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PRIME MINISTER

I have now received from Sir Frank McFadzean the Rolls Royce Corporate Plan incorporating their long term strategy which we agreed at MISC 22 (3rd Meeting) that I should seek. The Plan has been considered by an interdepartmental group of officials under the chairmanship of the Director General of the Central Policy Review Staff. I enclose a copy of the report which this group has prepared.

2 It is clear that Rolls Royce did not explore fully the possibility of radical alternatives to their present policies. So far as their present engines are concerned, however, the choice is effectively between continued exploitation, which will involve work to keep pace with their competitors, or fairly quickly dropping out of the civil market. It would be fine if our current support leads to a high technology winner that quickly becomes profitable - as the Plan assumes. However the Plan does not explain in detail how this is to be achieved. We shall need to study the Operating Plan due this autumn to reach a judgment; and we shall have to insist on profit.

3 So far as starting on a wholly new engine type is concerned, I think that officials are right to conclude that we should ensure that the company really review all the options fully - including a partnership with Pratt and Whitney as well as the Japanese on an engine to meet the market at which the RJ500 is aimed.

4 I accept that the possible divesting of helicopter engines and of nuclear activities should be considered when the studies referred to have been completed.

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5 So far as the Industrial and Marine Engine business is concerned, I propose to discuss with Sir Frank McFadzean the scope for some sort of partnership with a private sector concern. This is a course Rolls Royce themselves favoured earlier and one that seems to me more realistic than outright sale.

6 I should be glad to know whether you, and the other members of MISC 22 to whom I am copying this minute, agree to my giving a first response to the corporate plan on the lines recommended by officials and my own views set out above.

7 I am sending additional copies of this minute to Sir Robert Armstrong and Mr Ibbs.

KJ

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6 August 1980

Department of Industry
Ashdown House
123 Victoria Street

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ROLLS ROYCE'S LONG TERM STRATEGY

1 Introduction

As agreed earlier this year (MISC22 (80) 3rd Meeting) the new Chairman of Rolls Royce was requested to submit a report on the Company's long term strategy which was to examine alternative policies that could be adopted to ensure both a viable future and a much reduced dependence on public funds. In addition to examining specified ways of achieving that objective he was also asked to consider the possibility of the Company disposing of some of its peripheral activities. The strategic plan was submitted last month to the Secretary of State for Industry. This report sets out officials' comments on the major issues of the plan, sets out recommendations for the Government's initial response, and proposes further work to be carried out with the Company.

2 The plan sets out the broad strategy which the Company proposes to follow over the next decade. It is not designed to seek approval for specific new projects nor for specific sums of money. Separate submissions will be made in relation to major projects when the Company wishes to enter firm commitments, and approval of funding will have to await more concrete operating plans which the Company will draw up to implement its overall strategy. Ministers accordingly need at this stage to consider whether the broad strategy is acceptable as a basis for the preparation of an operating plan for the next 2 years in the light of the broad financial prospects which the Company foresee.

Summary of Company's Proposed Strategy

3 More than half of the Company's business at present is in military engines. They foresee limited prospects for growth in this side of their business over the next decade. However they foresee buoyant demand for civil engines and consider that the

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strong technical reputation which the RB211 has established over the last decade and particularly its current fuel efficiency compared with its competitors makes them well placed to expand the civil side of their business. The rapid growth in sales shown in the first two years of the forecast (but not thereafter) are virtually covered already by firm orders. But they are clear that the continued exploitation of the RB211 family during this period will require progressive developments to keep it abreast of the competition and to keep in line with the developing needs of the customers. They conclude, however, that for this strategy to be acceptable the business will have to become profitable, which will require raising productivity to the levels of their US competitors. The central feature of their plan, therefore, is the continued exploitation and development of the RB211, together with an ambitious set of measures designed to reduce the real cost of the engine compared with its competition.

4 In addition the Company foresee that to retain their position in the size of engine below the RB211 family they will need to introduce during the decade a new engine to replace the Spey, and, as endorsed by Ministers last winter (MISC22(79)4th Meeting), are working with the Japanese on pre-launch feasibility studies for this engine, designated RJ500.

