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Chancellor's (Lawson) Papers:
The Future of the Rolls Royce Group.

DD's: 25 Year

26/1/96.

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RESTRICTED

FROM: J M G TAYLOR
DATE: 28 January 1988

MR BENT

cc PS/Financial Secretary
Sir P Middleton
Mr Monck
Mr D J L Moore
Mr Beastall
Mrs Brown

NAO REPORT ON ROLLS ROYCE PRIVATISATION

The Chancellor has seen the reports in yesterday's papers about the NAO's report on the Government's handling of the Rolls Royce privatisation. He would be grateful for a note on this.

J M G TAYLOR

27 January 1988

PRIME MINISTER

Jonathan

~~AT~~ pse let me have a note on Lawson (p9)

MAIN EVENTS

Prime Minister interviewed by The Star

TUC

Labour Party NEC - nurses' strike motion, Bermondsey constituency expulsion

EC: Economic and Social Committee, Brussels (to 28 January)

STATISTICS

DOE: Construction - new orders (Nov)

DOE: Bricks and cement production and deliveries (4th qtr prov)

PUBLICATIONS

DES: Report by HM Inspectors on the TVEI Initiative in Staffordshire - A survey of the shared business experience element

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PARLIAMENT

Commons

Questions: Scotland; Foreign and Commonwealth; Trade and Industry

Business: 10 Minute Rule Bill: Telephone Talkabout (Abolition)
Opposition Day (8t allotted day). There will be a debate on an Opposition Motion entitled "The Government of Scotland"
Opposition Prayer on the Statement of Changes in Immigration Rules
Income and Corporation Taxes Bill (Lords): Remaining Stages (CONSOLIDATION MEASURE)

Adjournment Debate: The proposed take-over by Barker and Dobson plc of the DEE Corporation (Mr G Lofthouse)

Select Committees: TRADE AND INDUSTRY
Subject: The Post Office Inquiry
Witness: The Post Office

SOCIAL SERVICES
Subject: Resourcing the NHS
Witnesses: The National Association of Health Authorities of England and Wales

EDUCATION, SCIENCE AND ARTS
Subject: The Arts
Witnesses: Rt Hon Richard Luce MP, Minister for the Arts and officials from the Office of Arts and Libraries

EMPLOYMENT
Subject: The Work of the Department of Employment Group
Witnesses: Rt Hon Norman Fowler MP, Secretary of State for Employment and Mr John Cope MP, Minister of State for Employment

PARLIAMENT (Cont'd)

HOME AFFAIRS
Subject: Broadcasting
Witness: British Broadcasting Corporation

PUBLIC ACCOUNTS
Subject: Computer Security in Government Departments
Witness: Mr John Anson, Second Permanent Secretary (with responsibility for public expenditure), HM Treasury

ENVIRONMENT
Subject: Air Pollution
Witness: Central Electricity Generating Board

FOREIGN AFFAIRS
Subject: Gulf Issues and General Political Aspects of Arms Control Progress
Witness: Rt Hon Sir Geoffrey Howe QC MP, Secretary of State, Foreign and Commonwealth Office

TREASURY AND CIVIL SERVICE
Subject: The Government's Expenditure Plans 1988-89 to 1990-91
Witnesses: HM Treasury officials

JOINT COMMITTEE
PRIVATE BILL PROCEDURE
Witnesses: Sir Eldon Griffiths MP and Mr Andrew F Bennett MP

COMMITTEE ON PRIVATE BILLS
UNOPPOSED BILLS
1. University College, London
2. Keble College, Oxford
3. Selwyn College, Cambridge

Lords
Starred Questions
Debate to call attention to land use and sea use in and around Scotland (E Perth)

Debate to call attention to the report of Sir Philip Woodfield and his team on the supervision of charities

UQ to ask HMG whether they propose to give financial assistance to British Rail to enable it and the Regions of the United Kingdom to realise to the full any benefits of the opening of the Channel Tunnel

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MINISTERS - See Annex

PRESS DIGEST

MAIN NEWS

Government unveils plan to stop bullying in the Army - **Star** claims victory for its campaign. **Mail**: Agony Aunts for the Army - members of WRVS to be recruited as shoulders to cry on.

New anti-tank brigade to be formed to block Soviet penetration.

You are seen to be getting to grips with the NHS, with anything and everything up for consideration.

Nalgo members expected to walk out on February 3, too. Kinnock defied by two front benchers, one a health whip, who support projected strike.

Today quotes RCN spokesman as saying it is difficult to see how Government will keep review body if they give up no-strike pledge.

Conservative Backbench Finance Committee urges Chancellor to stick to tax cuts in Budget.

Sun describes it as jackpot time for GB Ltd with fattest order book for a decade - CBI.

Ford workers threaten all-out strike on Monday unless company improves pay deal.

More sackings in City as a result of Stock Market crash.

Princess Anne under fire from homosexuals - "enraged poofters" as **Star** describes them - for describing AIDS as "a classic own goal scored by the human race itself".

Doctor warns international AIDS conference in London that disease is set to overtake heart disease as main killer and that there will be 1m cases by 1991. **Today** wants renewed publicity campaign.

Independent journalist fined £20,000 for contempt of court for refusing to disclose sources; his newspaper to pay fine and costs. Indignation in some sections of the press about the allegedly curtailed freedom of the press.

Row over B/Airways' decision to do away with B/Cal stewardesses' tartans.

Guillotine to be imposed on Education Bill.

Guardian says UDM may win representation at new Asfordby mine; meanwhile future of new S. Wales pit in doubt because of objections to 6-day working.

Tom King agrees to early meeting of Anglo Irish Conference after outcome of Stalker affair.

Irish police cancel meeting today with RUC Chief Constable.

Guardian says Dublin outrage poses new threat to security cooperation.

Sun pronounces on Stalker affair - when IRA bomb to kill they are freedom fighters; when Ulster policemen shoot to kill they are state terrorists - the twisted logic behind Labour's disgraceful attack on Attorney General.

Livingstone to be carpeted by Labour Whips over outburst; Kinnock furious with him.

King's Cross tube fire will cost £10m to repair.

Mirror features knife used by one schoolboy to maim another which is unlikely to be banned under new Government laws even though police want its sale stopped.

Judge, jailing 11 Mersey Tunnel staff for £1m toll fiddle, says it "beggars belief" that it could go undetected for 2 years.

Lester Piggott's collapse in prison due to beating for refusing to give in to extortion racked, according to some papers. Others say it was caused by stress.

You get a surprise present at celebration dinner - watercolour of No 10 by Nicholas Ridley. Pictures in **Guardian**, **Times**.

Mail reports Kohl's Chief of Staff saying West German Government had bowed to blackmail and done a deal with Beirut kidnappers.

Eight French businessmen held on charges of supply of hi-tech military and other equipment to Soviet bloc.

Group of eminent Americans form Denis Thatcher Society.

Independent reports that John Butcher has a secret ambition to get his name alongside shows by Andrew Lloyd Webber. He has been working on a rock opera for over a year.

NHS

Star: Thatcher gets to grips with NHS - showing new found confidence in House.

Sun: You launch a 6-month campaign to revolutionise NHS - penalties for inefficient hospitals.

Mirror: Thatcher "scared" [according to Kinnock] "to meet nurses".

Today says any change in the no-strike rule of the RCN will cause the Government to think and would be seen as a breach of faith and trust. RCN spokesman says "it is difficult to see how the Government will keep the review body if we give up no-strike pledge". In another story **Today** says you are determined to push ahead with a complete overhaul,with ideas such as hotel charges, compulsory private insurance and tax changes on the agenda.

Express: Maggie mission on NHS. You want ideas from all Cabinet. Government will now consider anything and everything. In another story, RCN is preparing to gamble (over no-strike stance) that its members put patients first.

Mail: Maggie demands private aid for Health Service - you have given senior Ministers six months to plan how to give service a cash boost through private enterprise; leader headed "The Prime Minister takes charge" says until this week you took a soothing line. Now, and not before time, you have changed your diagnosis. Let us hope options to be considered include hospital charges as well as tax incentives. It is also vital Government find out precisely how and where £22bn is going. But in booming Britain no Government will begin to get a grip on NHS without some short term loosening of Treasury strings.

Trevor Clay, RCN, in **Mail**, says there is a lot of manipulation of its members by other unions and extreme Left wingers within COHSE and UPE. Strike vote meetings are being held with no constitutional standing. It is all part of the great deception being played on both public and nurses. But no one should underestimate anger among nurses.

Telegraph P1: Review of NHS starts at once. Bill Deedes, in feature, counsels caution against radical change while tempers are high.

Guardian: Thatcher sets (furious) pace for NHS changes; leader says few who witnessed your robust and cocksure performance on Panorama would wager anything much on your early retirement.

Independent: Government last night won overwhelming backbench support for its hardline stand on NHS funding. At Backbench Committee meeting 21 out of 23 told Lawson that there should be no more funds for the NHS; confusion was caused last night when Downing Street confirmed that no options were being ruled out of NHS review, including board and lodging charges. Edwina Currie had earlier said that such charges would not be introduced in this Parliament.

Independent: Former head of Policy Unit, John Redwood, is pressing for the Government to introduce a voucher system for NHS patients. He will propose that NHS patients should be given a voucher to cover the cost of private treatment if they fail to get their operations on the NHS within a reasonable time.

Times: You are to lead radical reform of NHS funds and all past pledges on health policy will be reassessed as everything is on the table; Tory backbench finance committee urge Chancellor not to pour more money into NHS until it has been reformed.

Times: COHSE's London branch calls for ballot of members to step up industrial action.

FT: Tory Whips report favourable reaction by Tory MPs to your initiative, which they see as the start of a belated counter-attack. Peter Riddell says policies of your Government have developed more haphazardly in response to public complaints and demands for radical change than from neat ideological blueprints. The NHS episode has shown both the strengths and weaknesses of your style of Government - the initial dithering and uncertainty in response to crisis, departments waiting for a lead from you and then a decisive initiative leading to radical change. To current observers, your latest move looks like a rushed attempt to regain the political initiative.

ULSTER

Express says Attorney General looked anything but happy announcing no prosecutions. The decision will have provoked widespread misgivings. Clearly there has been a cover up and it leaves a very bad taste.

Telegraph says Government's declaration that it is against the public interest to undertake prosecutions leaves a bad taste. Emphasis must now be on ensuring RUC does not expose itself to damaging controversy again.

Independent: Irish Government warned that the outcome of the Stalker affair could have serious political and security implications in Ireland. Tom King has agreed to an Irish request for an urgent special meeting of the Anglo-Irish ministerial conference to discuss the decision.

Conor Cruise O'Brien, in **Times**, says the decision over the "shoot to kill" affair is unlikely to destroy the Anglo Irish Agreement in the short run, but it is impossible to estimate how long it may survive the consequences. He adds that security cooperation will get more difficult for a while but it will survive as it existed long before the agreement was thought of.

INDEPENDENT JOURNALIST

Today says he was right not to reveal his sources but that does not mean High Court was wrong to fine him. There is no reason why journalists should be exempt from City inquiries.

Guardian worries what is meant by a free press after the "scandal" of fining the journalist and suggests the fine was completely out of kilter in relation to £25,000 fine imposed on insider dealer. The country has got to make up its mind what, if anything, it means by the freedom of the press.

Independent P1 lead: MPs and journalists condemn the judgement as a serious threat to investigative journalism. Case has been seen as a test of the Court's powers to investigate insider dealing resulting from leaks.

Independent leader says no country can be considered free in which the Government is above the law. The greatest threat to freedom in Britain today is posed by the development of an over-mighty executive, able to draw on enormous administrative resources. A Government which enjoys a comfortable majority can, bedsides destroying any independent initiative on the part of the backbenchers which it dislikes, pass large amounts of legislation which the House does not really approve and take many actions without informing the House at all.

ARMY BULLYING

Star says the Government's move is all thanks to the public who brought pressure to bear on MPs through **Star**.

LAW AND ORDER

Independent: Authorities are considering introducing an element of compulsion into the use of genetic fingerprinting in Northern Ireland terrorist cases.

Independent: The IRA's improvised impact grenade claimed its first fatal casualty on Monday night with death of an RUC Officer.

Independent: Government is expected to start returning Tamils to Sri Lanka when their asylum claims are rejected.

Times leader describes some of the opposition to Clause 28 of the Local Government Bill as silly and some as hysterical but this does not mean they are wrong because it is clumsily drafted. It calls for a change because somewhere a Tory local authority might just be fool enough to ban a masterpiece being put on at a municipal theatre.

POLITICS

Times: Labour orders inquiry into allegations that Derek Hatton has been secretly attending party meetings and that Merseyside constituency set up fighting fund for him.

INDUSTRY/ECONOMY

Independent: CBI produced a reassuring business survey calming fears that the economy was overheating and pointing to continuing output growth.

Independent: Lord Young is considering the interim report of inspectors appointed to investigate suspected insider dealing involving civil servants. The inspectors believe that they have identified the civil servant who was the source of the leaks.

Times: Scientists in US and Japan discover cheap and common source of superconductivity.

Times: Government gives first clear indication that electricity employees and customers will be given an opportunity to buy shares when it is privatised.

Times: CBI warn that proposed electricity price increases would cost industry £1bn a year more, equivalent to four-point rise in interest rates.

Times: Lord Havers to chair a Robert Maxwell Company - Solicitors' Law Stationers Society.

Times: Government warns Scargill not to encourage members to use industrial muscle to price themselves out of jobs.

X **Times**: National Audit Office report says millions of pounds of public money may have been lost through Government's handling Rolls-Royce privatisation.

Times: Survey says many office workers can blame sickness on building they work in.

FT: Manufacturing industry appears confident it can shrug off most of impact of recent turmoil in financial markets but expects output growth to slow. Lex says CBI's first quarterly survey since the crash is not all good news but presents a brighter picture than last week's official data.

FT: ECGD accounts qualified on Third World exposure.

FT: Feature points out that in the 100 days since the share crash of October 19, world share prices have dropped by almost as much again.

FT: Murdoch seeks joint venture to launch separate American edition of FT to take on the Wall Street Journal.

EDUCATION

Independent: Kenneth Baker is expected to come under pressure in Cabinet to change tack and support outright abolition of the ILEA.

Times leader discusses the "squabble" between Government and universities over Education Bill, saying that the vice-chancellors' demands are reasonable and that the Government should not take powers it has no intention of using.

WELFARE

Times: DHSS and DoE set to clash over role of local authorities in administering welfare for poor, elderly and handicapped.

DEFENCE

Times: MPs set to re-examine £1bn development programme at Aldermaston because of delays and staffing problems associated with Trident warheads.

Independent: Cooperation between Britain and the US on future generations of nuclear weapons will suffer if further cuts are made to the research capabilities of the Atomic Weapons Establishment - according to **Independent** sources.

EAST/WEST

Times: Shevardnadze accuses you of seeking an arms build-up to offset the US-Soviet decision to abolish medium-range missiles in references to your Panorama interview on Monday.

