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PRIME MINISTER

Future Arrangements for Rolls-Royce

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BACKGROUND

This paper by the Secretary of State for Industry reflects a good deal of discussion in which Cabinet Office, and in particular Sir Kenneth Berrill, have taken part. This does not mean that we necessarily agree with its conclusions but I hope we have helped to bring order into the presentation of a very complex situation.

2. There are really four interlinked issues:-

(a) The relationship between the Government, the NEB and Rolls-Royce.

As matters stand the NEB and Rolls-Royce are not on speaking terms (Sir Kenneth Keith is urging Sir Keith Joseph to sack Sir Leslie Murphy and vice versa).

(b) The quality of the Rolls-Royce management. It is common ground that the present management has lost control of the company.

Sir Kenneth Keith is an excellent salesman and has played a major part in pulling Rolls-Royce round after the trauma of 1971 but production-oriented management is missing.

(c) The financial prospects for the company. These are universally agreed to be unacceptable. On present figures Rolls-Royce is asking for nearly £1 billion over the next four years for a prospective profit of £20 million. Rolls-Royce, in common with much of British industry, has been hit by the strength of sterling - particularly so because in the civil aeroengine business, dominated as it is by the Americans, prices are quoted in dollars and the essential competition is American; by differential inflation in the United Kingdom as compared with the United States; and, paradoxically, because the boom in civil aircraft sales and Rolls-Royce's success in establishing its big civil engines in the civil

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aircraft market, requires substantial increases in working capital. Whatever management solution Ministers go for there will be very real difficulties in reducing substantially the figure for which Rolls-Royce are asking. The financial need arises mainly from the RB 211 family and we have commitments in varying degrees to Lockheeds, Boeing, British Airways, etc.

- (d) The disposal and/or privatisation of Rolls-Royce. There are two threads here - GEC's ambitions to buy parts of Rolls-Royce (notably on the industrial engine, marine engine and nuclear sides) and more generally, the company's poor profit expectations.

3. These problems do not all have to be solved at once but the management aspects are urgent - the private rows between NEB and Rolls-Royce could become public at any time. Moreover the solution of these problems links with disposals (if GEC are involved) and could, only too readily, provoke major questions affecting not only the future of Rolls-Royce but also our relations with the United States (where the fortunes of both Boeing and Lockheed are significantly dependent on Rolls-Royce's civil engine production) and have a very direct bearing on our defence capability. It is also relevant that Rolls-Royce is a major source of export earnings (£400 million a year) and one of our few engineering enterprises of world stature.

4. Sir Keith Joseph's proposals, summarised in paragraph 34 of his paper, constitute a coherent approach to these problems though his central recommendation about employing GEC to manage the company (and the price Sir Arnold Weinstock may exact for the help he gives) is likely to be politically very contentious. We do not yet know GEC's price but any price involving disposals carries the risk of charges of "asset-stripping". In addition there must be doubt about the extent to which GEC's management, however good, is capable of handling simultaneously the full range of Arnold Weinstock's ambitions (which appears to extend to BAe and Cable & Wireless as well as Rolls-Royce and further involvement in the nuclear business). There must also be doubt about whether the GEC proposal is the only way of coping with the managerial problem (both NEB and Sir Kenneth Keith have other ideas and the GEC solution may be welcome to neither); and given the United States and defence complications there

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are considerable presentational problems in any solution in a situation where, if the presentation goes wrong, the interests of the company and of the nation could be damaged.

5. There is no great urgency for a decision from the cash flow point of view: the reason why Sir Keith Joseph wants a very early decision is because the row between Murphy and Keith could come out into the open at any time. If the Group feel that they have insufficient information to go nap on the GEC solution, one possibility would be to ask a management consultant to report on Rolls-Royce's figures so that the Government may take decisions on the best strategy for Rolls-Royce before appointing a new manager to implement them.

HANDLING

6. You will want to ask the Secretary of State for Industry to introduce his paper. Thereafter the easiest course might be to run through his specific recommendations in paragraph 34. In doing so you might like to know that the "small group of officials" referred to in recommendation 5 has already been constituted, informally, under Sir Kenneth Berrill's chairmanship and, subject to the outcome of Ministerial discussion, is ready to work quickly on producing the necessary report. There has been some disagreement between the Department of Industry and the Treasury about whether Ministers should defer decisions until that report is available or whether the installation of the GEC management and the flow of information this would generate, is a necessary prerequisite to the production of an adequate report. The view we have taken is that the Official Committee should be asked to get on with it whatever view Ministers take on the management issue. If a flow of information from the company results from a Ministerial decision, well and good. If not there are other possibilities, eg. the employment of consultants, which could be brought into play.

CONCLUSIONS

7. The key decision is whether Sir Keith Joseph should be authorised to open discussions with Rolls-Royce, the NEB and Sir Arnold Weinstock on the lines he proposes. If so then recommendations 1 and 2 of paragraph 34 can be accepted. Recommendations 3 and 4 flow from the outcome of those consultations and the

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Group may want to have a report from Sir Keith Joseph about the reactions of the parties before taking a final decision. Recommendation 5 (setting up a small group of officials) can be endorsed at once. Recommendation 6 is a necessary part of an initial approach to GEC. Recommendation 7 needs to be reserved for further consideration when the initial soundings have been completed.

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