consultant has been over elaborate but will be adjusting, with his assistance, the principles he has used).

Second, the scheme would not be implemented without the formal approval of the Board's five non-executive directors. Furthermore, although the operation of the bonus scheme is in the hands of the Chairman initially, he is in course of consulting the non-executive Board members fully on the scheme, in advance of formal Board approval to ensure all are in support. Looking further ahead, the Chairman is at present restructuring the non-executive membership, as you know, and at this stage he is not ready to have a formal remuneration committee of non-executive directors. However, this is planned for establishment during 1984 and will then deal with remuneration of the Board and most senior executives, including operation of the bonus scheme. The role of non-executives was not detailed in the letter and note I sent you, but you can assume that by referring to an earlier decision of the Board in the cover letter this means the Board will act formally on adoption of the scheme; and that the mention of appropriate consultation in paragraph 9 of the note means consultation and agreement with the non-executive directors. The Chairman agrees fully with the comments you made about the importance of the non-executive directors.

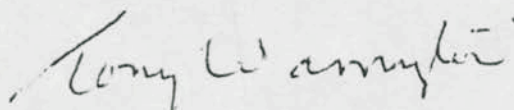
Continued...

Third, there is the issue of the emphasis, for the first year at least, on the importance of the Company's overall performance compared with an individual's performance. Although the new structure of management is aimed at greater individual responsibility, there is a long way to go in accounting and other terms in establishing the new structure, while at the same time ensuring responsibility for the well being of the Company as a whole is not lessened. Similarly, in at least the first year, there is no doubt that the Chairman's own contribution is crucial and therefore would put the limit to what bonuses others might achieve.

It is relevant to repeat the comment in the paper that the basic salaries, without bonus, are assumed to be at the appropriate levels in relation to the market place. These basic salaries have been assessed in relation to the greater responsibilities in the new organisation, with its smaller number of executive members, and in relation to both Hay assessments and remuneration in engineering firms generally. They are now appropriate to the market place, and the bonus scheme will only relate to achievement of significantly better than satisfactory results, a hard task, particularly in the coming year; and if people fall short of satisfactory their basic salaries or jobs themselves will be adjusted accordingly.

Finally, as regards the maximum bonus appropriate to the Chairman, the formula in his contract did say a bonus of up to 25% but we did agree separately to express this as up to £25,000. I have discussed this with the Chairman and we will put the ceiling of the scheme in the following terms: "the ceiling will be £25,000".

Yours sincerely,



A. Warrington

PPE FACTORS - DIRECTOR SUPPLY

Based upon the attached Job Description we would advise that the following factors would be appropriate as a measurement of personal performance. The percentages are given merely as examples and will need further consideration.

	<u>PPE % Multiplier</u>	
	<u>Reduced</u>	<u>Maximum</u>
	<u>Performance</u>	<u>for Factor</u>
<u>Purely objective factors</u>		
1. Job Description Item 3:		
Cash Limits not exceeded		50%
+1%	45%	
+2%	40%	
+3%	35%	
By more than 3%	0%	
2. Job Description Item 8:		
Profit Objectives:-		
-5% to +5%	5%	
+5% to +10%	10%	
+10% to +20%	15%	
over +20%		20%
<u>Factors with some element of subjectivity</u>		
3. Job Description Item 2:		
Achievement of all agreed time, quality and cost objectives for delivery to Business Groups		30%
Time failure up to 5%	20%	
by more than 5%	0%	
Costs up by up to 5%	20%	
by more than 5%	0%	
Quality failure	0%	
		----- 100% -----

For factor 3 the overall performance of the supply function may be objectively measured by comparison with whatever existing management control statistics are available, e.g. standard reject rates or standard costings. If necessary such standards could be evaluated or, for example, a management time control structure developed which might reflect contractual penalty clauses for late delivery which the Business Groups may have with their customers.

This type of non-financial factor can be measured objectively but such objectivity leads to measurement complexity. To reduce such complexity it would be necessary to introduce some element of subjectivity which must be introduced only as a matter of corporate philosophy. Subjectivity can be applied by higher management (e.g. by the Chairman in the case of board members) or by "peer group" judgement (e.g. in the case of the Supply Director by his "customers" the directors of the Business Groups).

In the setting of the objectives for any factor there may be genuine disagreement over the level of the objective itself between the individual and his manager (either party thinking the other's view is too optimistic or too cautious). This problem may be solved by adopting a matrix technique which could adjust the PPE percentage multiplier for each factor depending on both results and the view taken by the individual executive of each objective. An example of such a matrix is as follows:-

Objective considered appropriate by Director or supply expressed as a percentage of the Chairman's objective	Actual Results achieved as a %age of objective considered appropriate by Chairman				
	80%	90%	100%	110%	120%
80%	40%	60%	85%	100%	105%
90%	30%	75%	90%	105%	110%
100%	20%	70%	100%	110%	115%
110%	0%	55%	95%	115%	120%
120%	0%	40%	90%	110%	125%

The percentages shown would be applied to the PPE %age multiplier shown for the specific factor.