EC

Independent: Peter Jenksins on the European triangle says that you stand in Britain's traditional place, at the furthest point of the eternal European triangle. From there, it is impossible to play the role of leadership only to act as defender of a status quo which many think is no longer sustainable. But that is the task upon which you are determined.

MIDDLE EAST

Telegraph: Thatcher agrees on Israel peace talks.

FT: Mr Mubarak received a sympathetic general endorsement of his Middle East peace initiative in what were described as "supportive noises" from Downing Street.

BERNARD INGHAM

ANNEX

MINISTERS (UK VISITS, SPEECHES ETC)

DTI:	Lord Young addresses CBI, London
DTp:	Mr Channon attends topping-out ceremony, Stanstead Airport
MAFF:	Mr MacGregor opens new joint office of Cheshire and Lancashire County Branches of NFU, Skelmersdale
WO:	Mr Walker addresses Swansea Trade and Commerce Relocation Seminar, World Trade Centre, London
DEM:	Mr Lee addresses inaugural lunch at Hotel Olympia
DES:	Mrs Rumbold visits Essex LEA and Tabor High School, Essex about records of achievement; later attends reception for National Confederation of Parent Teacher Associations, with Mr Dunn, at the House of Lords
DOE:	Mr Waldegrave visits Middlesborough (Housing)
DOE:	Lord Caithness addresses All Party Conservation Group of both Houses, on Acid Rain
FCO:	Mrs Chalker addresses School of Oriental and African Studies, University of London
MAFF:	Baroness Trumpington visits NEC, Birmingham for British Growers, Look Ahead
SO:	Mr Forsyth attends Health Ministers Summit, London
WO:	Mr Roberts opens Chepstow Inner Relief Road; later meets overseas press to discuss visits to Cardiff Bay, National Garden Festival Site and the South Wales Valleys, Cardiff

MINISTERS (OVERSEAS VISITS)

MOD:	Mr Younger visits Italy (to 28 January)

MINISTERS (PRESS INTERVIEWS)

DTI:	Mr Clarke appears on A Week in Politics on inner cities, (prov)

TV AND RADIO

"Today": BBC Radio 4 (6.30)

"Kilroy": BBC 1 (9.20)

"Schools: Teaching CDT": Channel 4 (11.40) - series made at invitation of DES

"Business Daily": Channel 4 (12.00)

"The Parliament Programme": Channel 4 (14.00)

"You and Yours": BBC Radio 4 (12.00)

"Votes for Women": ITV (14.30) - series on current issues

"Before the Law": Channel 4 (18.30) - third of four part series examines operation of the Bail Act

"A Week in Politics": Channel 4 (20.30)

"Newsnight": BBC 2 (22.30)

"The World Tonight": BBC Radio 4 (22.30) followed by "The Financial World Tonight" and "Today in Parliament"

FROM : HM ROBERTS
DATE : 29/ 1/ 88

1. MR ~~WALKER~~ 29/1

cc PS/Financial Secretary
Sir P Middleton
Mr Burgner
Mr DJ Moore
Mr Beastall
Mrs Brown
Mr Lyne
Mr Bent

2. CHANCELLOR

NAO REPORT ON ROLLS-ROYCE PRIVATISATION

1. You asked for a note on the NAO Report on Rolls-Royce privatisation. A copy of the Report is attached.

Background

2. Newspapers have correctly identified the 2 main issues raised by NAO, namely the size of the Government's capital injection to Rolls-Royce prior to privatisation and the sale price of the share offer. (See extract from yesterday's Financial Times - attached.) The 2 issues are likely to figure prominently in the PAC hearing on 2 March.

3. NAO, of course, had no access to Treasary files so the often significant differences between HMT and DTI on these issues cannot be brought out.

Issues

Capital injection (discussed in paras 6-12 of the NAO Report)

4. The Report summarises the process by which the final capital injection of £283m ie nil gearing was reached. The conclusions are critical, suggesting that it was not necessary to contribute as much as £283m, and that there can be no certainty that the Government would have recovered a sum equivalent to its capital injection.

5. Comment : The Treasury broadly agrees with the view of NAO and therefore argued strongly throughout the negotiations for a lower injection. The strategy for deciding the level of capital injection was based on a gearing target. This was originally 25-30% implying an injection of £140m (September 1986). This was later revised upwards to £220m on the advice of Samuel Montagu to take account of a lower gearing level of 11% and the implications for Rolls-Royce earnings of the terms of a performance bond between Rolls-Royce and BAe. Treasury was steadfastly opposed to any further reduction in gearing : we were confident that the £220m would be sufficient to guarantee a successful flotation and there was no certainty that any additional input would be reflected in increased proceeds. Treasury were concerned that a higher than necessary injection would lead to criticism from NAO and the PAC. However, Sir Francis Tombs, the Chairman of Rolls-Royce had consistently pressed for nil gearing (as BAe had achieved on privatisation) : he threatened not to

proceed with privatisation unless this was achieved. Under this pressure, nil gearing was conceded albeit with great reluctance and a long battle by HMT; this amounted to £283m.

Share price (discussed in paras 27-36 of the NAO report)

6. The report outlines the way in which decisions were reached over the share price. The conclusions suggest that it is difficult to know whether HMG maximised the proceeds from the sale : the market moved upward in the week following the setting of the price leading to a 34% premium. But it adds that neither this nor the adjustment in the Stock Market following 19 October could have been foreseen.

7. Comment : Samuel Montagu's final advice was a price of 165p : a price of 160p was considered safe, 165p could be recommended, 170p was high risk policy and 175p was unsafe. Only Treasury supported 170p and this was agreed at the insistence of the Financial Secretary. Immediately subsequent press stories suggested that this was considered a tight price. On the first day of trading the share price closed at a premium of 34% of the fully paid price. By late June the premium had fallen to 23% and Rolls-Royce share price is now at 141p or 17% below offer price.

HMR

MS HM ROBERTS

FINANCIAL TIMES 27/1/88

Debt write-off for Rolls-Royce sale questioned

BY PHILIP COGGAN

A BATTLE behind the scenes over the privatisation of Rolls-Royce, the aerospace engine manufacturer, was revealed yesterday when the National Audit Office released a report which questions aspects of the company's flotation last May.

The Audit Office suggests that a capital injection by the Government before privatisation of £283m might have been unnecessarily high.

The report reveals that Sir Francis Tombs, Rolls-Royce's chairman, had said in discussions with the Government that he would not be prepared to take the company into the private sector if it was left with substantial debt.

In the light of his arguments, the report says that the Department of Trade and Industry "reluctantly agreed to provide a capital injection that would give a nil gearing" –that is, no borrowings.

Samuel Montagu, the DTI's merchant banking advisers, had originally proposed a capital injection of £140m, leaving Rolls-Royce with 25-30 per cent gearing. This figure was revised upwards to £220m in the autumn of 1986 (which would have left Rolls-Royce 11 per cent geared) but Sir Francis was not satisfied.

In the end, the capital injection of £283m was achieved by the issue of 166.5m extra shares at the offer price. The office's report says that there must be some doubts whether a capital injection of that size was needed, given that Samuel Montagu had taken account of Rolls-Royce's commitments before deciding that £220m would be adequate.

However, the National Audit Office notes the impossibility of determining what the proceeds of the offer might have been had a lower level of capital injection been provided.

There is also a question mark over the offer price chosen. The office says that the ideal premium in the aftermarket would be 10 per cent and therefore, in Rolls-Royce's case, the initial premium of 34 per cent may have been too high. But the report points out that measurement against that yardstick was effectively ruled out by the stock market crash. By November, the shares were at a 34 per cent discount to the offer price.

One positive aspect comes out of the report. The cost of the sale, at 2.1 per cent of the proceeds, was lower than that of any previous privatisation issue because there were no shareholder incentive schemes. After competition, commissions were set at 0.061 per cent compared with 0.111 per cent for British Airways and 0.175 per cent for British Gas.

NATIONAL AUDIT OFFICE

Report by the Comptroller and Auditor General

Department of Trade and Industry: Sale of Government Shareholding in Rolls-Royce plc

Ordered by the House of Commons to be printed
13 January 1988

Her Majesty's Stationery Office, London
£3.60 net

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This report has been prepared under Section 6 of the National Audit Act, 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

Gordon Downey
Comptroller and Auditor General

National Audit Office
31 December 1987

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies use their resources.

Contents

Report

Introduction

1. Since 1982, the Public Accounts Committee (PAC) have examined the arrangements for selling Government shareholdings in several publicly owned companies. In their 3rd Report of Session 1985 – 86 PAC recommended that for future sales departments should give further consideration to: the methods of offering the sale; the need for underwriting and the rates of commission agreed; the factors to be considered in arriving at the offer price; the desirability and value of overseas sales; and the need for special sales measures and incentives. The Treasury Minute noted the Committee's recommendations and generally accepted them (Cmnd 9755).

2. I have recently issued two Reports (HC 22 and 37 of 1987 – 88) which examined the arrangements by the Departments of Energy and Transport respectively for the sales of the Government shareholdings in British Gas plc (BG) and British Airways plc (BA) in the light of these recommendations by PAC. This Report records the results of a similar examination by the National Audit Office (NAO) of the arrangements made by the Department of Trade and Industry (DTI) for the sale of the Government shareholding in Rolls-Royce plc (RR).

Background to the sale

3. In July 1983 the Secretary of State for Trade and Industry (the Secretary of State) informed the House of his intention to return Rolls-Royce to the private sector under the statutory powers contained in the Industry Act 1980. Privatisation was impractical at this time as the company had incurred substantial losses in both 1982 and 1983. However the company returned to profitability in 1984, and in November 1985 the Secretary of State confirmed the Government's intention to privatise the company before the end of the then present Parliament.

4. The Department's principal objectives for the sale were:

(a) to maximise the proceeds of sale on the assumption that this was consistent with the issue being fully subscribed and with the achievement of a healthy aftermarket;

(b) to relinquish all financial obligations, including existing commitments at the date of privatisation;

(c) to finalise the sale within the life of the present Parliament; and

(d) that they should aim to minimise costs consistent with a successful sale.

The Government also stipulated that the Department should refrain from being generally innovative in relation to the terms of the offer having regard to the risks attached to the business in which RR operates.

5. The maximisation of proceeds consistent with the achievement of a healthy aftermarket and the creation of an adequate financial structure on flotation, were objectives common to all privatisations. However, the objectives of this sale differed from earlier sales in that there was no specific requirement to deepen or widen share ownership.

Preparation for sale

Capital structure

6. In 1973 the Government gave undertakings that in the event of liquidation, they would ensure that the debts of the company were met in full. It was the Government's intenton to withdraw these assurances on privatisation; and in order to provide the company with a satisfactory capital structure on flotation it was common ground between the Department, their advisers and the company that it was necessary to reduce existing borrowings by an injection of cash. From 1985 all parties accepted that the size of this injection should be determined primarily by the company's level of "gearing", which shows that proportion of its capital structure which is financed by debt. RR argued that, on flotation, it should have a nil gearing, ie it would have no borrowings or would have sufficient cash to redeem them should it choose to do so. RR estimated that this would require a capital injection of around £300 million.

7. The arguments put forward by RR in support of its claim were:

(a) the need to be cash positive ie have liquid assets in excess of liabilities on flotation to meet the demands of operating in a high technology area with long lead times, substantial potential liabilities, and a requirement for heavy expenditure on capital investment and R&D. The only comparable UK company, British Aerospace (BAe), had been cash positive on the first stage of its privatisation, and remained so.

(b) the need for a particularly strong balance sheet having a signficiantly lower gearing than the level of 25 per cent enjoyed by most UK industrial companies in order to reflect the risks associated with a cyclical aerospace industry;

(c) the need to fund an increasing number of collaborative projects;

(d) the effect that its off balance sheet obligations, such as forward foreign currency contracts and sales financing agreements, had on its operations and on the views of potential providers of finance.

8. The Department's advisers, Samuel Montagu & Co Limited (SM), advised DTI that providing the company's capital structure was considered by potential investors to be adequate the actual size of any injection might not significantly affect the net proceeds from the sale. They considered that, having regard to the capitalised value of any additional earnings arising from the capital injection and to its benefical effects on the price/earnings (P/E) ratio, any amount so injected would normally be broadly reflected in the increased value the market would put on RR. This conclusion was based on the calculation that, assuming a constant P/E ratio, net proceeds would be likely to vary by only £20 million for a wide range of levels of capital injection (£100 million to £300 million). However, the P/E ratio would not in fact remain constant at

different levels of capital injection and would be varied by the market to reflect the different levels of financial risk resulting from a different level of capital injection, thereby capitalising RR's earnings at a different rate. The net effect of this variation would be to leave net proceeds unchanged. SM advised however that any failure to convince potential investors that the company's capital structure was adequate could be extremely expensive.

9. After carefully considering RR's proposals SM concluded that it was not necessary for RR to have a positive net cash position on flotation. While SM agreed that the calculation of gearing in RR's case should be adjusted to recognise off balance sheet commitments, including existing and likely near future sales financing in the total net borrowings, and to exclude intangible assets from shareholders' funds, they considered that an adjusted gearing ratio of from 25 to 30 per cent would be adequate. This would require a capital injection of up to £140 million.

10. In the Autumn of 1986 the Department and SM reassessed the position. They concluded that the maximum level of flotation gearing with which the banks and investment analysts would now feel comfortable was about 11 per cent. This implied the need for a cash injection to the company of £220 million.

11. The Chairman of RR then had further discussions with the Department on the size on the capital injection. When re-presenting the arguments for a nil gearing (see paragraph 7) he stated that if the Government demanded a structure which left RR with substantial debt, he would not be prepared to take RR into the private sector, since he believed that it would not be possible for the Company to trade on such a basis. He emphasised that the size of the capital injection was a matter of judgement and could not be calculated arithmetically in relation to specific contractual arrangements.

12. In the light of the RR Chairman's presentation of the arguments, DTI reluctantly agreed to provide a capital injection that would give a nil gearing on flotation. In reaching this view, the Department had in mind the sales financing commitments which had been entered into by RR by that time and to the judgement that the size of the capital injection should be broadly reflected in correspondingly increased gross proceeds from the sale of shares. The actual amount required to achieve the nil gearing, based on the Company's position at 31 December 1986 was £283 million, and this was provided to the Company out of the gross proceeds from its flotation.

Formation of public company and transfer of business

13. On 1 May 1986 the company was re-registered as a public limited company under the Companies Act 1985 as Rolls-Royce plc. Part VII of the Sale Prospectus gives details of the subsequent changes in the constitution of the company's share capital. The main effects were the conversion of the 508 million 25p shares into 635 million 20p shares (paragraph 32) and the issue of 166.5 million new 20p shares at the offer price of £1.70 to produce the £283 million capital injection required. The share capital on the date of the offer therefore amounted to:

Authorised	Issued
1,050,000,000 Ordinary Shares of 20p each	801,470,588 Ordinary Shares of 20p each
1 Special Share of £1	1 Special Share of £1

The whole of this issued capital was owned by HM Government.

