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PRIME MINISTER

SHORT BROTHERS LIMITED: NEW AEROSTRUCTURES WORK

Introduction

1. I am writing to seek your and E(A) colleagues approval to permit Shorts, the Government-owned aerospace company in Belfast, to bid for important new aerostructures work.

Current policy

2. We agreed in December 1981 (E(EA)(81) 15th meeting) that Shorts should be permitted to accelerate and expand production of their modified commuter airliner (SD360), to continue missile development and to seek new work for their aircraft components division, subject to Ministerial approval to major cases. This strategy was confirmed by Ministers last February on the basis of the company's Corporate Plan 1982 Update.

New aerostructures proposal

3. Annex A to this memorandum describes a proposal for a new contract to provide wings for a stretched version of the Dutch Fokker F28 (the plane to be known as the P332): Annex 3 sets out the financing for this contract against the background of the provision made for new aerostructures contracts in the Corporate Plan 1982 Update.

Assessment

4. I am strongly in favour of authorising this contract. It would provide over 7,500 manyears of employment in Shorts, maintaining some 760 jobs at a unit cost of £7,000 well below

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the normal cost per job limit of £8,500 for assistance towards new private sector investments in the Belfast area. This employment would moreover be sustained at substantially less risk than is often associated with such few mobile investments as are prepared to locate in Northern Ireland at all.

5. Shorts is now the largest industrial employer in the Province and represents a unique centre of technological skill and competence. I am quite clear that it must be sustained. Were we to fail to authorise this comparatively rare aerostructures opportunity, a direct Government decision would be widely seen to have precipitated the progressive loss of up to 700 jobs.

6. In making this assessment I take full account of the fact that the P332 project is not attractive in commercial terms when taken in isolation. However it would take a significant contribution to lowering the company's fixed aerostructures costs when there are no alternative new contracts in prospect - an important consideration, especially for an aerostructures operation which does not employ the underpinning of regular defence supply contracts. In practice therefore to take the contract will be more beneficial financially than not to do so.

7. I do not believe that we need worry about competition with BAe - the P332 would doubtless proceed with another wing supplier if we were to refuse Shorts' proposal. Furthermore the P332 will be powered by the Rolls Royce Tay engine.

EC dimension

8. Officials have agreed that the Government aid proposed need not be notified to the Commission, largely because it

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falls within the agreed limits of regional assistance. Should however the Dutch and German Governments decide to notify, my officials would consult with their FCO counterparts on the best way forward.

Recommendation

9. I recommend that we authorise Shorts to bid for the P332 wing contract, including £8.6m in Government grants. I acknowledge that in a middle of the range assessment of sales the contract will not be profitable (See Annex A for market appraisal). There is a wide range of uncertainty about the market prospects and sales at the top of the realistic range would produce a profit. I recognise, however, the importance of giving due weight to the downside risks and I therefore propose that Shorts be encouraged to seek a higher price in negotiation with Fokker (so reducing risk by recovering non-recurring costs more quickly.) I would, however, be prepared to allow Shorts to proceed on the price costed in their submission (based on recovery over 125 wing sets) if absolutely necessary and subject to my agreement.

10. I am copying this letter to other E(A) colleagues, the Secretary of State for Foreign and Commonwealth Affairs, the Secretary of State for Defence and Sir Robert Armstrong. As Shorts must respond to Fokker not later than 12 October - under the tight timescales customary in aerospace sub-contracting - I should be grateful for replies by 11 October.

Derek Hill

J P

(Approved by the

Secretary of State and

CONFIDENTIAL signed in his absence)

SHORTS: P332 AEROSTRUCTURES CONTRACT

1. Shorts currently manufacture the wings for the 80 seater Dutch Fokker F28. Fokker plans to stretch this aircraft to 107 seats (the plane to be known as the P332) and Shorts have been invited to supply modified wings. A large German aerospace company has also been invited to participate on another part of this national programme. Shorts proposal has been fully analysed by management consultants Touche Ross who advise the Northern Ireland Department of Economic Development on matters concerning Shorts.

