



PRIME MINISTER

ROLLS ROYCE AND AIRBUS

Rolls-Royce foresee a reasonable chance of persuading the Saudi Arabian airline to choose the RB211, rather than the competing US engines, to power a large number of European Airbuses which it has decided to buy. In principle, such a link between Rolls-Royce and Airbus is very desirable, but it does raise some difficult issues. These have been considered by an interdepartmental group of officials under the chairmanship of Robin Ibbs, who are in agreement that Rolls should be authorised to go ahead in competing for this order, but in view of the seriousness of the issues, I am writing to make sure that you and other colleagues are content.

Having studied the officials' report (MISC 25 (80) 9), it seems clear to me that the commercial and financial case for authorising RR to proceed is compelling even if, as is assumed, Rolls-Royce have to fund the cost of developing the pylon by which their engine would be attached to the aircraft. However, there is a major problem, arising from the financial arrangements, of additional costs to Airbus Industrie (AI) that, under the present AI system, could be expected to fall either on British Aerospace or on the Government. These could in the extreme range up to an annual subsidy of £18 million and a need to provide finance for work in progress of £69 million and thus outweigh the commercial benefits to Rolls-Royce and the political benefits of demonstrating our commitment to a European aerospace industry and providing positive evidence of an improved relationship with Saudi Arabia.

/My...



10 DOWNING STREET

Tun

I have told Industry
that letter as
amended by 10/10
can now go. (They
are in a hurry as
McFidyeau is leaving
for Saudi Arabia)

Yours



My own conclusion is that we have no alternative but to take the matter step by step. Since it is clear that the outcome of the negotiations with our Airbus Industrie partners will not be known for some considerable time and, indeed, will be difficult to urge forward until RR have been positively selected by Saudia for their Airbus purchase, we should allow RR to enter the competition on the understanding that:

- a) a final decision will depend on the contractual details between RR and AI and between AI and its partners;
- b) we do not accept that all the RR launch costs should be met by Government.

This will permit us to see whether, in fact, RR can secure the Saudia order, allow more time for negotiations with the AI partners on changes in the financing system and ensure that if, at the end of the day, the financial outcome is still unacceptable, at least some of the blame can be laid on the intransigence of our French and German partners. It will also clearly be necessary to ensure that the Saudis understand what we are doing, so that a withdrawal of all RR offers does minimum damage to our relations. I would suggest that officials from the Department of Industry and the FCO should liaise closely on this.

... If you are content, I would propose to write to Frank McFadzean in the terms of the attached draft. I would, of course, consult colleagues again before any commitments were undertaken and in the



light of the proposals made by RR and the negotiations on the AI financing system.

I am sending copies of this minute to the Foreign Secretary, the Chancellor of the Exchequer, the Secretaries of State for Defence, Employment, Trade and Energy, Sir Robert Armstrong and Robin Ibbs.

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30 September 1980

Department of Industry
Ashdown House
123 Victoria Street
London SW1



DRAFT LETTER FOR THE SECRETARY OF STATE FOR INDUSTRY TO SEND TO:

Lord McFadzean of Kelvinside
Rolls-Royce Ltd
65 Buckingham Gate
LONDON
SW1E 6AT

ROLLS-ROYCE AND AIRBUS

You wrote to me on 30 July concerning the opportunity to launch the RB211 on the Airbus.

I have now been able to give thought to the issues involved and to consult my colleagues.

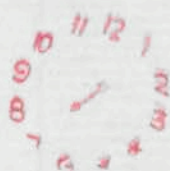
I fully recognise the strong commercial reasons behind your desire to pursue the Saudia Airbus contract and recognise that it is consistent with the strategy set out in the recent Corporate Plan. Moreover, the financial return from the expected investment more than meets the guidelines we have discussed for RR projects. I agree, therefore, that the company should pursue the Saudia contract, although in doing so but I must emphasise that I cannot at this stage accept the additional costs to RR from the programme will be met by Government. Given the priority which you obviously give to securing an outlet for the RB211 on the Airbus, I would expect that the company would endeavour to forego other expenditure of lesser priority in order to contribute to investment. No doubt this can be examined in the context of the Company's operating plan when this is put to the Department.



As I think you may be aware, the financial arrangements for the Airbus programme are such that use of the Rolls-Royce engine might have financial implications for British Aerospace. The nature of the implications will, of course, have to be resolved by those concerned in the Airbus programme, and is not, as such, a matter for Rolls-Royce. You should know, however, that the question could have important consequences for the UK interest in the Airbus programme, and a satisfactory outcome to it will be necessary before contracts can be concluded between Airbus Industrie and Rolls-Royce. We shall, of course, be using our influence within the Airbus programme to try to secure such a satisfactory outcome, but for the moment it is a hurdle that is still to be crossed.