14. The Special Share carries no voting rights but entitles the Secretary of State to attend and speak at general meetings of shareholders. Its main purpose is to protect certain provisions in RR's Articles of Association relating to limits on foreign and individual shareholdings, nationality of Directors, and disposals of material assets. Any change to these provisions requires the written consent of the holder of the Special Share.

Arrangements for sale

General

15. In addition to the appointment of the financial advisers (SM) the Department appointed Linklaters and Paines as legal advisers and James Capel and Co (JC) as lead brokers to the sale following competitive tendering. RR's existing auditors, Coopers and Lybrand, were appointed as reporting accountants. References in the text to advisers should be interpreted to include these other advisers as well as Samuel Montagu, in particular JC who played a major role in the key discussions.

Phased sale

16. The Department and their advisers considered whether the shares should be sold in more than one tranche as in the cases of Britoil, BAe and British Telecommunications (BT). SM advised that a single tranche sale might produce less than a sale in two tranches. However, the second of the two tranches would have to extend beyond the timetable set by the Government for completing the sale (paragraph 4). The outcome was that the Department decided to sell in one tranche because it was feasible to do so; because there were no certain financial benefits from selling in two tranches; and because there was the possibility that the Government deadline for the sale might not otherwise be met. They accepted SM advice that payment should be in two instalments.

Sale by tender

17. When determining the method of sale to be adopted the Department and their advisers took into account experience in previous privatisation issues. SM advised against a full tender on the grounds that this method was not popular with investors and that the proceeds available were likely to be less, and certainly not more, than under a fixed price offer. They also noted that with a tender offer there would be less flexibility in the basis of allotment and that it would not be possible to include an element of firm placing in the sub-underwriting. They also advised against a combination of tender and fixed price offers as this would add to rather than avoid the disadvantages of the full tender offer by creating confusion and uncertainty, the effect of which would be likely to reduce the level of sale proceeds. They firmly recommended that the offer for sale should be

by means of a fixed offer. The Department and the Treasury agreed that the sale should go ahead on this basis.

Overseas sales

18. RR's Articles of Association contain provision to ensure that the Company remained under UK control by restricting the number of foreign-held shares to 15 per cent. SM pointed out that, although there might be financial benefits from the reservation of a proportion of the issue for foreign investors with access to the London sharemarket, because of heavy demands on the equity market arising from the conjested privatisation timetable such action could create problems bearing in mind the limit on foreign shareholding. DTI considered this advice and decided that no special provisions for foreign investors should be incorporated in the offer.

The sale offer

19. On 30 April 1987 SM, on behalf of the Secretary of State, offered for sale 801.5 million Ordinary shares, of which a maximum of 473.8 million was placed with certain UK institutional investors and 327.7 million were offered to the general public, RR employees and pensioners. However provision was made for placings of shares with institutional investors to be reduced by approximately 79 million and added to the number available under the public and employee offer, if valid applications under that offer exceeded approximately 655 million shares.

Underwriting

20. The Department and their advisers considered the need to underwrite the issue. SM advised that the absence of underwriting would cause uncertainty in the markets, which in turn could lead to under-subscription. They believed that this could jeopardise the sale unless the offer price was substantially lower than could be achieved in an underwritten sale. DTI therefore concluded that, with the exception of the free and matching share offers to RR employees and as with every previous privatisation, the issue should be underwritten.

21. The Department and their advisers considered various underwriting structures and considered that the conventional arrangements using both primary and sub-underwriting was the most appropriate. Following competition, the Secretary of State concluded an agreement with a syndicate of banks as primary underwriters to underwrite 789.7 million shares, the entire offer except for 11.8 million shares reserved under the free and matching schemes for RR employees. Under this agreement the Secretary of State paid underwriting commissions amounting in aggregate to 0.061 per cent of the total value of the shares at the offer price (£941,764 including VAT).

22. This aggregate commission rate was significantly lower than that achieved on the BA sale (0.111 per cent) which was itself a reduction on that for BG (0.175 per cent). The improvement was partly due to the lead underwriters accepting a lower rate of commission than that paid to the core group in the BA sale, and partly to a higher proportion of the shares on offer being open to competition. The arrangements for sub-underwriting were similar to those agreed for previous sales whereby

certain institutions in the UK (Priority Applicants) were invited to apply for the shares on offer with the understanding that they would be:

(a) guaranteed an allocation of 50 per cent of these shares (Firm Placing Shares);

(b) provisionally allocated a further 10 per cent (Provisional Placing Shares); and

(c) committed to undertake to purchase the balance of any shares not otherwise allocated in the offer (Commitment Shares).

23. The Department and the Treasury considered using competition amongst sub-underwriters to reduce costs in this area and also the possibility of reducing the commission rate on Firm Placing Shares. They accepted SM's advice that any variation to the conventional sub-underwriting commission structure would not be acceptable to the market and that it would not be appropriate to attempt such an innovation in the RR offer. SM and JC accepted however that there was scope for commissions to be reduced on Firm Placing Shares. SM considered that as there were no prescribed commission rates for these shares, savings could be made by offering a lower rate for these compared with that paid in earlier sales. They were, however, concerned that to do too much in one issue would risk the overall success of that particular offer, either by inspiring a cartel-driven boycott of the sub-underwriting or at least making the underwriters nervous of that and thus depressing the price.

24. The Secretary of State agreed therefore that the Priority Applicants should receive the normal market rate commission of 1.25 per cent (£9.65 million including VAT) on the aggregate value of the Provisional Placing and Commitment Shares. He also agreed a commission of 0.25 per cent (£1.93 million including VAT) on the aggregate value of their Firm Placing Shares which was half the rate paid in both the BA and BG sales.

Sales incentives

25. In commenting on the BT sale, PAC questioned whether all the special measures including incentives were necessary to meet certain of the Government's objectives. In the case of BG and BA, a loyalty bonus was considered necessary in order to meet the objectives of widening or deepening share ownership. In the case of RR, although Ministers made clear that they would welcome applications from relatively inexperienced investors, they did not see a case for particular measures to attract such investors. Therefore, DTI Ministers decided that there was no need for such a bonus. Their advisers considered that the marketing implications were minimal, that on balance loyalty bonuses were not worth the costs involved, and that a financial incentive to retain shares in a company operating in a relatively high risk business might not be appropriate.

26. Special arrangements were made for RR employees and pensioners (as noted in Part VII of the Prospectus). The minimum benefit to an eligible employee taking full advantage of the arrangements is £571, almost exactly the same as the employee offer in the case of BG (£570). The benefit to an employee with 40 years service would rise to £649,

which again matches the BG offer of £650. It is estimated that the maximum cost to the Government of the free, matching and discount offers would be £14.4 million.

Share pricing and valuation

27. The Department set the price at which the shares of RR were to be offered for sale in conjunction with SM, the Treasury and JC. The independent adviser on pricing appointed in the BG and BA privatisations was not available when sought for the RR issue. DTI did not appoint a specific independent adviser but obtained the views of the Secretary of State's special adviser. The main factors which influenced pricing were the assumptions to be made about RR's earnings and the P/E ratio; the need to create a satisfactory after-market through the creation of a not excessive premium; and stock market conditions. The advisers considered that the dividend yield would also be an important factor in determining the issue price although RR was not seen primarily as a dividend stock.

28. As there were no UK or overseas quoted companies which exactly paralleled RR the Department took advice from SM and JC and examined the financial indicators of broadly comparable UK companies and decided that those of BAe provided the best yardstick. However there were three factors in RR's financial situation which provided some uncertainty in the calculation of an appropriate P/E ratio, namely that profit growth showed that the company was in a recovery phase; the treatment of its tax position due to accumulated tax losses; and its more conservative accounting policy towards Research and Development expenditure.

29. Unlike some earlier sales, the Prospectus did not include a forecast of future profits on account of the timing of RR's 1986 results which were available just before publication of the Prospectus. Consideration of the appropriate price was made therefore on the basis of the 1986 earnings, adjusted to allow for the benefit of the Government's capital injection (paragraph 12) calculated on the basis of an interest rate of 10 per cent a year. After allowing some credit for RR's accounting policies, its tax position, and the overall volatility of the aerospace sector, the Department accepted SM's and JC's initial advice that a P/E ratio on a full tax basis in the range of 13 to 16 would be appropriate.

30. SM believed that the yield should be in excess of BAe's current return (3.82 per cent) which was regarded as the key yardstick but below that offered in the BA sale (6.8 per cent). In their preliminary advice they recommended that the return on the offer price should be in the range of 4.25 to 4.75 per cent, but that this would need to be kept under review in the period up to Impact — the day on which the price was set.

31. The Department initially proposed that the appropriate dividend pay out should be £43.75 million, representing a dividend covered three times by the 1986 earnings after the actual tax charge (£133 million), compared with 2.9 for BAe. RR believed that £35 million was the appropriate dividend covered 3.8 times by earnings. The Department considered this cover excessively generous as did SM and JC and a figure of £40 million was agreed giving a dividend cover of 3.3 as shown in the Prospectus.

32. Having regard to all these factors, the Department and SM considered that with a nominal value of 25p the price per share could be as much as 211p. This they argued would be regarded as high by investors and could lead to problems in marketing the issue. In order to bring the price into line with the market perception the nominal value of the shares was reduced to 20p (which would imply a price of 169p rather than 211p) and the number of issued shares was increased from 508 million to 635 million.

33. When the final pricing deliberations began on 24 April SM and JC recommended a range of 160p to 175p. The Department and the Treasury were keen to see the issue tightly priced to avoid a repetition of the excessively strong aftermarket in BA shares. JC advised that the aftermarket price based on the valuation should be around 180p but that overseas demand could drive the price up to 200p or beyond. The Department and the Treasury suggested that having 180p at the top end of the range would help to pull expectations about the price upwards. It was agreed therefore, that the range to be quoted to the underwriters should be 160p to 180p.

34. At the final meeting held on 27 April, SM recommended that the choice of price was effectively between 165p and 170p. They recommended 165p on the basis that 170p carried risks of a less than fully successful issue, which might not be commensurate with the potential additional proceeds. They were supported by JC who advised that this would represent a "real" (ie initial aftermarket) price of 180p, the accepted level of premium necessary to encourage buyers. Although the Department did not have an explicit formal target they had in mind that brokers' experience was that a successful flotation led in the more settled longer term to a premium of around 10 per cent. They noted that the premium could well be higher in the immediate aftermarket on account of overseas demand. The Department and Treasury considered that the price should be set at 170p and SM confirmed that the offer could be underwritten at that price. The Department therefore decided to set the price at 170p, half payable on application and half on 23 September 1987.

35. At this price of 170p RR had a market capitalisation of £1,362 million. The price represented a P/E ratio on a full tax basis of 14.2, within SM's recommended range and compared with BAe's P/E ratio of about 13.3 on the same basis. The gross dividend yield was 4.06 per cent which compared with SM's initial advised level of 4.25 to 4.75 per cent and BAe's yield of 3.82 per cent. The Department were unable to say with any certainty what the P/E ratio would have been if they had not provided the capital injection; or whether they had recovered in proceeds from the flotation the full amount of £283 million. However, they referred the NAO to SM's advice as set out in paragraph 8 above. And they pointed out that a successful flotation could have been jeopardised if they had provided an injection of less than the amount the RR Chairman considered necessary and the market had become aware of this.

36. In the course of the final deliberations, the Department were advised that any new issue price not a multiple of 5p would look like a political compromise.

Results of the sale

37. The Department received just over 2 million valid applications for some 3.15 billion shares from the public, RR employees and pensioners, resulting in their part of the offer being more than nine times subscribed. In accordance with the terms of the offer for sale, the clawback procedure came into operation and some 79 million Provisionally Placed Shares were deducted from the offer to the institutions and added to that to the public, employees and pensioners. Not all the shares available for the free, matching, discount and priority offers to the employees and pensioners were taken up and the resulting surplus was added to the public allocation.

38. No allocations were made in respect of public applications in excess of 100,000 shares while applications for up to 100,000 shares received a scaled down allocation, with smaller applications receiving more favourable treatment, eg applications for the minimum amount of 400 shares were reduced to 150 and applications for 15,000 to 425. The maximum numbers of shares under the various parts of the offer compare with the final allocations as follows:

Offered to	Initial offer		Final allocation	
	Million shares	% of total	Million shares	% of total
UK public	247.6	30.9	339.8	42.4
RR employees & pensioners:				
Free, matching & disc. offer	40.05	5.0	23.7	2.9
Priority offer	40.05	5.0	39.8	5.0
Reserved for appeals etc	—	—	3.3	0.4
	327.7	40.9	406.6	50.7
Institutions	473.8	59.1	394.9	49.3
Total	**801.5**	**100.0**	**801.5**	**100.0**

The net proceeds from the sale are expected to amount to £1,319.3 million, from which the Department have paid RR the capital injection of £283 million (see Appendix 1).

The share price

39. On the first day of trading, 20 May 1987, the share price opened at 128.5p, moving up to a peak of 147p and closing at 143p. This premium represented 68 per cent of the partly-paid share price of 85p (34 per cent of the fully paid price) and an overall value of some £465 million.

40. SM examined the performance of RR shares in the aftermarket up to 26 June when the partly paid price was 124p, a premium of some 23 per cent on a fully paid basis. (In the period since the issue had been priced, during which there was a cut in interest rates, the Stock Exchange All Share Index, and the performance of other UK aerospace companies,

excluding BAe, had increased by 15.8 per cent). The partly-paid price subsequently fell to 112.5p on 11 September, shortly before the second instalment was due (paragraph 34). The latter price represented a premium of 16 per cent on the fully paid price.

41. SM concluded that the main reason for the excess of the initial RR premium over the normal market increase was overseas demand, particularly from Japan. They also considered that the subsequent decline relative to the market was mainly due to fears that the 15 per cent limit on foreign owned shares may have been exceeded and some purchases would not qualify for registration in due course. The Department agree with this and consider that a further contributory factor towards the intial premium was the unexpected level of interest from the retail sector.

42. The RR share price has since been affected by the general fall in stock market prices. In the period 16 October to 20 November the SE All Share Index declined sharply by 31 per cent and the Mechanical Engineering Index fell by 41 per cent. In the same period the RR share price fell from 206p (fully paid) to 112p, a fall of 46 per cent, and in late November it stood at a discount of 34 per cent to the issue price on a fully paid basis.

The costs of the sale

43. The Department estimate that the net costs of the sale excluding departmental administration and stamp duty will total £29.1 million (Appendix 1), representing 2.1 per cent of sale proceeds; this compares with an average of 5.2 per cent for previous Government privatisations, 4.7 per cent for BA and 6.4 per cent for BG (Figure 1).

44. The principal reasons for the percentage being lower than those in other sales are the absence of consumer incentives and an overseas offering; lower rates for underwriting and selling commissions; a reduction in advisory fees; and a reduction in marketing costs. Most of the costs of the sale were shared equally between the Department and RR. The Department's 50 per cent share of the marketing costs (estimated at £4 million) is considerably less than the estimated costs of marketing BA and BG and represents a cost per applicant of £1.97 compared with £5.10 for BA and £8.75 for BG. The Department devoted considerable effort to minimising costs and avoiding unnecessary expenses.