2. If Shorts entered the contract, they would be dealing with a known customer on work with which they are entirely familiar. It would maintain work for some 760 people at peak (1987/89) and over the period to 1995 provide a total of over 7,500 manyears of employment at Shorts. On the basis of Shorts' proposal the contract - denominated in sterling - would provide a positive contribution of £29.9m towards fixed overheads and interest charges over a 12 year period (11.9 discounted rate of return before Government grants). After allowing for interest charges the contribution to fixed overheads would be £17m which would be £6.6m less than necessary to cover the project's share of those overheads the bulk of which will be incurred whether or not this contract is won. Alternative major new aerostructures contracts are unlikely to emerge in the foreseeable future.

3. The cumulative adverse cashflow (peaking at £16.8m before interest charges in December 1986) can be met from provision for new projects in Shorts' Plan but, because of heavy initial tooling and development costs recoverable as deliveries are made, the contract would in early years have an adverse effect, by comparison with provision for new aerostructures work made in the Plan, on company profitability of £1.6m and £2.2m before interest in 1984/85 and 1985/86 respectively. (Annex B, Table 1, shows the Plan's provision for the impact of anticipated aerostructures projects in cash and profitability terms. This compares with forecasts of P332 cash requirements and profitability shown at Table 2).



4. Shorts are now in process of revising their forecasts beyond March 1984, to reflect changing market circumstances, as part of their preparation of a new plan. This is expected in late October and will come forward in due course thereafter for collective Ministerial consideration.

Risks

5. The main risks in the P332 bid arise in two areas:-

- (a) Market: the P332 would compete directly with the British Aerospace 146-200 and could find itself in certain markets faced with the prospective McDonnell Douglas MD-90 (117 seats) and Boeing 737-200 (120 seats) as well as early, smaller versions of these models available second-hand. Market forecasts prepared by Fokker, McDonnell Douglas and Boeing suggest a potential sales range of between 325-750 aircraft of 100-125 seats between 1983-1997. Fokker's projection is at the top of this range and they believe that within it the P332 could enjoy 200 sales by 1997 (up to 20 a year). Shorts on the other hand forecast a more modest sales volume for the P332 of about 125 by 1995 (ie growing to 15 a year). The Department of Trade and Industry believe that sales of 10-15 a year are possible, Touche Ross 8-17 a year. The market risk relates to the number of aircraft over which amortisation takes place: Shorts have assumed 125 wing sets, but, if only 100 were sold, gross contribution would fall to £22m.
- (b) Programme management: the introduction of P332 wing manufacture, possible in parallel with modest continuation of F28 wing production, will pose

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management problems. Shorts are aware of these difficulties and claim to have developed adequate techniques to cope with them.

Government Assistance

6. Shorts have sought Government assistance of £8.6m (£3.3m non-discretionary capital grant, £5.3m discretionary support for innovation) for the project over the period to 1991-92, the balance of funding coming from bank finance. The Government grant can be accommodated within existing PES provision for Northern Ireland.

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TABLE 1

CORPORATE PLAN - AEROSTRUCTURES DIVISION

	Year ending 31 March	1984	1985	1986	
Profit/(Loss) on anticipated projects		(0.971)	(0.745)	0.732	£m
Cash requirements for anticipated projects		(2.634)	(8.722)	(13.748)	£m

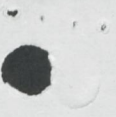
TABLE 2

P332 CONTRACT	Year ending 31 March	1984	1985	1986	
Profit/(Loss)		(0.940)	(2.320)	(1.480)	£m
Net Cash Flow		(2.030)	(5.865)	(6.655)	£m

Footnote

The figures in the above tables are after grant but before interest.

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Treasury Chambers, Parliament Street, SW1P 3AG

The Hon Adam Butler Esq MP
Minister of State
Northern Ireland Office
Whitehall
LONDON
SW1A 2AZ

5 December 1983

Via Adam

SHORT BROTHERS NEW AEROSTRUCTURES WORK

Thank you for your letter of 18 November.