5 In the plan the Company set themselves an objective to break even in cash flow terms after 1982 on the assumption that launch aid will be separately provided for major new developments, such as the RJ500. Despite this objective the plan does not demonstrate that it can be achieved, because it does not attempt to provide a cash flow forecast for the 10 year period. It provides a broad projection at constant economic conditions (i.e without forecasting price changes) and assuming a constant £2.20 exchange rate. It is also on the basis of the continued waiver up to 1984 - to which the Government have not agreed - of levies to recoup earlier launch aid on RB211 sales. Figures on this simplified

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basis show break even from 1983 after allowing for launch aid of £16m in that year for the planned RF500, with an increasing surplus in subsequent years. The Company believes that a broadly similar picture would remain after making reasonable assumptions for inflation, but the detailed work necessary to substantiate this has not yet been carried out. A proper judgement of the Company's financial prospects must depend on the completion of such forecasts allowing for inflation. So far such forecasts have only been attempted on a provisional basis for 1981 and 1982. These forecast for 1981 and 1982 after allowing for inflation (but still at \$2.20 exchange rate) shows a requirement for continuing substantial external finance in those years (provisionally put at roughly £250 million over the 2 year period). A fuller summary of the plan and of the financial projections is attached in the Annex (see especially paras 5 and 6). This provisional external financing requirement compares with the £270 million which has been committed for 1980.

Alternative Strategies

6 While the strategy examines the scope for making existing policies more profitable, it does not identify an alternative strategy for maintaining its civil business. Although we have pressed them on this point, Rolls conclude that any variant of their policy for the RB211 which still maintained that sector of their business would be more expensive than their present strategy; the only alternative in their view is a progressive withdrawal from the civil engine business.

Views of Officials on Overall Strategy

7 If the Company's existing civil business is to be maintained, officials accept the basic feature of the Company's conclusion that there is little alternative to continued exploitation of the RB211 family of engines. The Company has extensive commitments for this family of engines which could not be broken without putting its whole future in question. If the RB211 family is to be successfully exploited it is realistic to foresee a need

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for continued improvements to the family through the decade. Officials do, however, recommend that the Company should give deeper consideration than it appears they have done to the possibility of collaboration on the proposed new intermediate engine with Pratt and Whitney as well as with the Japanese. This issue is covered in more detail in paragraph 10 below.

8 There are, however, very substantial risks to the success of the Company's strategy. First it is very sensitive to the future of the dollar/sterling exchange rate. Their forecast of progressive improvement in financial results is based on an exchange rate of \$2.20, which may be unrealistically low for the earlier years. Second, they are vulnerable to inflation in this country being higher than in the United States, although the projection is based on inflation in both countries being at the same level. Although they are pursuing policies to reduce their sensitivity to the exchange rate this and comparative inflation rates will remain critical factors for the Company. Third, there are risks to their sales. We do not take serious issue with Rolls' assessment of their sales prospects, except for the RJ500, which we consider are too optimistic. We accept that there is no present reason to foresee major technical changes which would invalidate the market prospect. But any of their sales forecasts could be affected by unexpected developments in airline demand, for example if the recession proved deeper than expected or if Lockheed suffered a serious financial crisis. Finally, the plan assumes striking improvements in productivity, especially bearing in mind that two-thirds of manufacturing costs will be borne by sub-contracts. No allowance is made for internal or external industrial disputes. (A fuller assessment of these risks is contained in the Annex). There is thus no guarantee that their objective of break-even in cash flow terms by 1983 will be met.

*Of course
this is obvious.*

*There can't
be a guarantee*

9 Officials advise, therefore, that the major issue for Ministers is whether the financial prospects set out in the Annex, taking

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account of the risks, are an acceptable basis for the Company to continue to exploit its RB211 family of engines. The alternative would be the progressive withdrawal from their civil business, which, in the Company's view, would put their military capability at risk in the longer term. The Company have indicated that there is no lower-risk strategy which would meet the objective of remaining a world-scale manufacturer of aero-engines.