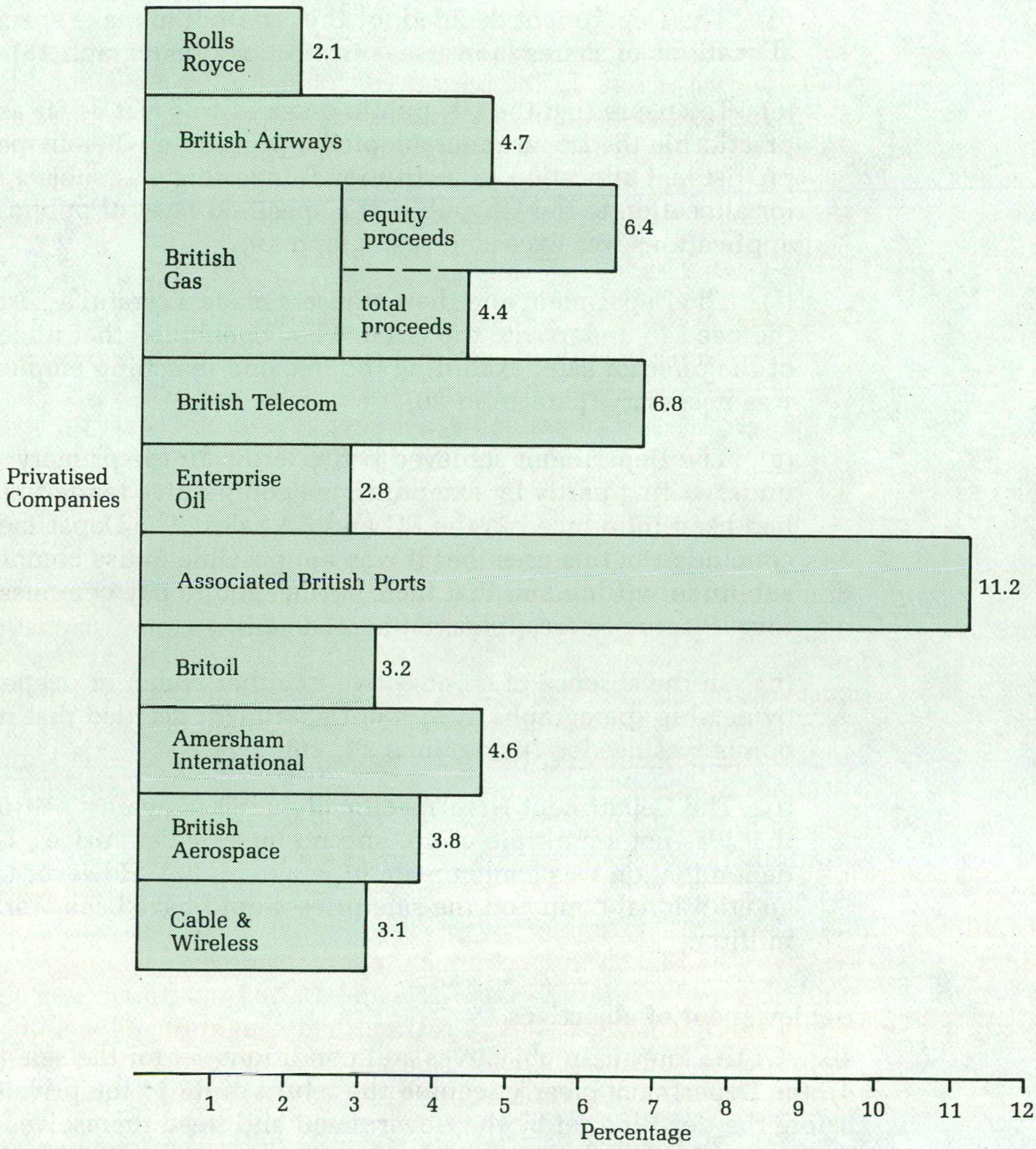
Summary of findings and conclusions

45. The NAO examination established that the Department and the Treasury had taken the recommendations made by PAC on previous sales into account in reaching their decisions. The Department did not always adopt the PAC suggestions in full but had sought the advice of appropriate consultants before determining the course they decided to adopt. The NAO's main specific findings are set out below.

(a) To prepare the Company for sale, the Department strengthened RR's balance sheet by a capital injection of £283 million, some £63 million higher than the £220 million recommended by SM. The Department's decision was influenced by the Chairman's desire for the company to be cash positive on flotation; by the sales financing commitments entered into by RR up to that date; and by the

Figure 1

Expenses as percentage of equity proceeds



Department's judgement, based upon advice from SM, that the injection would be broadly reflected in additional proceeds (paragraph 12).

(b) The Department considered the possible advantages of a phased sale with their advisers but decided against it because they believed that there were no certain financial benefits from selling in two tranches and in order to meet the Government's deadline for privatising RR (paragraph 16).

(c) The Department examined the alternatives of sale by tender or by partial tender and decided in the light of professional advice that the sale should be on a fixed price basis (paragraph 17).

(d) The Department decided for this sale not to make special allocations of shares to overseas institutions (paragraph 18).

(e) To ensure that the UK public demand was met as far as was practicable the Department adopted a procedure whereby part of the provisional allocation to institutional investors was subject to recall for allocation to the UK public if a specified level of public applications was exceeded (paragraph 19).

(f) The Department and their advisers made a careful assessment of the need to underwrite the issue. They concluded that underwriting of the offer for sale, excluding the free and matching employee offers, was necessary (paragraph 20).

(g) The Department achieved better terms for the primary underwriting partly by extending the competitive tendering which had been introduced in the BG and BA sales. The Department concluded in this case that it was not possible to use competition on sub-underwriting and that there was a need to pay commission on Firm Placing Shares (paragraphs 21 to 24).

(h) In the absence of an objective to either widen or deepen share ownership (paragraphs 4, 5), the Department decided that no loyalty bonus was needed (paragraphs 25, 26).

(i) The Department were specifically advised against setting a price that was not a multiple of 5p, and no intermediate price denomination was contemplated (paragraph 36). However in this sale an additional penny on the sale price would have been worth £8 million.

Achievement of objectives

46. Of the four main objectives and conditions set for the sale (paragraph 4), the Department clearly secured the return of RR to the private sector before the deadline set by the Government and freed themselves from all their commitments and financial obligations as at the date of privatisation. They also avoided innovation in relation to the terms of the offer and took significant steps to minimise costs. It is possible, however, in the NAO's view, that the Department's capital injection to RR and the level set for the share price may both have affected the achievement of the remaining objective of maximising proceeds.

47. In the NAO's view, there were two main issues raised by the Department's capital injection to RR: whether it was necessary to contribute as much as £283 million, and whether the size of the injection was in reality immaterial on the argument that it would in any case simply be recovered from the increased proceeds from the flotation (paragraphs 6 – 12 and 35). There must be some doubts attaching to the first of these issues given that SM had taken account of RR's commitments to customers in their view, prior to discussions with the Chairman, that an injection of only £220 million would be adequate. Against these doubts, the Department had to consider the possible consequences of being seen to take a different view from the RR Chairman of the right capital structure for the company. On the second issue, the NAO consider that the Government may well have recovered a sum broadly equivalent to the amount of their capital injection. But they note the impossibility of saying with any confidence what the proceeds might have been had a lower level of capital injection been provided, and observe that large sums were at risk.

48. In the NAO's view, it is now hard to say whether the RR share price was set at a level that maximised the proceeds from the sale. The Department had in mind their brokers' experience that the premium associated with successful issues should be around 10 per cent in the more settled longer term; but any measurement against that yardstick has been effectively distorted by the general, steep decline in share prices starting in October 1987. The initial premium of 34 per cent (on the fully paid price) may have seemed high. However, as the Department have pointed out, the pricing decision was taken on the basis of the best information available at the time and the performance of markets in the week after the price was set could not have been foreseen. Equally, the Department could not have foreseen subsequent movements in the markets which resulted in a fall in the RR share price to a level in November 1987 some 34 per cent lower than the issue price.

Glossary of Abbreviations

BA	British Airways plc
BAe	British Aerospace plc
BG	British Gas plc
BT	British Telecommunications plc
DTI	Department of Trade and Industry
JC	James Capel & Co (Brokers to the Offer)
NAO	National Audit Office
PAC	Public Accounts Committee
P/E	Price to Earnings Ratio
RR	Rolls-Royce plc
SM	Samuel Montagu & Co Ltd (Financial advisers to the Department)

Appendix 1

Estimated receipts from and costs of sale of shares in Rolls-Royce plc

	£ million	£ million	£ million
Value of shares included in offer at selling price			1,362.5
Less:			
Shares to employees and pensioners under free and matching offers	12.0		
Employee discounts	2.4		
		14.4	
Plus:			
Estimated premium from sale of unallocated shares		0.3	
			14.1
Sale proceeds			**1,348.4**
Costs in respect of UK offer (excluding incentives)			
Underwriting	12.5		
Selling and Broking Commissions	4.2		
Receiving Bank costs	11.0		
Marketing	4.0		
Advisers Fees	2.2		
		33.9	
Less:			
Receipts to be netted off against costs			
Interest on Application money		4.8	
Net costs			**29.1**
Net proceeds			**1,319.3 million**

Note

£283 million of the net proceeds was paid to RR.

Appendix 2

Proceeds and costs of sale of recent Government shareholdings

Company	Date of Sale	Equity Sale Proceeds	Expenses	Net Proceeds
		£m	£m	£m
Cable and Wireless	1981	224	7[1]	217
British Aerospace	1981	149	6[2]	143
Amersham International	1982	63[3]	3[4]	60
Britoil	1982	548[5]	17[6]	531
Associated British Ports	1983	22[7]	2	20
Enterprise Oil	1984	393	11	382
British Telecom	1984	3,863	263	3,600
British Gas	1986	8,091[8]	360	7,731
British Airways	1987	892	42	850
Rolls-Royce	1987	1,348	29[9]	1,319

Notes

1. Excludes £35m subscribed by the Government for new shares.
2. Excludes £100m capital injection and £55m PDC dividends foregone by the Government.
3. Excludes proceeds paid to the company and interest on amounts held temporarily in respect of unsuccessful applicants.
4. Excludes stamp duty (£0.86 million).
5. Excludes £88m debenture repayment.
6. Includes maximum possible cost of incentives for small shareholders.
7. Excludes £25m paid by the company to the Consolidated Fund and interest held temporarily in respect of unsuccessful applicants.
8. Includes £2,500m debenture repayable to the Consolidated Fund.
9. Excludes capital injection of £283 million.

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PMP

FROM: J M G TAYLOR
DATE: 1 February 1988

MS H M ROBERTS

cc PS/Financial Secretary
Sir P Middleton
Mr Burgner
Mr Waller
Mr Beastall
Mrs Brown
Mr Lyne
Mr Bent

NAO REPORT ON ROLLS ROYCE PRIVATISATION

The Chancellor was grateful for your note of 29 January.

JT

J M G TAYLOR

Inland Revenue

Policy Division
Somerset House

PMP

FROM: MRS A C MAJER
DATE: 29 March 1988

FINANCIAL SECRETARY

ROLLS ROYCE PRIVATISATION : EMPLOYEE DISCOUNT OFFER

1. Rolls Royce have approached us for a concession to relieve employees of an income tax charge on the discount offer they took up when buying shares in the company's privatisation offer last year. You may wish to be aware of our intention to deny this request, since it is possible that adverse publicity could result.

2. Discounts of the kind in question are taxable under the ordinary rules of Schedule E. The maximum discount in the Rolls Royce case was £200. Individual discounts are not yet known, but tax liabilities could range up to £120, depending upon the employee's tax rate and the number of shares he purchased under the discount offer. In most of the approximately 9,200 cases, however, it is likely that tax on the benefit will fall below the assessing tolerance level of £75 - ie no tax will be due provided there is no other reason for reviewing individuals' liability for 1987/88. The company has pressed us for a concession principally on the grounds that ever since the Stock Market crash the shares have traded at well below the discounted price.

---

c PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Monck
Mr Scholar
Mr Burgner
Mrs Lomax
Ms Sinclair
Mr Waller
Mr Cropper

Mr Isaac
Mr Lewis
Mr German
Mr Farmer
Mrs Eaton
Mrs Majer
Mr Williams
PS/IR

3. Requests for concessions on similar grounds have normally been refused in the past, and we do not see that Rolls Royce have any persuasive case for special treatment. We therefore propose to refuse Rolls Royce's request. However, this could result in adverse publicity and approaches to Ministers. The Rolls Royce Chairman mentioned the tax liability to the Chancellor at a dinner in December.

Background

4. Where an employee acquires shares by reason of his employment at less than market value he is liable to income tax on the difference between the market value and the price paid (Section 181 ICTA 1970). (The question of exempting such benefits arising as a result of employee priority at a discount in a public share offer was reviewed and rejected in the discussions leading to the new provisions covering the exemption of employee priority shares in such offers. The exemption applies only where the employee pays the same price as members of the public.)

5. Under the Rolls Royce offer shares were offered to the public in May 1987 at a price of 170p each. In addition to a fixed price priority offer and a 'free and matching' offer, which are not relevant to the present issue, employees could each apply for up to 1,176 shares at a 10% discount. Payment was in two instalments, the discount being deductible from the second instalment due on 23 September 1987. Some 9,200 employees took advantage of the offer. Ever since the Stock Exchange fall on 19 October the shares have traded at well below the discounted price of 153p. (The closing price on 28 March was 117p.)

6. Rolls Royce have never disputed that the discount is taxable on each employee. They warned the employees about the potential tax liability at pre-privatisation briefing meetings and, following discussions with the local Tax Inspector, they have announced to employees since the crash

that the tax will be collected by means of amended personal tax codes.

7. In practice, we would not seek to tax an employee if his liability in respect of such a benefit, taken together with any other under or overpayment, fell below £75. So Rolls Royce employees liable at the 1987/88 basic rate of 27p who bought the maximum discounted allocation of 1,176 shares would not be asked to pay any tax on the acquisition of these shares, provided there is no other reason for reviewing liability for 1987/88. If there is and, taken together, the resulting underpayment exceeds £75 we would proceed to raise an assessment. (NB. The assessing tolerances level is not published.)

8. In January of this year Rolls Royce approached the local Inspector seeking the waiver of any tax charge on employees. They claimed that the fact that the share allocation letters ceased to be negotiable on 23 September and that share certificates were not issued until early November led inexperienced investors (the majority of employees) to believe that they could not sell the shares between those dates, which spanned the crash. The collapse of their share prices is unique among privatisations (if not among public offers generally), the market value of others, including British Gas, having remained above the discount price. The taxation of the employees' benefits would, they say, lead to adverse publicity which would discourage employee participation in future privatisations. Moreover, the Chancellor is said to have "expressed surprise and concern" about the charge to the Rolls Royce Chairman, when the latter raised the subject at a dinner in December. Finally, the company suggest that the extra statutory concession (announced on 25 September 1987) exempting from income tax gifts to employees from third parties costing no more than £100 in any tax year is relevant to their case in that the employee discount may be regarded as representing a gift (from the Government) of part of a shareholding.