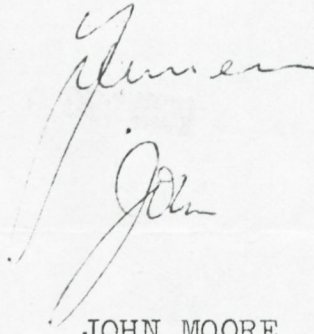
While I am indeed pleased to see that your efforts have led Shorts to negotiate better terms, which substantially reduce both risk and loss on the P332-contract, I find it more difficult to accept that my other proviso - a prospect of a reasonable commercial profit - has been met. This is because, for technical reasons my officials can explain to yours, I am much less than fully persuaded by the changes you propose in the treatment of interest charges. Insofar as there may be some much smaller adjustment to be made on this account, I would calculate that, on the central sales assumption of 125 units, the contract might be expected to break even.

This is not wholly satisfactory. With eventual privatisation in view, we wish to see Shorts behaving like a fully commercial company now. The need for them to find profitable new contracts increases as prospects for their existing business deteriorate. The P332 contract on the terms now proposed will not help that process, despite the strong position Shorts started from as existing sub-contractor for the Fokker Friendship.

I do however understand the reasons why you judge, in the sixth paragraph of your letter, that it would be counter-productive to press Shorts further. I recognise too that, in the still very depressed conditions of the aerospace market, the revised terms are not unusual for an aerostuctures contract. Since the substantial reduction in the downside risk has met the more important of my two provisos, I can go along with what you propose;

but I do so only on the understanding, which your officials have confirmed, that the P332 will not so preempt capacity that Shorts will be precluded from taking on a further, and profitable, major aerostructures contract (perhaps related to the Boeing 7-7).

I am sending copies of this letter to the Prime Minister and to other recipients of yours.

A handwritten signature in cursive script, appearing to read "John Moore". The signature is written in dark ink and is positioned above the printed name.

JOHN MOORE

1000 POC
Shurt Brothers
Corporate Plan
Nov. 80.

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Minister of State

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

NCPM at the top

AT 2/1/11

John Moore Esq MP
Financial Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

19 November 1983

Dear John,

SHORT BROS: NEW AEROSTRUCTURES WORK

Jim Prior has asked me to reply to your letter of 7 October about the Fokker P332 project. We were both grateful for your and other colleagues' prompt replies.

You will recall that in putting this case forward we had indicated that we would be encouraging Shorts to secure improved terms in its negotiations with Fokker. In particular we wished to minimise the risks associated with the recovery of non-recurring costs and therefore asked the company to achieve amortisation over a smaller number of wingsets. Your letter helpfully reinforced the pressure we put on the company for improved terms which, I believe, meet those objectives which we jointly shared.

Fokker have agreed to a fixed payment plan for recoupment of non-recurring costs. This arrangement has the effect of minimising Shorts' risk as payment for these costs will be made in regular instalments and will not be a function of the number of wingsets delivered.

These terms give a substantial additional benefit, as explained fully in the attached Appendix: whilst the overall revenue from the project is almost unaltered, cashflow is improved in comparison

with the original proposal and this yields major interest benefits. The arrangement, by reducing risk and improving cashflow, goes a long way to dispel the anxieties we both shared about the market prospects for the P332 aircraft.

The treatment of interest has been looked at again by our consultants (Touche Ross). They have pointed out that, again as explained in the Appendix, a more proper assessment of the total worth of the project should also include benefits during the period of the contract, and that real rates of interest should be applied. The effect of this, together with the renegotiation produces an overall profit of £6.1m and a discounted rate of return before grant of 12.1%.

Shorts have made good progress in their negotiations with Fokker and in my judgment it would be counter-productive to expect them to seek any further improvements in the price of wing sets, as there are serious risks in pushing Fokker too hard. First, the civil jet airliner market is tight and the P332 prospects will be very sensitive to price. Secondly, although Fokker did not approach any other wing suppliers, there is a large number of alternative sources - indeed they could build for themselves - and in a situation where new aerostructures projects are limited Fokker could be confident of securing a competitive price. Thirdly, Fokker already build wings for Shorts' own SD330 and SD360 and, understandably, Shorts want to avoid retaliatory action.

I believe that these revised terms meet the provisos in your letter of 7 October and I trust that you will now be able to confirm your agreement to the contract proceeding. I do not believe that there is any scope for further significant improvement and I need hardly remind you of the difficulties we would face if we had to turn down a contract on these terms, and produce as a result of our own actions the loss of some 700 jobs associated with the project.

