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FROM: P J KITCATT

DATE: 16 June 1986

CHANCELLOR

cc Chief Secretary
 Financial Secretary
 Sir P Middleton
 Mr F E R Butler
 Mr Monck
 Mr Burgner
 Mr Moore
 Mr Scholar
 Mr Turnbull
 Mr Grimstone
 Ms Seammen
 Mr Hyman
 Mr Graham
 Mr Smart
 Mr Ross-Goobey

NAPN.

RO FLOTATION AND THE ALTERNATIVES

There is to be a further meeting under the Prime Minister's chairmanship tomorrow.

2. There will be four papers:-

(i) Mr Younger's minute of 13 June;

(ii) a note on how a decision to float now would be presented (to be circulated later tonight by MOD - officials' draft at Annex A);

(iii) a note on how a decision not to float now would be presented (officials' draft at Annex B);

(iv) advice by the Law Officers (not yet available).

Line to Take

3. You will want to put the arguments in favour of going ahead. But you will want to acknowledge the risks in doing so, including, if something goes wrong, the risk of having to pull in, say, the next two or three weeks. If Mr Younger's advice is no longer

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for flotation as planned it is probably wise to accept it; on top of all the other doubts, a reluctant Minister in charge of the operation looks like a recipe for disaster. In that case, you should press for careful scrutiny of the alternatives and their public presentation.

Legal Position

4. The advice of the Law Officers (which we have not seen) may also affect your attitude - the point to be established is whether law-suits affecting flotation (eg the prospectus) are possible. We understand that (a) the advice is likely to be that there is no legal impediment to the non-competitive contract, but (b) if Vickers consider that the scheme setting up RO plc damages their interests they can have recourse to HMG (not RO plc) for compensation.

Background

5. Today's developments were as follows.

6. The Prime Minister met Mr Younger this morning. Her preference was for abandoning flotation in July and taking Mr Younger's alternative course (minute of 13 June) of placing the 7th Challenger order with Leeds; selling the Leeds and Nottingham factories to Vickers; floating the rest later. Mr Younger did not demur but wanted to consult you. In your absence, he spoke to the Financial Secretary.

7. Also as a result of Mr Younger's discussion with the Prime Minister, the notes of which the drafts are at Annexes A and B were commissioned; also the Law Officers' advice.

The Alternatives

8. Mr Younger's minute, and the note at Annex B, deals with only one alternative. It does not discuss the option of a trade sale of the whole of RO plc, or selling in bits.

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9. A trade sale of the whole would be the most attractive option (Mr Graham's minute of 13 June). MOD do not believe there would be any effective interest, but this remains to be seen. I suggest you press Mr Younger hard. Similarly with selling in bits. In general, if flotation in July is off, the best public position for the present is probably to be willing to consider all practicable alternatives for getting RO plc into the private sector at a defensible price. There needs to be more than just a flavour of competitive bidding which is one of the objections to being tied now to Mr Younger's one alternative.

7th Challenger Order

10. Mr Younger wants to place the contract for 7th Challenger with RO plc even if flotation does not go ahead. As you will see from the Annexes, this is not an easy course of action to justify, even if we accept the MOD judgement that this is likely to be better value for money than holding a competition. The trouble is that this can't be proved.

11. The disadvantages of holding a competition are that we could not sell either RO plc as a whole, or Leeds on its own, until it was over. And if Vickers won, Leeds would not be worth much.

12. On this, too, I suggest you press Mr Younger hard; in general, the presumption should be that if flotation is off there should be a competition, which RO plc should win on merit (cf what the Prime Minister said about Rolls Royce and British Airways). This would certainly be easier to present publicly.

13. If the decision is against a competition, you will want to resist giving Vickers "compensation" in the form of other MOD orders (which is what they want).

Presentation

14. Depending on the decision, either Annex A or B will need refining - especially B. The Treasury should be involved. Presumably the aim will be an announcement on Wednesday.

PM

ARGUMENTS TO USE IF FLOTATION GOES AHEAD

1. General. Royal Ordnance plc is a commercial company which belongs in the private sector. It needs to become more efficient and this can best be achieved through the application of commercial disciplines, free from public sector constraints.
2. Timing. The sooner commercial disciplines begin to bite the better.
3. CHALLENGER. All previous orders have been on Royal Ordnance. We have obtained in negotiation a good price which ^{we believe} represents value for money both for the 7th Regiment and for the 5th and 6th Regiments, and satisfactory delivery dates.
4. Lack of Competition. Competition only one way of achieving value for money. In this case we believe we have achieved value for money without competition. Competition now would lose the terms we have negotiated with Royal Ordnance.

6. Vickers.

- a. Recognise their disappointment and concern. Hope they will discuss with privatised Royal Ordnance possibility for rationalisation of UK tank manufacturing capability.
- b. If Vickers consider the Scheme which vested assets in Royal Ordnance damaged their interests they can have recourse to HMG under the Ordnance Factory and Military Services Act.

Legality

5.7 No impediment to non-competitive contract either generally or in the context of flotation. Prospectus will make clear that contract has been awarded non-competitively.

7. Featherbedding RO. Royal Ordnance is in transition between Trading Fund status and commercial viability. Necessarily the full impact of competition policy has to be staged so that it becomes the efficient contractor that we wish to see.

British Airways / Rolls Royce

3- In the case of British Airways and Rolls Royce competition was the order of the day and was justified as being necessary for the health of RR. The same argument applies to RO.

Line to Take

8. The cases are quite different. We are dealing here not with competing tanks but the manufacture of a tank to a set design already in volume production by one company. This has enabled us to negotiate a particularly advantageous deal which would not be likely to be improved upon by a competition. Indeed a competition now, with the inevitable delays while all parties prepared their quotes and we evaluated them, would ~~certainly give~~ ^{be likely to give} us a worse deal.

ARGUMENTS TO USE IF FLOTATION IS CANCELLED

1. General. Flotation in 1986 was an ambitious target which presented a major challenge to the Company and to HMG. In the event we have decided that although substantial progress has been made in the process of transforming Royal Ordnance into a fully fledged commercial entity we have not been able to develop and have in place all the features necessary for a successful flotation.
2. Way Ahead. We have always recognised and made clear that there is more than one approach to privatisation of Royal Ordnance. We have now decided that a direct sale of the Company's tank factory at Leeds and possibly the whole of its Weapons and Fighting Vehicles Division will be a sensible first step towards privatisation. We shall be seeking bids from Vickers [and other manufacturers of Armoured Fighting Vehicles] to this end. Options for the privatisation of the rest of Royal Ordnance will be considered further, with flotation as a whole a possibility. This approach will secure greater rationalisation of the UK's Armoured Fighting Vehicle manufacturing capability.

4 Giving in to Vickers' pressure. Not at all. Our approach secures value for money in tank procurement and promotes industrial rationalisation. The CHALLENGER contract will be placed with Royal Ordnance but Vickers [and other companies] will have the chance to bid for the purchase of Leeds plus CHALLENGER contract. If they succeed they can determine on commercial grounds the division of work between Leeds and Newcastle.

3. [As for para. 4 of Annex A]