9. The note of the Rolls Royce dinner (copy attached), which we have just seen, makes no reference to the Chancellor's purported response. Indeed, as you will see, it indicates that Sir Francis Tombs said he would not be pressing the matter. We are also puzzled by the reference in that note to "many Rolls Royce workers .... receiving Inland Revenue assessments or coding changes to recover tax on this "benefit"". In practice, assessments for 1987/88 would not be made until after the end of the tax year - ie several months after the date of the dinner. And the District took no general initiative to amend codings, although it may be that some employees reported their liability.

10. The Rolls Royce case does not fall within the ambit of the extra statutory concession relating to gifts from third parties. The poor performance of Rolls Royce shares in comparison with other privatisation issues is unfortunate, as is any misunderstanding on the part of employees about the saleability of their shares in the period surrounding Black Monday or the risks of shareholding generally (a matter ~~in~~ this case, surely for the employer rather than Government). But when they purchased the shares employees should, of course, have appreciated that share values can fall as well as rise. In any event, irrespective of the shares' subsequent performance, they have received a benefit by paying less for their shares than members of the public - who have suffered a greater paper loss to date. Further, until the shares are sold there is no real loss - the price may recover in the future.

11. Whatever the decision, it could attract publicity and protest - either from Rolls Royce and its employees or, if a concession is granted, from members of the public who took up the Rolls Royce share offer at the full price or from employee shareholders in other companies who have suffered a tax charge in similar circumstances. (We see no respectable case for extending a blanket concession to either of these groups.)

12. Whilst recognising that the refusal of a concession could, possibly, have some discouraging effect on employee participation in future privatisations, we do not think that there is a persuasive argument for giving Rolls Royce employees special treatment. We would propose to soften the blow of refusal by reassuring Rolls Royce that for those employees liable at the basic rate and whose affairs are otherwise in order it is likely that our normal practice would result in no assessments being raised - even in the case of maximum discounts - given the amount of tax involved on the discounts alone.

Conclusion

13. We therefore propose to refuse Rolls Royce's request for waiver of the Schedule E tax due on employees' acquisitions of Rolls Royce shares at a discount, and would be grateful to know that you are content.

A C Majer

MRS A C MAJER

FROM: A C S ALLAN

DATE: 15 December 1987

MISS H M ROBERTS

cc PS/Chief Secretary
Mr Monck
Mr Burgner
Mr D Moore
Mr Waller
PS/IR

DINNER WITH ROLLS ROYCE

Thank you for your brief of 4 December. Discussion at the dinner was primarily about Rolls Royce; ACOST topics were not raised at all.

2. On Rolls Royce, the main points made were

(i) General satisfaction with the way the company was doing, though some concern about the current level of the $/£ exchange rate. They could live with $1.80 for perhaps a year at most, but would be seriously concerned if it persisted beyond that. Of their competitors, GE were definitely the more potent threat; Pratt and Whitney had proved much less effective recently.

(ii) There was some chiding about the difficulties Rolls Royce face because of the limit on foreign shareholdings; but no real pressure for action. They put the blame on DTI for having failed to listen to advice when the privatisation was being put together.

(iii) A keen interest among their workforce in what was happening on the Rolls Royce share price; this was felt to be a helpful development, even though their workforce was naturally concerned about why the share price had fallen so fast. Sir Francis Tombs noted that many Rolls Royce workers who had bought priority shares at a 10 per cent discount on the public offer price were now receiving Inland Revenue assessments or coding changes to recover tax on this "benefit", even though the present share price was well below even the discounted price the employees had paid. (Please could the Revenue confirm this tax treatment is correct.) But he was not pressing for any change (and certainly not a retrospective one to help Rolls Royce workers).

(iv) There was a general pressure for more launch aid, on the basis that this was a good investment for the Government; and that Rolls Royce would certainly not want to get involved in deals where they themselves did not believe a return would be forthcoming.

3. There was also - inevitably - some discussion about electricity privatisation, largely on the lines that everything would have been much easier if the Government had followed Sir Francis Tombs' prescription and set up several regional, vertically integrated companies, on the SSEB model!

ACSA

A C S ALLAN

42/2/DCG/4368/40

FINANCIAL SECRETARY TO THE TREASURY

NOTE OF A MEETING HELD IN THE FINANCIAL SECRETARY'S OFFICE ON WEDNESDAY 11 MAY 1988 AT 3.00PM

ROLLS ROYCE PRIVATISATION: EMPLOYEE DISCOUNT OFFER

Those present: Financial Secretary
Mr D Farmer) IR
Mrs A Majer)

The Financial Secretary held a brief meeting to discuss Mrs Majer's submission of 29 March 1988.

The Financial Secretary asked how many Rolls Royce employees would be subject to an income tax charge on the discount offer.

Mr Farmer emphasised that in all but a handful of the cases no tax charge would arise. This was because there was an assessing tolerance level of £75 worth of benefit, and most of the employees would be below this level because as base rate taxpayers, they would not be liable even where they had bought the maximum allocation of 1176 shares.

Mr Farmer was confident that very few employees on higher tax rates would be affected especially as many would not have bought the maximum allocation.

The Financial Secretary felt that on these facts the Revenue should refuse Rolls Royce's request for waiver of the Schedule E tax due on employees' acquisitions of Rolls Royce shares at a discount.

Susan Feest

SUSAN FEEST
11 May 1988

dti

the department for Enterprise

The Rt. Hon. Kenneth Clarke QC MP
Chancellor of the Duchy of Lancaster and
Minister of Trade and Industry

CHIEF SECRETARY
REC. 15 JUL 1988
ACTION Mr Waller — with attachment
COPIES TO Cx Sir Peter Middleton
Mr Anson Mr Monck
Mr Burgner Mr Moore
Mr Robson Mr Turnbull
Mr Call

Department of Trade and Industry

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London SW1H 0ET

Switchboard 01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Direct line 215 5147
Our ref
Your ref
Date 15 July 1988

Dear John,

ROLLS-ROYCE: LAUNCH AID APPLICATION FOR THE RB211 524J AND 524L ENGINES

Sir Francis Tombs wrote to me on 14 June making a formal application for launch aid for the RB211 524J and 524L engines. I have delayed writing to you about this until we had received the supporting material he promised to send us. This has now arrived. Copies of both documents are enclosed.

In summary, the application is for £107 million launch aid for the 524J and 524L engines. The company calculates the total launch costs to be £391.5 million. They hope risk-sharing partners will put up about £70 million of this. In addition the company intends developing the 535E4 (at present on the Boeing 757), but are not expecting any launch aid contribution towards the £29.9 million launch costs involved.

As the company has put in a formal application under the Civil Aviation Act 1982 I feel we are bound to give this proper consideration. There is a fairly standard procedure for the assessment by officials from my Department and the Ministry of Defence of the technical, market and financial aspects of launch

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aid applications. This I propose should operate in this case. I believe that in the past the Treasury has been represented on the small group of officials involved in the assessment. We would be happy to welcome someone this time.

As you will see,the supporting material the company has produced is pretty thin, and our first task will be to get them to amplify this considerably. One aspect I particularly want officials to examine is the question of private sector finance as an alternative to launch aid. We shall have to hear what the company has to say on this point, but I suspect they have not really given it much thought. If not I shall insist that they do so. It will also be made clear to the company that we shall be using a 5% real rate of return to the Government from any launch aid we might give as the basis for the discussions with them.

David Young made it clear in his letter of 25 May that there was no provision in our PES bids for possible launch aid for Rolls-Royce. If I do eventually decide to recommend that launch aid should be made available to Rolls-Royce, I will in accordance with the normal practice seek additional provision to meet the whole of the cost in the PES years, and will look to the Reserve to meet any payments that might be made in the current year.

On timing, we are to a large extent in the hands of the company. The sooner they provide the extra material needed the quicker officials can get on with the assessment. Subject to this consideration I would hope to have a paper to use as the basis for discussion with colleagues in mid-October.

I am copying this letter to George Younger.

Yours,
Ken

KENNETH CLARKE

JY1AAY

CHANCELLOR OF THE DUCHY OF LANCASTER
15 JUN 1988

ROLLS ROYCE

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

Chairman's Office

June 14, 1988

The Rt Hon Kenneth Clarke QC, MP
Chancellor of the Duchy of Lancaster and
Minister of Trade and Industry
1 Victoria Street
London SW1H 0ET

Dear Chancellor,

You will recall that at our meeting on 7 June I said that I expected that the Board would shortly decide to launch a further development of the RB211-524 series to be known as the 'L'. I now confirm that on 9 June the Board decided on developments of the RB211 family of engines, including the L, subject to Government support under the Civil Aviation Act 1982 of approximately £100 million relating to the specific requirements of thrust growth of the RB211-524. I am therefore applying formally for such support.

The RB211-524 is currently being developed to 60,600lbs of thrust in the H version for the Boeing 767, having reached 58,000lbs thrust in the G version which enters service on the Boeing 747 early in 1989. Further improvements of the Boeing 767 and 747 aircraft together with the requirements of the new Airbus A330 aircraft and McDonnell Douglas MD11 aircraft mean that increased thrust is now required. This will be provided by the RB211-524L engine, designed for 70,000lbs thrust and to be rated initially at 65,000lbs thrust; and by a growth of the 524H to 63,000lbs thrust using features of the L, to be designated the J. Aspects of the 524 developments will also be used to enhance the 535E4 engine (of 40,600lbs thrust) to respond to the competitive Pratt and Whitney PW2037 whose improvements are being funded by the US Department of Defence.

These engine developments will require gross R&D, tooling and learner funds of approximately £420 million to Spring 1995 ie: two years after entry into service of the L. The Company expects overseas Risk and Revenue sharing partners on the L project to meet some of this cost (perhaps £70 million) and to fund around £250 million itself. The remaining approximately £100 million, or a third of the cost faced by the Company, is what is needed to continue the Government's previous investment in this engine family.

/.......

[AW:L7004]

iae.nj Rob/100

FROM: H M ROBERTS
DATE: 7 September 1988

1. MR WALLER
2. CHIEF SECRETARY

cc Chancellor
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mr Moore
Mr Robson
Mr Meyrick
Mr Harding
Ms Osmond
Ms Yule

1. Alex
2. pwp.

ROLLS-ROYCE: APPLICATION FOR LAUNCH AID FOR RB-211 524 J AND L

Summary

You are aware that Rolls-Royce have made an application to DTI for £107m of launch aid for the further development of the RB-211 engine. This application is under detailed consideration by HMG. Monday's press coverage (extracts attached) notes that Rolls' managing director, Sir Ralph Robins, said at the Farnborough Air Shown that the company will go ahead with the proposed engine development whether or not it receives launch aid. This means that the project fails on a basic criterion for Government support because the project has no additionality. This submission advises you to write to Lord Young pressing him to let the company know that HMG would not now expect to pay any launch aid to Rolls-Royce.

Background

2. Rolls-Royce's application relates to 2 new RB-211 variants, the 70,000 lb thrust RB211-524L and the smaller RB-211-524J which will have a 63,000 lb thrust. These represents developments of the existing RB-211 versions: the RB-211 is currently being developed to 60,000 lb of thrust in the H version for the Boeing 767 following the 58,000 thrust in the G version which enters service on the Boeing 747 early in 1989. The new L engine for entry into service in 1993 is targeted at the Airbus A330, the McDonnell Douglas MD11 and the Boeing 747 and the J version for entry into service in late 1992 is targeted at Boeing 767.

3. On costing, Rolls-Royce's latest estimates are total R&D, tooling and learner costs of £452m to 1995 of which £70m of financing will be met through risk-sharing collaboration with other aerospace companies. Of this, Rolls is proposing £107m launch aid from HMG on an overall rate of return for the project of about 10.3 per cent.

4. The case put forward by Rolls-Royce is being looked at in detail by DTI and MOD officials and ourselves. This reflects the usual process for considering launch aid applications: although significant technical detail has been received from the company, the financial information conveyed remains thin. In particular Sir Francis Tomb has so far refused to let us see detailed company-wide financial forecasts and have given no clear answer to the question of whether Rolls has investigated private sector funding options. The data presented so far raises some doubts about both the technical and financial viability of the project particularly in the light of the relatively low project rate of return of 10.3%. DTI officials will shortly be writing to the company saying that, in the absence of group profitability, cashflow forecasts, to launch aid applications cannot be considered further. This will probably provoke Tomb into writing to DTI Ministers.

5. As foreshadowed in Lord Young's letter to you of 3 August, officials are unlikely to have sufficient information to enable them to present full advice to Ministers until the end of October. If the full procedures are followed it will therefore be impossible to consider the application <u>within</u> the Survey as your agenda letter of 21 July to Lord Young suggested. Your letter of 25 July to Kenneth Clarke (attached) emphasised both your scepticism about launch aid and your desire to have the application resolved within the Survey.

6. As you are aware, the Civil Aviation Act requires the Secretary of State for Trade and Industry to consider applications for launch aid from civil aviation companies. This support has hitherto been confirmed to aeroengine and airframe manufacturers of which Rolls-Royce is of course one. The main criteria for support against which applications are generally considered include the riskiness of the project, the availability of private

sector finance, the rate of return on the project and, crucially, additionality.

7. Ralph Robin's statement that RR will go ahead with the J and L RB-211 developments even without launch aid means that the project has no additionality. (This implies that other forms of private finance - internal or external - are available to Rolls; this would be consistent with the company's low gearing following privatisation in May 1987 with nil gearing). Prima facie there is thus no case for Government support. This presents a good opportunity for HMG to turn down the launch aid application quickly. The best route would probably be for Lord Young to write to Sir Francis Tombs, Chairman of Rolls-Royce, saying that he understands from company statements that the projects will go ahead anyway and that he therefore is not minded to grant this launch aid application. Giving Rolls-Royce an opportunity to respond in this way safequards HMG from accusations of having truncated the usual procedure for considering such applications.

Conclusion

8. Lord Young is away in Australia until 15 September. DTI officials will be advising him to write to Rolls-Roycc along the lines proposed above on his return. It may be helpful if you also write along the lines of the attached draft re-emphasing the case against launch aid and highlighting this as a means of resolving the issue within the Survey as your agenda letter had proposed. I suggest you might copy the letter to the Prime Minister in vicw of the public row with Sir Francis Tombs which a refusal to aid RR will probably cause.

MS H M ROBERTS

DRAFT LETTER TO LORD YOUNG

ROLLS-ROYCE: APPLICATION FOR LAUNCH AID

I note from recent press reports that Rolls-Royce have said that they intend to go ahead with development of the RB-211 524 J and L engines whether or not the company receives launch aid from the Government. Like you no doubt, I do not find this very surprising given the advantageous gearing terms on which Rolls-Royce were privatised.

