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PRIME MINISTER

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Rolls-Royce Financing

(MISC 22(80) 1)

BACKGROUND

This paper by Sir Kenneth Berrill recommends funding Rolls-Royce for the 1980-81 financial year, so that they can carry out their corporate plan for the time being, while Sir Frank McFadzean reviews their strategy. He is due to report on this by the summer.

2. There is only £10 million in PESC for Rolls-Royce in 1980-81 (after allowing repayment of loans). Rolls-Royce now want a further £140 million. The difference is caused by high levels of inflation, the exchange rate and Rolls-Royce's working capital, all of which were discussed by Ministers last autumn.

Rolls-Royce are assuming they will obtain a further £90 million of funding from the private sector during the year. Officials are recommending that Rolls-Royce should try to increase further their borrowing from the private sector so as to reduce the extra direct Government expenditure if possible to below the £140 million. But if they fail to do so, it means a maximum of £122 million (i.e. £140 million at 1980 Survey prices) from the Contingency Reserve.

3. Officials from all Departments broadly agree about the need for this interim funding. Without it, there would be a hiatus in financing until Sir Frank McFadzean had reviewed his strategy; and any resulting publicly expressed doubts about Rolls-Royce's future could be damaging for customer confidence and Rolls-Royce's order position. Also, because of the long lead times in ordering, it is unlikely in any case that Sir Frank's review will make much difference to next year's funding requirements, since these largely represent commitments which Rolls-Royce entered into over the last two to three years.

HANDLING

4. After asking Sir Kenneth Berrill to introduce his paper, you will want colleagues' views - particularly those of Sir Keith Joseph and the Chancellor - on:-

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- (a) Sir Frank McFadzean's review. Are there any pointers to his likely conclusions? Is he likely to propose any radical changes of direction? One such change has already been introduced, namely Rolls-Royce no longer take on orders unless on average these break even at \$2.20 to the pound. Do Ministers agree that he should be asked to cover the specific points mentioned in paragraph 9 of Sir Kenneth Berrill's paper?
- (b) Financial risks. Rolls-Royce are bound to remain vulnerable to changes in the exchange rate and inflation, because of tough American competition. They could be vulnerable to strike action because of the need to increase production levels to meet buoyant demand. What is Sir Keith Joseph able to report on Sir Frank McFadzean's general view of these risks?
- (c) Short-term funding. Has the Chancellor any comments on the implications for the Contingency Reserve? What are the real prospects of Rolls-Royce increasing their borrowing from the private sector?

CONCLUSIONS

5. You may like to record conclusions on each of the recommendations A-G at the end of Sir Kenneth Berrill's paper. In particular you may want to agree -

- (i) That the potential call of £122 million on the Contingency Reserve for 1980-81 should be accepted - though the precise figure will depend on further discussions between Sir Keith Joseph and Treasury Ministers and how much more Rolls-Royce can borrow from the private sector.
- (ii) On any specific pointers which might be given to Sir Frank McFadzean about the elements Ministers would want him to cover in his review (e.g. as in paragraph 9 of the paper).

REA

ROBERT ARMSTRONG

11th March, 1980