Lastly, I note that you disagree with our view that, even if the contract did not fully cover fixed overheads and interest, it would

still have been advantageous to Shorts. Clearly this is no longer relevant to the P332 project in the light of the revised terms. I believe however that we should come to an agreed view on this and I have asked my officials to explain to yours why we, and Touche Ross, adhere to our original view.

I am copying this letter to the Prime Minister and members of E(A), the Secretary of State for Foreign and Commonwealth Affairs, the Secretary of State for Defence and Sir Robert Armstrong.

Yours ever
Adam
ADAM BUTLER

GLK

SHORTS - P332REVISED TERMS

1. The original arrangement for repayment of non-recurring costs by Fokker was that they would be recovered from payments attaching to the sale of the first 125 wing sets and, on Shorts' estimate of demand, full recovery would have been achieved by 1995. As a result of further negotiations, however, Fokker has agreed to repay these costs in six equal instalments between 1986/87 and 1991/92 inclusive and the estimated effect is to increase cash flow in those years by £0.8/1.6m each year. (In compensation, receipts in the years 1992/93 to 1994/95 inclusive would fall by £2.0m each year). The impact of the earlier receipt of this income is to reduce total interest charges by £3.6m.
2. The original consideration of the project prudently regarded its only income as being that received from Fokker and treated as expenditure not only the costs of manufacturing the wing sets but interest charges as well. The consideration nevertheless judged the contract on whether or not the Company would be better off with or without the project, ie the contribution (after interest costs) which the contract would make to fixed overheads versus the savings in fixed overheads which could be achieved without the contract. This being so, in calculating the level of contribution throughout the contract, all variable income - including interest gains in the later stages of the contract - might properly have been taken into account as well as all variable expenditure. As the later stages of the contract show substantial cash inflows - £3/4m per annum - this interest benefit amounts to £6.2m by March 1995.
3. Shorts' submission of the costs and benefits of the project were based on 1983 prices and included interest costs at a rate of 12% per annum. (It also provided summaries which showed the impact of inflation). It is a generally accepted case, however, that interest rates are made up of a real rate of interest and an element to cover inflation and various estimates of the real rate lie between 2% and 5%. Shorts uses a mixture of 3%, 4% and 5% in its Corporate Plan.
4. Applying a real rate of 4% to the forecast cash flow of the P332 project - interest charges and interest income - reduces the net charge in the forecasts at 1983 prices by £3.6m. Of course, the

Company will in practice pay a higher rate but any resultant increase in interest charges will be offset by gains from repaying amounts borrowed at, say 1983 prices at, say 1990 prices. Similarly, any increases in interest receipts will be offset by the losses on amounts lent at, say 1990 prices being repaid at, say, 1995 prices.

FINANCIAL SUMMARY

5. A summary of the effects of these changes is as follows:-

	£m
Revised contribution to fixed overheads and interest	29.2
<u>Less fixed overheads</u>	<u>23.6</u>
	5.6
<u>Add Net Interest Benefit (see below)</u>	<u>0.5</u>
Overall profit	<u><u>6.1</u></u>

6. The net interest benefit is calculated as follows:-

	£m	£m
Original cost at nominal rates of interest (12%)		(12.9)
Advancement of repayment of non-recurring cost	3.6	
Application of interest received	<u>6.2</u>	<u>9.8</u>
Revised cost at nominal rates of interest (12%)		(3.1)
Conversion to real rates of interest (4%)		<u>3.6</u>
Estimated Benefit at real rates of interest (4%)		<u><u>0.5</u></u>

INDUSTRIAL touch: Short Keros.

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DEPARTMENT OF TRADE AND INDUSTRY

1-19 VICTORIA STREET

LONDON SW1H 0ET 5422

TELEPHONE DIRECT LINE 01-215

SWITCHBOARD 01-215 7877

5/2/83

JF4469

Secretary of State for Trade and Industry

The Rt Hon James Prior MP
Secretary of State for Northern Ireland
Northern Ireland Office
Government Offices
Great George Street
LONDON
SW1P 3AJ

13 October 1983

NBPM at the stage

Note: Shorts have gone back to Fokker to seek improvement in terms of order to satisfy Treasury conditions. Report on outcome to follow.