2. When I wrote to Kenneth Clarke on 25 July on this matter, I emphasised my doubts about this form of support for Rolls-Royce and my hopes that the issue may be resolved within this year's Survey. Your reply dated 3 August suggested that a quick resolution was probably not feasible.

3. However, the recent announcement by the company means that the projects have nil additionality for HMG since they will go ahead without launch aid. This is of course a very strong prima facie reason for refusing launch aid and the announcement provides an ideal opportunity to dispose of the application quickly. I therefore suggest that you to write to the Chairman of Rolls-Royce, Sir Francis Tombs, saying that since Rolls-Royce intend the projects to go ahead without launch aid there can be no case for Government funding so you are minded to turn down the application thus ensuring that the porjects are funded by the company, in accordance with Government policy on near market, single company R&D programmes.

4. I am sending a copy of this letter to the Prime Minister and George Younger.

JOHN MAJOR

INDEPENDENT 5/9/88

Rolls-Royce to press on with engine

ROLLS-ROYCE will go ahead with the £300m development of the world's most powerful civil aircraft engine whether or not the Government provides launch aid, the company's managing director Sir Ralph Robins indicated yesterday.

This suggests that Rolls is resigned to receiving little or none of the £100m launch aid requested from Lord Young, Secretary of State for Trade and Industry, for the crucial launch of the RB211-524L engine. If Rolls fails to get the £100m, it will be a major blow, forcing it to shoulder all the development risk. But the company is confident the market for the unit is sufficiently large to make it a success.

Lord Young is taking a tough line on subsidies to large and profitable companies following the reorganisation of the DTI.

Rolls is already lining up the 70,000lb-thrust 524 engine for the European Airbus A330 aircraft and the American-made McDonnell Douglas MD-11 and Boeing 767. The engine is due to come into service in 1993.

Asked if Rolls would go ahead without Government funding, Sir Ralph said at the Farnborough International Air Show: "Yes, we are going to do the 524L."

Meanwhile Rolls is waiting nervously for a decision from the Ministry of Defence on whether its RTM322 engine has been selected in preference to a rival US engine to power the new Anglo-Italian military helicopter, the EH101. Britain and Italy want 500.

US engine maker General Electric is offering a rival engine which has already been selected in preference to the Rolls unit by the US Department of Defence.

The EH101 engine order is worth around £75m, but if the MoD selects the Rolls engine, it could provide the springboard for worldwide sales worth up to £800m.

■British Aerospace yesterday announced orders worth more than $400m for 19 of its 146 "Whispering" jets. The Australian based transport group TNT has ordered 11 freighter versions of the 146, Air UK has ordered two 146-300 airliners and a further six orders have been placed by unnamed airlines.

FINANCIAL TIMES 5/9/88

Rolls-Royce backs high thrust jet

By Michael Donne

ROLLS-ROYCE, one of the world's "big three" jet engine builders, is now fully committed to developing its new higher-thrust L model of the RB-211-524 engine, and will build it even if the company does not win government launch aid for the venture.

Rolls-Royce has asked the Government for £100m in aid, about a third of the estimated overall development cost.

So far, there has been no government response, but detailed technical and financial discussions continue, and Rolls-Royce is confident that support will be forthcoming.

The need for Rolls-Royce to press ahead with the L engine, which will have a power output of 67,500 lb and above, was confirmed at the air show yesterday by the announcement of General Electric of the US that it had decided to develop a competitive engine, the CF6-80 E1, of 65,000 lb thrust and upwards.

Such "super-power" engines are needed to power the forthcoming generation of bigger and heavier airliners, such as the 335-seater short-to-medium-range Airbus A-330, and bigger versions of the long-range Boeing 767 twin and the three-engined McDonnell Douglas MD-11.

Pratt & Whitney, which has a big engine of its own, the PW-4000, has yet to announce a bigger-thrust version but is expected to do so this week.

dti
the department for Enterprise

The Rt. Hon. Kenneth Clarke QC MP
Chancellor of the Duchy of Lancaster and
Minister of Trade and Industry

Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CHIEF SECRETARY

Mr Waller — Mr Hatherleach
cx Sir Peter Middleton
Mr Anson Mr Monck
Mr Burgner Mr Moore
Mr Robson Mr Turnbull
Mr Call

Department of
Trade and Industry

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Direct line 215 5147
Our ref
Your ref
Date 15 July 1988

Dear John,

ROLLS-ROYCE: LAUNCH AID APPLICATION FOR THE RB211 524J AND 524L ENGINES

Sir Francis Tombs wrote to me on 14 June making a formal application for launch aid for the RB211 524J and 524L engines. I have delayed writing to you about this until we had received the supporting material he promised to send us. This has now arrived. Copies of both documents are enclosed.

In summary, the application is for £107 million launch aid for the 524J and 524L engines. The company calculates the total launch costs to be £391.5 million. They hope risk-sharing partners will put up about £70 million of this. In addition the company intends developing the 535E4 (at present on the Boeing 757), but are not expecting any launch aid contribution towards the £29.9 million launch costs involved.

As the company has put in a formal application under the Civil Aviation Act 1982 I feel we are bound to give this proper consideration. There is a fairly standard procedure for the assessment by officials from my Department and the Ministry of Defence of the technical, market and financial aspects of launch

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aid applications. This I propose should operate in this case. I believe that in the past the Treasury has been represented on the small group of officials involved in the assessment. We would be happy to welcome someone this time.

As you will see, the supporting material the company has produced is pretty thin, and our first task will be to get them to amplify this considerably. One aspect I particularly want officials to examine is the question of private sector finance as an alternative to launch aid. We shall have to hear what the company has to say on this point, but I suspect they have not really given it much thought. If not I shall insist that they do so. It will also be made clear to the company that we shall be using a 5% real rate of return to the Government from any launch aid we might give as the basis for the discussions with them.

David Young made it clear in his letter of 25 May that there was no provision in our PES bids for possible launch aid for Rolls-Royce. If I do eventually decide to recommend that launch aid should be made available to Rolls-Royce, I will in accordance with the normal practice seek additional provision to meet the whole of the cost in the PES years, and will look to the Reserve to meet any payments that might be made in the current year.

On timing, we are to a large extent in the hands of the company. The sooner they provide the extra material needed the quicker officials can get on with the assessment. Subject to this consideration I would hope to have a paper to use as the basis for discussion with colleagues in mid-October.

I am copying this letter to George Younger.

Yours,

Ken

KENNETH CLARKE

JY1AAY

RM 2/018

dti

the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Department of
Trade and Industry

1-19 Victoria Street
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Switchboard
01-215 7877

Direct line 215 5422
Our ref PS1BGU
Your ref
Date 3 August 1988

cc: PS/Chancellor of the Duchy of Lancaster
PS/Mr Atkins
PS/Sir Brian Hayes
Mr Williams Dep Sec
Mr Michell Air o/R
Mr Durie FRM
Mr Richardson Air 1 o/R
Mr Ralph Air 3
Mr O'Shea FRM 1
Mr Mason IDU
Mr Miall IDU
Mr Mann Ec
Dr A Morris DEng (MOD)
Mr Waller HMT

Dear John,

ROLLS-ROYCE : LAUNCH AID APPLICATION

Thank you for your letter of 25 July to Kenneth Clarke, to which I am replying as I have taken over his responsibilities for aerospace matters. Your letter crossed with mine of 26 July on the Public Expenditure Survey, in which I in fact addressed the points you make.

Whilst I appreciate your desire that the question of launch aid for the Rolls-Royce RB211 524J and L should be discussed and settled in the Survey, as I explained I doubt whether it will be possible to achieve this. Whilst my officials will naturally stress to the company the need for a rapid response to requests for further information, and, together with officials of your Department and MoD they will proceed with the assessment of the case as speedily as possible, nevertheless I remain doubtful that it will be possible to complete the paper for Ministerial consideration before the end of September at the earliest. You will appreciate that this is a very tight timetable - previous launch aid assessments have taken up to six months - and we are dependent on receiving further information from Rolls-Royce, which the company are in the process of providing.

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the department for Enterprise

As to the decision whether to recommend assistance in this case, I must, of course, give proper consideration to the application and I shall consequently not be in a position to say what my view will be until the officials' assessment of the case has been completed and I have had a chance to study it.

I am sending a copy of this letter to George Younger.

Y.e.

David

the Enterprise initiative

Commercial in Confidence

iae2.rb/Rob/min2

FROM: H M ROBERTS
DATE: 15 February 1989

1. MR REVOLTA - note at end

2. CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mrs Lomax
Mr MacAuslan
Mr Meyrick
Ms Osmond
Mr Call
Mr Tyrie

ROLLS-ROYCE: REQUEST FOR LEVY CONCESSIONS

Summary

This note reports developments in the Rolls-Royce application for levy concessions. Rolls-Royce applied last year for £107m launch aid in support of development of the RB211 engine (the 524 J/L programme). Lord Young decided in December to reject this application although this has not yet been made public. Subsequently Rolls-Royce applied for remission of levies due on existing launch aid contracts. The figures are still being discussed with the company but discussions should be completed within the next couple of weeks when DTI officials will submit advice to Lord Young who will then hold a meeting with Sir Francis Tombs, the Chairman of Rolls-Royce to tie up the launch aid decision and reach agreement on levy concessions.

Issues

2. The original launch aid application related to 2 new RB-211 variants. The 70,000 lb thrust 524L is targeted at the Airbus A330, the McDonnell Douglas MD11 and the Boeing 747. The smaller 63,000 lb thrust 524J is targeted at the Boeing 767. Rolls-Royce asked for launch aid of £107m to allow development of these engines so that Rolls-Royce's position in the marketplace is retained and the Government would continue to receive levy payments for the launch aid provided for this and earlier contracts. Lord Young turned down this application on the basis that Rolls-Royce had

failed to make an additionality case; the 524J/L developments would proceed anyway because they were necessary for the continuing commercial credibility of the company as a major supplier of civil aeroengines.

3. Further consideration on how to present this decision - perhaps in the form of the Rolls-Royce board withdrawing the application - will be given at the meeting between Lord Young and Sir Francis Tombs.

4. Following the launch aid decision Rolls-Royce submitted an application for levy concessions on existing launch aid contracts with the company. These fell into 3 areas.

5. First, launch aid on smaller engines given jointly with MOD before 1971 for the Dart, Conway, Avon, Spey and Tyne engines. Rolls-Royce proposed that these payments (over £20m over the next 10 years) should cease. The sums are significant taken over the whole period and DTI is inclined to turn this proposal down.

6. Second, some suspension of levies due on the RB211-535E4 on which launch aid was paid in 1983-1985. Specifically, Rolls-Royce won a contract with American Airlines to supply 50 Boeing 757s. Sales of the E4 have been poor and Rolls-Royce have priced these engines at a loss (of £47m) in order to secure a market foothold. They have asked that the corresponding £13.7m levy payments due be foregone. DTI are minded to turn down this request since it is not for HMG to carry the down-side risks of the company's commercial judgement.

7. Third, on the RB-211 524 series of engines launch aid was given for development of the RB-211 524D engine. But Rolls-Royce has subsequently developed further variants to the 524G and H engines which are now going into service. The proposed 524 J and L are further variants of this engine. Under the terms of the launch aid contract Rolls-Royce and HMG have to agree rates at which levy should be paid on new variants of a launch-aided engine having regard to the extent to which the original technology is reflected in the new variants. Levies were originally expressed as a percentage of sales (the form in which launch aid contracts were agreed in late 1970s), although sales of the original 524D engine

have now all but ceased being overtaken by later variants. Rolls-Royce are seeking a relatively low % levy on the G and H and J and L variants and discussions with the company are proceeding on this basis. The basis of such negotiations is the assumption that the original launch aid should - at a minimum - be repaid in constant price terms. Any concession to Rolls-Royce proposed by DTI officials will need to be assessed against this benchmark. Careful consideration will need to be given to the presentation of any concession. One possibility under discussion is to write off part of the launch aid (in recognition of the collapse of the Tristar market in 1983 a crucial target for the original RB211 524D) but seek a positive NPV rate of return on the remainder.

Conclusion

8. The way forward on the smaller engines (Dart, Spey etc) and on the RB211 535 E4 options is clear - DTI expect to turn these proposals down. On the RB211 524 series some concession may be desirable although it will need to be substantially less than the £107m launch aid originally applied for compared with a base case of constant prices repayment of launch aid.

HMR

Ms H M ROBERTS

Because of the further development of this engine, we have no option but to negotiate revised levy rates with RR. We will submit specific proposals in due course, but you should be aware that these negotiations are in hand, and could prove troublesome if Sir Francis Tombs plays a tough hand.

DCWR

D C W REVOLTA

iae2.rb/Rob/min1

Seen in draft HMR

FROM: H M ROBERTS
DATE: 24 February 1989

1. MR ~~REVOLTA~~

2. CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mr MacAuslan
Mr Meyrick
Ms Osmond
Mr Call
Mr Tyrie

ROLLS-ROYCE: REQUEST FOR LEVY CONCESSIONS

Summary

This reports negotiations with Rolls-Royce on levy concessions for the RB-211 524 series of engines, the only proposal under consideration. (My submission of 15 February set out the background). We now need your agreement to a final negotiating package for officials to pursue with the company. It is hoped that agreement by officials can be endorsed at a meeting of Lord Young with Sir Francis Tombs, the Rolls-Royce chairman, now planned for Monday 6 March. The proposed package would provide a 1% real return on Government launch aid and would cost about £16m in foregone levies over the Survey period (1990-91 to 1992-93).

Issues

2. To recap on the RB-211 524 series under discussion: launch aid was given for the RB-211 524B and D variants in the early/mid and late 70s respectively, under the Labour administration. Rolls-Royce has subsequently developed RB-211 524G and H engines to a thrust of up to 63,000lb and these are now going into service. The planned RB-211 J and L variants on which Rolls-Royce applied unsuccessfully for launch aid in the autumn will take the thrust up to 70,000lb.

3. The launch aid contract for the RB-524 series provides for repayment of launch aid via levies on sales of engines and spares, originally set at 7% and 2% respectively. Unlike the later Airbus contracts there is no provision for full repayment within a specified period and levies are wholly dependent on timing of actual sales.

4. The original contract allows for levies to be paid only on 524 engine variants which were directly launch aided: but it also provides for the Government and the company to reach agreement on an appropriate rate of levies for further developments of the engine, since such variants are dependent on the technology originally developed via launch aid. In reaching agreement parties must take account of the extent to which the derivative embodies the original technology and the relative financial participation of the company and HMG. If no agreement is reached the issue goes to arbitration.

5. The original contract was signed by the then Government under the presumption that at best the Government would recover its launch aid, with the clear inference that this was in cash terms only. Since 1979 however, policy has been for Government to seek a real rate of return on its launch aid (and this was stated in the Rolls-Royce privatisation prospectus). In discussions with DTI officials and the company we have stressed the importance of the rate of return both to get a handle on the figures under discussion and to set talks in the correct policy framework. The company have resisted a rate of return criterion since it did not feature in the original contract.