However there is a significant risk that they will not meet their annual figures for profitability and cash flow implied by the financial projections in the plan.

Recommendation 1. We should accept in principle the Company's strategy of continued exploitation of the RB211 family. But the Company should be told now that their detailed plan due in the autumn must substantiate the objectives for cash flow and profitability which they have set themselves in the Corporate Plan.

RJ500

10 The major development foreseen by the Company in the next decade is a new intermediate sized engine in collaboration with Japan. This would inevitably involve very acute competition with the two major US competitors, General Electric and Pratt and Whitney. We have considerable doubts whether the market is large enough to sustain three competing designs. We also see it to be in the long term national interest for Rolls to try to work towards an alliance with one of the US majors, rather than continue in direct competition. Such collaboration with the US is being pursued successfully by the French. The resources required for aero-engine development are so large as to make it doubtful whether the UK can expect to preserve an independent role in the long term. Since Rolls Royce already have collaborative agreement with Pratt and Whitney on the Pegasus military engine, and since there seems no scope for collaboration on an intermediate engine with General Electric, who, in collaboration with the French, already have a new engine of this size, it seems right to explore

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thoroughly all prospects of producing any new intermediate engine in conjunction with Pratt and Whitney as well as the Japanese.

Recommendation 2. Ministers should repeat their previous warning to Rolls-Royce that they are doubtful whether Rolls' present plan for the RJ500 will prove acceptable, and should ask the Company to explore and report on the possibility of linking with Pratt and Whitney as well as the Japanese for any new engine in this class.

Peripheral Activities

11 The strategic plan considers the possibility of disposing of each of the three parts of the business which could most easily be separated - the Industrial and Marine Division (IMD), the helicopter and small engine business, and the nuclear activities.

- a IMD. The Company argue that disposal of IMD would not be practicable because of the very close inter-relationship with its gas turbine business, and reject the idea of closing down the industrial business. We think this should be studied further.
- b Helicopters and Small Engines. The Company are of the view that it is beneficial to their business for them to produce helicopter as well as fixed-wing aero-engines provided that the future volume of business will be sufficient. The proceeds from disposal would in any event be insignificant. The size of their future market in this field is very dependent on decisions by the Ministry of Defence, who are their largest customer. MOD are reviewing their future requirements, and it is not possible to take decisions on the future of this part of the business until that review has been completed.
- c Nuclear business. The Company regard this as a possibility for disposal. Officials of the Department of Energy, in conjunction with the Department of Industry and Ministry of Defence, are considering whether there is a case for

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bringing these companies valued at almost £7m by Rolls Royce, into the civil nuclear industry while protecting defence interests.

We recommend that this exercise should continue separately with a view to consulting Ministers in due course.

Recommendation 3. Further consideration should be given to possible disposal of IMD and helicopter and nuclear businesses.

Further Work

12 The strategic plan raised a number of detailed points about future financing arrangements, control of military exports and other matters. These do not require decisions at this stage, and it is recommended that they be pursued individually outside the framework of the corporate plan.

13 Among the issues requiring further study is the consideration of a new financial duty on the Company, to replace that previously set on the NEB. (This was for a return on capital of 10% by 1981 with a progressive increase thereafter). This can be best considered on the basis of the operating plan to be submitted by the Company later in the year.

Summary of Recommendations and issues for consideration

Recommendation 1. We should accept in principle the Company's strategy of continued exploitation of the RB211 family. But the Company should be told now that their detailed plan due in the autumn must substantiate the objectives for cash flow and profitability which they have set themselves in the corporate plan.

Recommendation 2. Ministers should repeat their previous warning to Rolls Royce that they are doubtful whether Rolls' present plans for the RJ500 will prove acceptable, and should ask the Company to explore and report on the possibility of linking with Pratt and Whitney as well as the Japanese for any new engine in this class.

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Recommendation 3 Further consideration should be given to possible disposal of IMD and the helicopter and nuclear businesses following further work.