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Finally, in view of the complex nature of the issues and HMG's involvement in the Airbus programme, I would be grateful if you would keep me closely in touch with developments. Likewise, if I or officials in the Department could be of assistance to you, especially in negotiations with Saudia, I am very willing to help.

30 SEP 1980



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10, DOWNING STREET

From the Private Secretary

6 October 1980

Rolls Royce and Airbus

Your Secretary of State minuted the Prime Minister on 30 September on the above subject. This is just to confirm that the Prime Minister was content with his proposal to write to Lord McFadzean subject to the amendments to the draft proposed by Robin Ibbs in his minute of 2 October (a copy of which you received).

I am sending a copy of this letter to George Walden (Foreign and Commonwealth Office), John Wiggins (HM Treasury), Bryan Norbury (Ministry of Defence), Richard Dykes (Department of Employment), Stuart Hampson (Department of Trade), Julian West (Department of Energy), David Wright (Cabinet Office) and Gerry Spence (Mr. Ibbs' Office).

T. P. LANKESTER

Ian Ellison, Esq.,
Department of Industry

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2/8

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Prime Ministry
All Departments are agreed that this contract is worth pursuing (though RR will have to re-order their priorities). The CPAs have suggested a slight strengthening of the proposed letter to Frank MacFadzean, which seems sensible.
Content?

Qa 05144

To: PRIME MINISTER
From: J R IBBS

After letter & Ph. 14th amendments - not

Rolls Royce and Airbus

Flug A

1. As the Secretary of State for Industry records in his minute of 30 September to you, the interdepartmental group of officials under my chairmanship has considered this question. I do not dissent from the recommendations of the Secretary of State which embrace the main caveats recommended by officials, but wish to bring one or two points to your attention and to make some suggestions on the draft of the letter to Lord McFadzean.

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2. The commercial case from Rolls Royce's point of view for fitting their engines on the Airbus seems to be sound on the basis of the figures provided by the company, although there must as always be some elements of risk and uncertainty. Also, while it is broadly consistent with the general commercial strategy set out in their recent corporate plan, it is not consistent with their financial strategy. Indeed, they are asking for further finance (of the order of up to £30 million over four years) and it is reasonable that Rolls Royce should meet this by re-ordering their priorities. There is also the possibility - not mentioned in the Secretary of State's minute - for some financing from the Saudis in return for a share of future profits. This would ease the financing burden and should be encouraged, provided suitable terms could be negotiated.

*i.e. they will have to cut back somewhere else.
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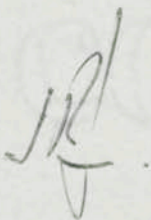
3. Because of the complicated financing arrangements within Airbus Industrie, consequential costs from fitting Rolls Royce engines would fall to British Aerospace. These are uncertain but could be quite large (perhaps as much as £7 million per annum as a form of subsidy plus costs for financing additional working capital). With a more equitable financing system in Airbus Industrie this would be shared by all the partners in the consortium. Every effort should be made to persuade the French and German partners to agree to change the system. Unless this can be achieved the Rolls Royce project would not from an overall viewpoint be financially acceptable.

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4. It would be wrong at this stage to prevent Rolls Royce from undertaking preliminary negotiations for the Saudia contract. However, it is important that, right from the beginning, both Rolls Royce and the Saudis understand clearly that no agreement can be completed until the financial arrangements within Airbus Industrie have been renegotiated to our satisfaction. For this reason I suggest that Rolls Royce be invited to secure the Saudis' preference for their engines subject to further negotiation. Support from the FCO will be necessary to explain the position fully to the Saudis. It is important to ensure that the responsibility for any subsequent failure falls to the Airbus Industrie consortium and not ourselves and that, if necessary, we could withdraw with the minimum of diplomatic embarrassment.

5. In the light of these comments I attach suggested amendments to the draft letter to Lord McFadzean.

6. I am sending copies of this minute to the Foreign Secretary, the Chancellor of the Exchequer, the Secretaries of State for Industry, Defence, Employment, Trade and Energy, and to Sir Robert Armstrong.



2 October 1980

Att

ROLLS ROYCE AND AIRBUS

Suggested amendments for the draft letter from the Secretary of State for Industry to Lord McFadzean.

Paragraph 3, the first sentence to read:

'I appreciate the strong reasons behind your desire to pursue the Saudia Airbus contract and recognise that it is broadly consistent with the commercial strategy set out in the recent corporate plan.'

Paragraph 3, add to end:

'I note that there is a possibility of Saudia^{Airbus}/contributing 50 per cent of the cost of the certification programme on a risk sharing basis. I am content for you to pursue this further to see whether acceptable terms can be negotiated.'

Paragraph 4, add to end:

'It is essential that the Saudis should understand that if you persuade them to express a preference for the RB211 engine, implementation of this will depend upon satisfactory negotiations between Rolls Royce and Airbus Industrie and also between British Aerospace and its Airbus Industrie partners.'

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2 OCT 1980

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