Launch aid

6. Total launch aid paid from 1972 to 1983 on the RB-211 series up to the D derivative was £176m cash, or £319m at 1988 prices.

Future Levies

7. The method which DTI and ourselves have agreed with the company for calculating future levies is based on the relative financial contributions of Government and the company to the G/H and prospective J/L developments respectively. For example launch aid represented 53% of the development costs of £633m (1988 prices) up to the D variant. Further expenditure of over £900m (1988 prices) by the company is needed to develop up to J/L variants. Thus as the company develops the G/H and then the J/L the Government's expenditure becomes diluted: the method scales down accordingly levies payable (from the original 7% on engines and 2% on spares). Recalculating on this basis gives a projection of future levies of £280m (at 1988 prices) to which must be added the £90m (1988 prices) of levies already received, totalling £370m (1988 prices).

8. In terms of the rate of return offered, this represents a real return of about 1% (equivalent to £377m at 1988 prices). This is more than the minimum of £319m for 0% real return set out in my earlier minute (and which was explicitly the Government's best hope at the time the contract was signed). In negotiations with the company DTI had originally pressed at our request for 2% real return as an opening position but we are prepared to settle for 1%.

Incidence of Repayment

9. We have looked at the possibilities for increasing the rate at which launch aid will be repaid: present sales projections on which the figures above are based go up to 2017. Since expenditure on spares is generally later in time than expenditure on engines we explored the possibility of front-end loading levies on to engines. But since spares are common across a range of Rolls-Royce engines there is little scope to move away from the fixed 2% now applied. Similarly setting an overall time limit on levy repayments would arbitrarily cut off levies from spares derived from other engines.

10. One possibility for improving the timing of levy repayments would be to have a higher levy rate on G/H engines which will be delivered earlier than on the J/L engines now under development. This is consistent with the dilution of HMG's launch aid as the engine series develops. For the 1% overall rate of return option above this implies 3.5% levies on G/H, 1.5% levies on J/L and 2% levies on spares compared with the present 7% and 2% levies. The company is likely to resist a differential levy rate across the engine series because this would have an adverse impact on their cash flow through the 1990s compared with the equivalent single engine levy rate of 2.4%.

Survey Implications

11. It is not possible to compare overall the package proposed above with the status quo because until the present contract is renegotiated HMG officially does not stand to receive any levy payments from the G/H derivatives, let alone the J/L derivatives. Hence the adoption of a rate of return criterion. But such a comparison is possible in the short term, and the approximate cost of levies foregone for 1989-90 and over the Survey period is as follows:

Year	Levies foregone £m	
1989-90	6.4	
1990-91	6.3)	
1991-92	5.3)	16.2 over Survey
1992-93	4.6)	
Total	22.6	

Assessment

12. Different rates of return have a significant impact on the total levies paid by the company as shown in the table below.

Real rate of return	**Total levies at 1988 prices**	**Equivalent rate of levies Engines**	**Spares**
0	319	1%	2%
1	377	2.4%	2%
2	446	4.1%	2%

13. Our judgement is that to press for a higher rate of return than 1% runs the risk of pushing Sir Francis Tombs into seeking arbitration, which we would wish to avoid presentationally. Rolls-Royce's principal concern is their cash flow in the early 1990s, and although the company have approached the negotiation from a different standpoint, their final position on a figure which is defensible under the contract appears to be close to our calculations. Given that the Government originally expected no more than repayment of launch aid there is some chance that an arbitration could generate a worse outcome. We should therefore be prepared to settle for the package of levies which offer a 1% return.

Conclusion

14. The package proposed, which gives a real rate of return of 1% to be achieved via 3.5% levies on G/H engines, 1.5% levies on J/L engines and 2% levies on spares, seems the best achievable outcome. It has a PES cost of £22-6m over the next 4 years and this can be imported as an argument for cuts in this year's PES round.

15. These figures would be our minimum position, but for the reasons given the range of defensible figures is narrow, and we do not expect to persuade Rolls-Royce to settle even at this figure without difficulty. Even if officials agree this package, it may be that Sir Francis Tombs who is notoriously unpredictable will choose to reject a deal, but we think that having your advance authority on a package should persuade Lord Young to stand firm when he meets Sir Francis Tombs.

HR

Ms H M ROBERTS

iae2.rb/Yule/098

Seen in draft
[initials]

FROM: MS R YULE
DATE: 19 April 1989
Ext: 4658

1. MR REVOLTA

2. CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Robson
Mr Wilson
Ms Roberts
Mr Harrison

ROLLS-ROYCE DINNER

You are to have dinner with Sir Francis Tombs, Sir Ralph Robbins and Peter McFarlane of Rolls-Royce on Thursday 20 April. We do not know of any specific reason why Rolls-Royce wish to meet.

2. I attach briefing on the current market position of Rolls-Royce and recent issues which may come up in discussion.

[signature]

pp R YULE

Market Position

RR forms one of the 3 largest manufacturers of aeroengines in the West, behind General Electric and Pratt & Whitney (US). Its business involves design, development and manufacture of both civil and military aeroengines. It also produces gas-turbines for warships and industrial use. **70% of sales are outside UK but UK Government is single most important customer.** It has an overall workforce of 40,400.

1988 results announced last month show **pre-tax profits of £168m** on a turnover of £1.97bn. The results have been slightly depressed by exceptional redundancy costs (£29m) and the effect of the weak dollar on the key US market. Results for previous years attached at Annex A. Turnover by division gives: civil aeroengines 45%, military aeroengines 40%, industrial and marine 6%, other 9%.

RR order book for engines (civil and military) stood at **£4.1bn** at end 1988 - a 50% increase on 1987. This has increased further in 1989 with the announcement (22 March) of a £1bn deal with American Airlines, £1.03bn with Air Europe (8 Feb) and a deal worth up to £350m with Cathay Pacific (4 April). It is also bidding for the engine contract in the TWA £2bn deal with Airbus Industries.

City speculation suggests RR share price currently cheap (180p) and possibly vulnerable to a bid. This follows the lapse on 1 January 1989 of the 15% limitation imposed on privatisation on any individual shareholding in RR. The 15% limit on foreign-held shares also set when the company was privatised in 1987 still applies. See Annex A for Special Share details.

Foreign Shareholding limit

Foreign held shares were limited on privatisation by means of the Government Special Share to **15%** of issued voting shares. This was justified on the grounds of national security interests in view of RR's major role in design, development and production of UK military equipment.

The European Commission consider the limit illegal under EC law because it discriminates between UK and other EC nationals. Forced sale of RR shares last year to bring the overall foreign-held stake to below 15% led to losses for shareholders (including some EC nationals) because of the fall in the share price after, "Black Monday'. The UK claims immunity under Article 223 of Treaty of Rome which allows member states to take such measure as necessary to protect national security interests.

Negotiations are continuing between EC and Lord Young. The UK have proposed raising shareholding limit to **24%** (Sir Francis Tombs seeks 25%). This level would reduce the chance of foreign shareholders having to sell, but remain below 30% level at which a full takeover panel bid had to be launched under takeover panel rules. The EC would like the limit phased out entirely in the long term. Some indications that Brussels may accept this compromise, but they are likely to postpone a decision on the case for 2 months.

The foreign shareholder ceiling has helped to depress RR's share price by limiting share trading and RR's ability to raise money on equity market. Any agreed changes to the limit will have implications for British Aerospace shares which operate under a similar 15% foreign shareholding limitation.

NEI takeover

RR announced on 10 April its acquisition of Northern Engineering Industries for £306m as part of long term diversification programme. It is thought that Sir Francis Tombs seeks to emulate diversified character of US competitors General Electric and Pratt and Whitney. NEI produce turbines, boilers, mining, rail and other industrial equipment. There is speculation that some parts of NEI are to be sold off - RR deny this and state no plans for redundancies.

The move by RR is seen as a conglomerate merger rather than a takeover - due to the complementary, rather than competitive, nature of their activities.

Launch Aid

The Government announced (15 March) rejection of the RR request of over £100m launch aid for development of RB 211-524J and 524L civil aeroengines. These are the latest and most powerful derivatives in the RB-211-524 series. RR will now finance development costs (estimated at £300m - £500m) themselves with contributions from risk and revenue sharing partners. Two Japanese companies Kawaski Heavy Industries and IHI Industries have agreed to take 10% stake. RR is negotiating with a third partner, thought to be Sena (Spain). The 524L is due to enter service in 1993 on a new generation of wide-bodied airliners. It will be most powerful civil engine yet with a thrust of up to 70000lbs, and crucial to RR's market position.

It is an important Treasury objective to reduce industry's dependence on and expectation of such financing, and so Lord Young's rejection of this launch aid application is encouraging

Levies

On the back of the launch aid rejection the Government agreed significant **levy concessions** to RR. These levies became payable by RR on all sales of the RB-211-524 series as a result of the Government launch aid payment for development of the original 524D model in 1982. [These concessions will cost HMG around £15-20m in foregone levies over the period 1989-93.]

Defence Issues

EJ200

The engine which will power the European Fighter Aircraft. It is being produced in collaboration with Fiat, MTU (Germany) and Sener (Spain). This project will incorporate new technology currently being tested in the XG40 Engine Technology Demonstrator Programme which has recently successfully completed its first trial runs. EJ200 will be more powerful for its weight and size than existing comparable aeroengines. Also, and more important for us, it is designed to have better reliability and maintainability. Rolls Royce privately consider themselves the technology leaders of this project (with some justification).

Pegasus

Powers the Harrier and Sea Harrier. Rolls Royce are working on a more powerful derivative called 11-61. They are keen to sell this to the RAF. However, this variant has been developed as a private venture and as yet MOD have not identified a requirement to fit it to their aircraft.

RTM322

A collaborative helicopter engine project with France and Italy. It is being developed as an alternative to the US who are the world leaders in helicopter engines. As yet there has been no launch customer for this engine and Rolls Royce are keen to see ll it to MOD for the EH101 helicopter currently under development with Italy. In the face of opposition from the Chief Secretary, MOD Ministers went ahead with an announcement at Farnborough last year that RTM322 had been chosen as the preferred engine for EH101 should a more powerful derivative be required. We have made it clear that we do not regard this as binding and <u>if</u> a more powerful engine is required for EH101 we will expect to see full competition with the alternatives before a decision is reached.

Sales

On recent military aero engine export successes: the Al Yammamah deals with Saudi Arabia will provide Rolls Royce with work for some time. Including phase 2 of the deal the order is now for a total of some 120 Tornado aircraft, each powered by two RB199 engines and 90 Hawks each powered by an Adour engine. The Adour engine also powers the T-45 training aircraft, based on the Hawk, of which some 300 are being built for the US Navy.

ROLLS ROYCE PLC - PRIVATISATION DETAILS

Date of Privatisation

20 May 1987.

Proceeds

	RR	HMG
£m	283	1065.4
Net of expenses	n/a	1027.5

Expenses

£m	45.0
Total	[Note: most of these expenses were shared between HMG and the company]

Method of Sale

801.5 million shares, representing 100 per cent of ordinary share capital, offered at 170p per share in fixed price offer for sale. Of these, 11.765 million shares were not underwritten to take account of employees' applications for free and matching shares. There was no overseas offer. The offer price was payable in two instalments, 85p on application and 85p on 23 September 1987. The Government retains a Special Share.

Status pre-privatisation

Companies Act Company, 100 per cent owned by Government.

Legislative power to sell

Industry Act 1980.

Special Share

Provisions in the Articles of Association entrenched by the Special Share include:

(i) number of foreign-held shares permanently restricted to 15 per cent;

(ii) three quarters of the Rolls Royce Board, including the Chairman and the Managing Director, must be British citizens;

(iii) the disposal of 25 per cent of the assets of the Group as a whole or of the nuclear business requires the consent of the Special Shareholder.

(iv) No individual allowed to exceed 15 per cent shareholding. (Elapsed 1 January 1989.)

Structure of the Offer

	No of Shares (million)
Placed with UK institutions	394.9
Public offer (UK)	339.8
Employees and pensioners and priority offer	63.5
	801.5

Performance before and after privatisation

Year ending 31 December.

	1982	1983	1984	1985	1986	1987	1988
Pre tax profits	(93)	(115)	26	81	120	156	168
Turnover (£m)	1,493	1,331	1,409	1,601	1,802	2059	1970
Capital Expenditure (£m)	53	49	26	56	81	82	
Employees (no)	52,222	46,344	41,864	41,406	42,000	41,600	40,400

Shareholders

870,000

Share price

Offer price (part paid) 85p. Closing price (first day trading 20 May) 147p. Premium of 62p or 36 per cent on fully paid price. Prices on payment of second instalment 170p.

Relative movement in part-paid share price

	RR	FT all Share Index
At privatisation (20 May)	170 p	1086.05
Low since privatisation (3 December 1987)	99p	
Current price (14 April)	180p	2028
% change since privatisation	5%	86%

ROBINS, Sir Ralph (Harry), Kt 1988; FEng 1988; Managing Director, Rolls-Royce plc, since 1984; *b* 16 June 1932; *s* of Leonard Haddon and Maud Lillian Robins; *m* 1962, Patricia Maureen Grimes; two *d*. *Educ:* Imperial Coll., Univ. of London (BSc, ACGI). MIMechE. Development Engr, Rolls-Royce, Derby, 1955–66; Exec. Vice-Pres., Rolls-Royce Inc., 1971; Man. Dir, RR Industrial & Marine Div., 1973; Commercial Dir, RR Ltd, 1978; Chm., International Aero Engines AG, 1983–84. Chm., Defence Industries Council, 1986–; Dep. Pres., Soc. of British Aerospace Companies, 1987–88 (Pres., 1986–87). *Recreations:* tennis, golf, music. *Address:* Rolls-Royce plc, 65 Buckingham Gate, SW1E 6AT.

TOMBS, Sir Francis (Leonard), Kt 1978; FEng 1977; Chairman: T & N (formerly Turner & Newall), since 1982; Rolls-Royce, since 1985 (Director, since 1982); Director: N. M. Rothschild & Sons, since 1981; Shell-UK, since 1983; *b* 17 May 1924; *s* of Joseph and Jane Tombs; *m* 1949, Marjorie Evans; three *d*. *Educ:* Elmore Green Sch., Walsall; Birmingham Coll. of Technology. BSc (Econ); FIMechE; FIEE; FInstE. GEC, 1939–45; Birmingham Corp., 1946–47; British Electricity Authority, Midlands, then Central Electricity Authority, Merseyside and N Wales, 1947–57; GEC, Erith, 1957–65; C. A. Parsons, Erith, 1965–68; James Howden & Godfrey Ltd, 1968–69; successively Dir of Engrg, Dep. Chm., Chm., South of Scotland Electricity Bd, 1969–77; Chm., Electricity Council, 1977–80. Chm., Weir Group, 1981–83. Member: Nature Conservancy Council, 1978–; Standing Commn on Energy and the Environment, 1978–; SERC, 1982–85; Chairman: Engrg Council, 1985–88; ACARD, 1985–87 (Mem., 1984–87); ACOST, 1987–. Pres., IEE, 1981–82. Chm., Assoc. of British Orchestras, 1982–86. Hon. FIChemE 1985; Hon. FICE 1986. Hon. LLD Strathclyde, 1976; Hon. D(Tech) Loughborough, 1979; Hon. DSc: Aston, 1979; Lodz, Poland, 1980; Cranfield, 1985; DSc(Eng) QUB, 1986; Hon. DLitt Bradford, 1986. *Recreations:* music, golf, sailing. *Address:* Honington Lodge, Honington, Shipston-upon-Stour, Warwickshire CV36 5AA.