If this matrix technique is applied the commitment of executives to the introduction of a performance related element in their remuneration package is likely to be enhanced. Its application in the example shown could however increase the PPE factor to a maximum of 125% thus lifting the bonus ceiling to 28.125% of salary. This can of course be eliminated by applying a maximum PPE factor of 100%, even though the matrix applies to individual factors.



## ACCOUNTABILITY STATEMENT

## DIRECTOR - SUPPLY

Purpose of Job

To direct the provision of the components required by the Civil and Military Engine Groups. To oversee the Company's Industrial and Marine activities.

In addition he will be responsible for the Company's Employee Relations activities and for the administration of those sites solely concerned with Supply activities.

Reports to

Chairman

Principal Accountabilities

1. Manage all the manufacturing and purchasing activities of the Company for aero components.
2. Deliver components ordered by the Business Groups at the required time and quality and at a cost which is comparable to world-wide levels, and to plan a capability in keeping with the Business Groups' requirements.
3. Manage the Supply Group within cash limits agreed with the Chairman.
4. Provide Personnel, Employee Relations and Site Services for all personnel on Supply only sites.
5. Operate within the framework set by relevant legislation and by Corporate policies. Seek advice from the appropriate Corporate professional head on the appraisal and salary reviews of senior personnel and agreement on senior appointments.
6. Define the corporate Employee Relations and Administration policies and co-ordinate their execution, excluding Organisational and Management Development.
7. Provide a Building, Plant and Equipment service for each Site.

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8. Oversee the Rolls-Royce Limited Industrial and Marine business, define its financial, commercial and technological performance goals and monitor their achievement.
9. Develop and maintain an organisational structure suited to the needs of the allocated tasks and staffed by competent individuals whose performance objectives are clearly defined.

PPE FACTORS - DIRECTOR CORPORATE ENGINEERING

The same general comments apply to this case stated on the Factor Sheet for the Director Supply and this sheet should be read in conjunction with those general comments.

PPE % Multiplier

Reduced                      Maximum  
Performance              for Factor

Purely objective factors

1. Job Description Item 1:

Achieved within + or -1% of budget		35%
+ or -2% of budget	30%	
+ or -3% of budget	25%	

2. Job Description Item 4:

Achievement of financial return objectives on specified opportunities agreed with Chairman		20%
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Factors with some element of subjectivity

3. Job Description Item 2:

Achievement of specified new project developments to an objective agreed with the Chairman		30%
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4. Job Description Item 8:

100% compliance with all air-worthiness procedures within agreed time scales		5%
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5. Job Description Item 10:

100% compliance with Company's requirements		5%
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6. Job Description Item 13:

100% implementation of Product Assurance policies		5%
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## ACCOUNTABILITY STATEMENT

## DIRECTOR - CORPORATE ENGINEERING

Purpose of Job

To direct the advancement of the Company's technology base and the development of new product concepts. To be the technical authority for the Company's products and the test facilities required for their development. To be the authority for Engineering appointments and the most effective use of Engineering resources. To contribute to the formulation of the Company's Product Strategy.

In addition he will be responsible for the Company's Product Assurance activities.

Reports to

Chairman

Principal Accountabilities

1. Formulate and direct the Research, Technology and Advanced Engineering programmes necessary to improve the Company's technology and manufacturing competitiveness within agreed budgets.
2. Direct the development of new projects up to the stage where engineering responsibility can be transferred and they have been allocated as committed projects to one of the Engine Groups. Agree with the Business Groups the Engineering content of all project business plans. Provide technical resource and assistance to the Business Groups.
3. Carry the formal responsibility for Design with the attendant Authority throughout the Company.
4. Seek opportunities outside the aero engine field for the Company to obtain a financial return on its existing investment in aero engine technology.
5. Define the forward Engineering, Computing, Experimental and Test resources needed to satisfy the total Company Engineering programme.
6. Direct the formulation and approval of the forward plans for all Engineering and associated computing and test facility capital investments.
7. Formulate budgets and plans for the Corporate Engineering Group, monitor progress towards programme objectives and conformity to agreed costs.

8. Define Engineering policies, procedures and standards and audit compliance. Ensure compliance with all appropriate airworthiness procedures.
9. Define the present and future Company requirements for professional engineers and within the framework of the Corporate Personnel policies ensure arrangements for their sourcing, professional development and succession. Review the professional performance of Engineering staff throughout the Company, advise on the appraisal and salary reviews of senior Engineering personnel and agree appointments.
10. Conduct engineering audits of major new Company commitments or initiatives and reviews of major project problems and ensure that the professional engineering standards of the activities in the Business groups (including Industrial and Marine) meet the Company's requirements.
11. Operate within the framework set by relevant legislation and by Corporate policies. Seek advice from the appropriate Corporate professional head on the appraisal and salary reviews of senior personnel and agreement on senior appointments.
12. Promote the Company's image in technology.
13. Establish Product Assurance policies for the Company and assure their implementation.
14. Develop and maintain an organisational structure suited to the allocated tasks and staffed by competent individuals whose performance objectives are clearly defined.

.....  
Chairman

IND. POL.  
Interview of R. Reyle  
p62.