AT 13/10

SHORT BROTHERS LIMITED : NEW AEROSTRUCTURES WORK

Your minute to the Prime Minister and E(A) colleagues sought approval to permit Shorts to bid for new aerostuctures work on the Fokker P332 aircraft.

2 I agree that the project, a logical extension of Shorts' existing business, should make a valuable contribution to the company's fixed costs, with a consequent beneficial effect on other programmes.

3 The P332 will undoubtedly find itself in frequent competition with the British Aerospace 146: BAe's major new civil aircraft programme. However I agree with your view that Fokker will go ahead with the project regardless of whether Shorts participate or not, so this factor does not bear too heavily on Shorts' case. As you say, the aircraft will also provide useful business for Rolls-Royce, who will supply Tay engines.

4 Shorts' sales estimates are at the top end of our assessment of 10-15 aircraft per year and we believe there to be a roughly even chance that Shorts will achieve 125 sets delivered in 1986-1995. Your note assesses the financial implications of a sales performance at the lower end of the range.



5 In conclusion, I support your line on this project, which is in keeping with our agreement earlier this year, following the 1982 up-date of Shorts' Corporate Plan, that Shorts should be authorised to pursue actively new aero-structures orders.

6 Copies go to the Prime Minister, to E(A) colleagues, Geoffrey Howe, Michael Heseltine and Sir Robert Armstrong.

Yours *Earl,*
Leal

Incl Pol,
Nov 80,
Shent Bros.

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SECRETARY OF STATE FOR NORTHERN IRELAND

Short Brothers Ltd: New Aerostructures Work

1. Thank you for sending me a copy of your recent minute to the Prime Minister on this subject.
2. I am writing to confirm my agreement that the proposed aid need not be notified to the Commission, for the reasons adduced in your minute. I note that your officials will be consulting mine in the event of the Dutch and German Governments deciding to notify.
3. I have also seen John Moore's letter of 7 October and I agree with his point that our approval of the project should be subject to minimizing the risks of financial loss.
4. I am copying this minute to members of E(A), the Secretary of State for Defence and Sir Robert Armstrong.

A handwritten signature in black ink, appearing to be 'G. Howe', written in a cursive style.

GEOFFREY HOWE

Foreign and Commonwealth Office
13 October 1983

Ind Pol
New 801
Short Bros.

13 OCT 1983



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Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon James Prior MP
Secretary of State for
Northern Ireland
Government Offices
Great George Street
LONDON SW1P 3AJ

7 October 1983

SHORT BROTHERS: NEW AEROSTRUCTURES WORK

As you know, the Prime Minister has asked me to write to you direct with my reaction to the proposal in your 3 October minute to her.

I can readily see the importance of this contract to Shorts since it will provide the core of the aerostructures business, perhaps for 15 years. I also believe that the aerostructures business is important for Shorts as a means of spreading risks and avoiding excessive dependence on commuter aircraft.

However, I am also conscious of the fact that when their last Corporate Plan was discussed, we had high hopes of Shorts moving into profitability fairly soon. This, of course, is not only a prerequisite for privatisation (and we hoped, at E(DL), that this could be achieved in this Parliament), but also the only long-term way of ensuring that employment in Shorts is maintained and expanded.

For that reason, I am very concerned that Shorts are proposing to accept this contract with the expectation, on their own central assumptions, that it will make a loss. I welcome and support your proposal that Shorts be encouraged to seek a higher price in their negotiations with Fokker, but I believe we should go further than this and urge Shorts to negotiate terms which, at the very least, ensure a reasonable commercial profit on their own central assumption.

Those assumptions include a central estimate that 125 units will be sold. While this is, indeed, in the centre of the range of estimates provided by Touche Ross and DTI, there are grounds for considering it optimistic. Touche Ross point out that Fokker's own estimate of 200 units requires them to take 10 per cent of the US market, even though they are not well established there and only 6 per cent of aircraft purchases in the USA are from non-US manufacturers. Even Shorts' own central estimate, therefore, of 125 units requires Fokker to achieve a US market share, on its own, equivalent to all other non-US manufacturers taken together. It is also relevant that US manufacturers, Boeing and McDonnell Douglas, against whom Fokker will be competing for the first time, have a less optimistic view of the overall market size.