FROM: A C S ALLAN
DATE: 21 April 1989

Can I have a copy of ACSA's minute pl.

1. Julie
See X + await letter
2. Pry

MS YULE

cc PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Robson
Mr I P Wilson
Mr Revolta
Ms Roberts
Mr Harrison

ROLLS-ROYCE DINNER

Thank you for your minute of 19 April and the brief for the Chancellor's dinner. Rolls-Royce were in a very confident mood, with so many recent large orders that planning production is now a concern for them. Indeed, it says a lot about their current position that, rather than bend the Chancellor's ear about economic policy and manufacturing industry, they chose to devote most of the discussion to the Health Service and Water privatisation!

2. Sir Francis Tombs raised launch aid, but without any strong pressure. His line was that Rolls-Royce could manage perfectly well setting up risk-sharing joint ventures with overseas companies as an alternative to launch aid. But this involved an export of jobs and technology and he was not convinced it was really in the UK's national interest.

3. He explained the rationale behind the NEI take-over, stressing particularly the way the two businesses complemented each other.

4. There was some discussion about training and skill shortages. This is not a problem for Rolls-Royce: they find they can always attract the cream of engineering graduates, and do a lot of training themselves. But they felt that other companies were having more difficulties.

5. They had no complaint at all about the current level of interest rates, since they are pretty cash rich at the moment. Nor did they really have any complaints about the exchange rate: they would of course make more money with a lower real exchange rate, but they had no illusions that a lower nominal rate would produce this.

6. They suggested that the Chancellor might visit their Derby operations. The Chancellor said he would try to do this sometime in the Summer when he was in his constituency.

ACSA

A C S ALLAN

FROM: J M G TAYLOR
DATE: 13 July 1989

MP

Can I see

PPS pl

MR REVOLTA

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr D J L Moore
Mr Robson
Mr I P Wilson
Mr Stevens
Mr S Kelly
Mrs Chaplin

ROLLS ROYCE AND BRITISH AEROSPACE FOREIGN SHAREHOLDING LIMITS

The Chancellor was most grateful for your note of 11 July. As you will have seen, he wrote to Lord Young as drafted.

2. The Chancellor would be grateful to know what the position is (in terms of eg limits on foreign shareholdings) in relation to the various French special shares. I should be grateful for advice.

J M G TAYLOR

DINNER

Monday 24th July, 1989, at 7.30 p.m.

31 Walpole Street,
London S.W.3.

(Tel.: 730 2351)

The Rt. Hon. Nigel Lawson MP.	
Mr. Alex Allen	Principal Private Secretary to the Chancellor of the Exchequer
Mr. Robert Horton	Deputy Chairman, The British Petroleum Company plc
Sir Colin Marshall	Chief Executive, British Airways plc.
Mr. Eric Parker	Group Chief Executive, Trafalgar House plc.
Mr. Patrick Sheehy	Chairman, BAT Industries plc.
Mr. Anthony Tennant	Chairman and Group Chief Executive, Guinness plc.
Mr. Edward Dawnay	Executive Director, Lazard Brothers & Co., Limited.

MPL

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Julie

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Registered in England No. 162175

17th July, 1989.

Dear Mr Allan.

I am looking forward to seeing you at Dinner next Monday, 24th July, at 7.30 p.m., at my home, 31 Walpole Street, London S.W.3. (Tel.: 730 2351). I enclose a list of the guests.

My intention is that we should have a totally informal chat about political and business affairs with no particular subject on the agenda.

Yours Sincerely
John Nott.

Alex Allan Esq.,
Private Secretary to The Rt. Hon. Nigel Lawson MP.,
HM Treasury.

dti

the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

19/7

CH/EXCHEQUER
REC. 19 JUL 1989
ACTION Mr MONCK
COPIES TO PS/FST, PS/EST, Sir P. MIDDLETON, Mr ANSON, Mr WILSON, Mr MOORE, Mr ROBSON, Mr BENT, Mr REVOLTA, Mr CHAPLIN, MISS WHELDON - T. SOL

Department of Trade and Industry

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Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref LQ3AKA
Your ref
Date 19 July 1989

Dear Paul,

ROLLS ROYCE AND BRITISH AEROSPACE FOREIGN SHAREHOLDING LIMIT

As you know, the Commission have accepted my Secretary of State's compromise of an increase in the foreign shareholding limit from 15% to 29.5% together with a review. However, they have said that they want the review to take place by the end of 1992 instead of after 5 years as proposed. My Secretary of State wishes to announce tomorrow, by means of a written PQ, that he accepts the Commission decision (as in attached draft).

I should be grateful for your (and copy recipients) agreement by noon tomorrow 20 July.

I am copying this letter to Richard Gozney (FCO) and Jonathan Taylor (HM Treasury).

Yours, Gareth.

GARETH JONES
Private Secretary

the Enterprise initiative

dti

Q: To ask the Secretary of State for Trade and Industry/the Chancellor of the Duchy of Lancaster if he will make a statement about the outcome of his/his Department's discussions with the European Commission on the limits on foreign shareholdings contained in the Articles of Association of Rolls-Royce.

A: The Government has decided, following discussions with the Commission on Rolls-Royce, that the limit on foreign shareholdings could reasonably be increased for both Rolls-Royce and British Aerospace from 15% to 29.5% without prejudicing the principle that they should remain under British control. In reaching this decision the Government took into account not only the concern expressed by the Commission about the effect of the restriction on other EC nationals wishing to buy shares in Rolls-Royce, but also the wishes of Rolls-Royce and British Aerospace to have the limit increased given the international nature of their business. The Government has made it clear in discussions with the Commission that in its view the imposition of a limit is fully justified by Article 223 of the Treaty of Rome.

The Government also agreed with the Commission that at the end of 1992 it would review the limit on foreign shareholdings in the light of any changes in the structure of the European defence industry and in the pattern of defence procurement over the period.

The next step is for both companies to seek the agreement of their shareholders to the necessary changes to their Articles of Association. The present limits remain in force until such time as these Articles are amended.

2417

98a/1 pe2.la.7.20.7.gaseltine

COVERING COMMERCIAL IN CONFIDENCE

FROM: MISS K GASELTINE
EXT: 4778
DATE: 20 July 1989

1. ~~MR MOORE~~ DW 20/7.
2. MRS THORPE

cc Mr Ilett
Mr Pirie
Mr S Kelly
Mr G Roberts
Mr B Morris

CHANCELLOR'S DINNER WITH SIR JOHN NOTT, LAZARD BROTHERS: 24 JULY

Your minute of 14 June requested a note from PE for this dinner. Sir Colin Marshall, Chief Executive of British Airways, and Mr Bob Horton, Deputy Chairman of BP, are amongst the guests.

Lazard Brothers

2. I attach a list of appointments in connection with past privatisations which Lazards have held or tendered for unsuccessfully. You should note that Lazards are acting as advisers to Thames Water Authority and to National Power. Lazards have taken a policy decision not to participate in primary underwriting competitions for Government share sales, presumably because commission rates are too low. Their last involvement as underwriter was in the British Airways sale in 1987, for which they were also acting as the company's adviser. (From this sale onwards, the Government has always used a formal competitive tender for primary underwriting.)

Lazards are advising BR on privatisation options and on private sector participation in the Channel Tunnel rail link. DW

British Airways

3. Following the 1987 share sale, the Government still holds just under 10 million shares in BA, in order to satisfy entitlements under the share bonus arrangements. These shares were transferred in January from the Department of Transport to Treasury Solicitor, who holds them on behalf of the Treasury. The bonus issue will be in February 1990, but it will not be necessary to distribute the entire holding. No date has been fixed for the sale of any residual holding (likely to be at least 3 million shares); such a sale will take place as the circumstances of the company and market conditions permit.

British Petroleum

4. Share sale: difficulties with the October 1987 share offer, the takeover of Britoil in February 1988 and the buy-back of 790 million shares from the Kuwait Investment Office in March 1989 are now past. The collection of the final instalment on shares sold in the 1987 offer has just been successfully completed.

5. Brazilian rain forests: the Sunday Times alleged on 18 June that BP was involved in the destruction of rain forests through its Brazilian tin mining interests in the National Forest of Jamari. BP's Chairman, Sir Peter Walters, wrote to the newspaper, enclosing a detailed document circulated to BP employees which claimed that the Sunday Times had misrepresented BP's involvement, in particular the extent of the operations taking place in a "protected area", the extent of land cleared to enable mining to go ahead and the total level of damage caused. The document also refuted suggestions that BP had denied Brazilian officials access to the site. Mr Chris Patten, ODA, met the relevant Brazilian Environment Minister Mr Mesquita during a recent visit to Brazil, and it appears that Mr Mesquita told him that the damage was not on the scale suggested and that Brazilian authorities were as much to blame as the BP-owned companies involved. The Sunday Times have further suggested, in a report on 25 June, that Mr Mesquita is considering whether legal action was appropriate, but it is not clear if such action will be taken or how BP would fare if it were.

Kate Gaseltine
MISS K GASELTINE

C12 LAZARD BROTHERS

Adviser to Government	:	British Sugar Corporation British Aerospace (1985) Britoil (1985) PBI/NSDO
Adviser to Company	:	BGC - Wytch Farm Enterprise Oil (advised BGC) Royal Ordnance British Airways British Shipbuilders (Warship Yards) British Technology Group Electricity (~~CEGB~~): National Power Thames Water Authority British Rail Engineering Limited
Underwriter		BP (1977, 1979, 1983) British Telecom British Aerospace (1985) Britoil (1985) British Gas Corporation British Airways
Tendered unsuccessfully for Adviser to Government	:	Amersham International Associated British Ports National Bus Company Rolls Royce N. Ireland Electricity Cable and Wireless (1985) Docklands Light Railway 3rd Dartford Crossing

CH/EXCHEQUER
REC. 20 JUL 1989
ACTION Mr Monck
COPIES TO PS/EST PS/EST, Sir P Middleton, Mr Anson, Mr Wilson, Mr Moore, Mr Revolta, Mrs Chaplin, Miss Wheldon TSOL

2077

Foreign and Commonwealth Office

London SW1A 2AH

20 July 1989

Dear Gareth,

Rolls Royce and British Aerospace: Foreign Shareholding Limit

The Foreign Secretary agrees that, as proposed in your letter of 19 July to Paul Gray, we should accept the Commission decision.

Copies go to Paul Gray (No 10) and Jonathan Taylor (HM Treasury).

Yours ever,

Richard Gozney

(R H T Gozney)
Private Secretary

Gareth Jones Esq
Department of Trade and Industry

CH/EXCHEQUER

REC. 21 JUL 1989 ✓ 21/7

ACTION Mr Monck

COPIES TO PS/FST, PS/EST, Sir P Middleton, Mr Anson, Mr Wilson, Mr Moore, Mr Revolta, Mrs Chaplin, Miss Wheldon T/Sol

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 July 1989

Dear Gareth,

ROLLS ROYCE AND BRITISH AEROSPACE FOREIGN SHAREHOLDING LIMIT

Thank you for your letter of 19 July which the Prime Minister has seen. She has noted that the Commission wants the Review of the Foreign Shareholding Limit to take place by the end of 1992; with some reluctance she is content for the Government to accept this.

I am copying this letter to Richard Gozney (Foreign and Commonwealth Office) and to Jonathan Taylor (HM Treasury).

Yours,

Paul

PAUL GRAY

Gareth Jones, Esq.,
Department of Trade and Industry

chex.ps/aa/24 **UNCLASSIFIED**

FROM: A C S ALLAN
DATE: 27 July 1989

BF 5/8

MISS K GASELTINE

cc Mr D J L Moore
Mr Ilett
Mr Pirie
Mr S Kelly
Mr G Roberts
Mr B Morris
Ms R Yule

CHANCELLOR'S DINNER WITH SIR JOHN NOTT, LAZARD BROTHERS: 24 JULY

The Chancellor was grateful for your minute of 20 July, and the briefing for his dinner on Monday.

2. The discussion was pretty general, concentrating on leveraged takeovers (Mr Sheehy was one of the guests!), policy towards Europe, pay (both board pay and more generally) and the prospects for the economy.

3. One specific point which Sir John Nott raised was that the British Government still carried a substantial liability in the event of Pan Am going bust, arising from the rescue of Rolls Royce in the early 1970s. The Chancellor would be grateful to know if this is true, and for some more information about this. I should be grateful if Ms Yule could provide a note.

ACSA

A C S ALLAN

UNCLASSIFIED

iae2.rb/DR/15.8

FROM: D C W REVOLTA (IAE2)
DATE: 15 August 1989
EXT: 4659

PS/CHANCELLOR

cc PS/Sir P Middleton
Mr Anson
Mr Monck
Mr Wilson
Mr D J L Moore
Mr Bent
Mr Stevens

Thanks. No need to pursue ~ no cncs.

ROLLS ROYCE AND PAN AM

Your minute of 27 July asked us to follow up a point made by Sir John Nott at a Lazards dinner on 24 July, to the effect that the British Government still carried a substantial liability in the event of Pan Am going bust, arising from the rescue of Rolls Royce in the early 1970s.

2. I am afraid that we can find nothing whatever to give substance to this remark. We have been into the point with DTI, and they have been back informally to Rolls Royce themselves; but there is no suggestion that there would be any financial liability falling directly or indirectly to the Government if Pan Am were to fail.

3. The best construction of what Sir John Nott had in mind would presumably be that Pan Am were making staged payments to Rolls Royce with a covering guarantee from the British Government; but there is no trace of payments of this kind, or of a contingent liability of this nature. Indeed, I understand that Pan Am rarely specify Rolls Royce engines when ordering new aircraft for their fleet. They did so on one occasion in 1978, but the aircraft in question have since been sold.

4. If you are able to throw any more light on the reported remark, I would be glad to make further enquiries.

DCWR

D C W REVOLTA

FROM: J M G TAYLOR
DATE: 25 August 1989

MR D C W REVOLTA (IAE2)

cc PS/Sir P Middleton
Mr Anson
Mr Monck
Mr Wilson
Mr D J L Moore
Mr Bent
Mr Stevens

mp

ROLLS ROYCE AND PAN AM

The Chancellor was grateful for your note of 15 August. He thinks there is no need to pursue this further, in the circumstances.

J M G TAYLOR