Shorts' working assumptions are a matter for their commercial judgement, but the fact that they look to be on the optimistic side make it all the more important that Shorts do not enter the contract expecting a loss. Shorts must be in a very favourable position, as existing suppliers, with advantages over competitors in terms of their learning curve, equipment, and general good will. Indeed, it was to gain this kind of advantage that we authorised Shorts to bid for the EDSA contract with the USAF even though it was not itself commercially attractive. We must expect Shorts to capitalise on their advantage and negotiate profitable terms. It is difficult to see how we can hope that other aerostructures contracts (where they may not be so well placed) can be profitable for Shorts if this one is not. The prospects for secure employment and privatisation must be very severely reduced if Shorts saddle themselves with a contract which could mean that their aerostructures business remains unprofitable for the foreseeable future.

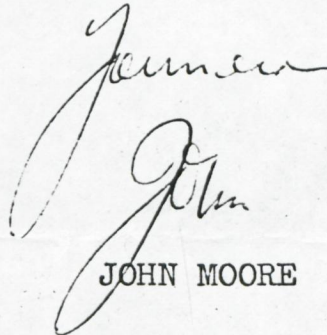
You will have recognised that in my assumptions about the profitability of this contract, I have taken full account of both interest charges and a fixed costs contribution. You acknowledge that interest charges must be taken into account; and Touche Ross's conclusion takes full account of fixed costs. Over a period as long as 15 years, there would be scope for reducing Shorts' 'fixed' aerostructures costs substantially, if the contract were not taken. Like Touche Ross, therefore, I believe fixed costs should be taken into account, and I cannot accept the argument (in paragraph 6 of your minute) that to take the contract on Shorts' assumptions about terms will be more financially beneficial than not to do so.

My final point is to suggest that Shorts attempt to minimise their risk by asking Fokker for a contribution to development costs and/or a minimum number of orders.

I will be prepared, therefore, to agree to the project provided that:

- i. Shorts negotiate a price and other terms which provide a reasonable commercial profit on the basis of their present assumptions on costs and sales (ie 125 units); and
- ii. the risks are minimised, perhaps by requesting a contribution from Fokker to development costs and/or by negotiating a minimum number of orders.

I would be happy to discuss this further if you wish.
I am copying this letter to the Prime Minister and other recipients of your minute.


JOHN MOORE

Ind Pol,
Shant Bros,
Nov '80

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PRIME MINISTERSHORT BROTHERS LIMITED : NEW AEROSTRUCTURES WORK

Jim Prior copied to me his recent note seeking approval to permit Short Brothers Limited to bid for a contract to provide wings for a stretched version of the Fokker F28.

2. The MOD does of course provide technical advice to the Northern Ireland Department of Economic Development and to DTI on civil aircraft matters. My officials have already advised Jim's that Shorts' proposals are technically valid; that the new proposal represents a logical extension of current work; and that Shorts should be able to take on the contract without detriment to existing or likely future civil work. The proposal causes no problems in respect of Shorts' activities for the MOD. Indeed I believe that Shorts' pursuit of new aerostuctures projects will better equip them to compete for defence aircraft and aerostuctures work in the future.

3. I am content therefore to support the recommendation that we authorise Shorts to bid for the contract.

4. I am copying this to Jim Prior and to the other recipients of his letter.

hgs

Ministry of Defence

7th October 1983

Incl Pol,
Nov 180,
Short Bras.



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MR. TURNBULL

SHORT BROTHERS LIMITED

Mr. Prior's recent minute to the Prime Minister seeks Government grants of £8.6 million to assist Shorts in bidding for new work from Fokker. As a subsidy to maintain employment in Northern Ireland, this seems relatively modest (cf Harland and Wolff).

However, for aerospace work, Government can give itself a chance of recouping at least some of its outlay by offering Launch Aid under the terms of the 1949 Civil Aviation Act. Launch Aid differs from an unconditional grant in that it entitles Government to negotiate partial or total repayment by means of a levy. If the Short/Fokker product turns out better than anticipated in Mr. Prior's note, Government can get something back; if not neither Shorts nor Government is worse off.

RJ.

ROBERT YOUNG
6 October 1983