

BAE Systems plc
Stirling Square
6 Carlton Gardens, London
SW1Y 5AD United Kingdom

T +44 (0)1252 373232
F +44 (0)1252 383991
www.baesystems.com

BAE SYSTEMS

From The Office Of
Ian King
Chief Executive Officer

05 October 2010

IN STRICT CONFIDENCE

Rt Hon David Cameron MP
Prime Minister
No 10 Downing Street
London
SW1A 2AA

Our Ref: IGK/bk/jmj/165

Dear Prime Minister

I have written to you on two separate occasions during the course of the Strategic Defence and Security Review. As you approach the conclusion of the Review, I understand that you are giving serious consideration to the cancellation of the second aircraft carrier, Prince of Wales. I wanted to make sure that you and NSC colleagues understood what this would mean in practice, before you make your final decision.

BAE Systems has invested £500m of shareholder funds since 2008, in response to the MOD's aim of consolidating the surface ship sector. This investment was predicated on a stable workload over a 15 year period, based on the construction of two aircraft carriers, the development of a new frigate, and the support of these and other ships in the existing RN fleet. It was underpinned by an agreement with MOD that, in return for a guaranteed level of funded work, we would sustain in the UK the key capabilities needed for warship design, development, build, integration and support, and we would rationalise and transform the business. We have already saved £70m from MOD costs in the first year of that agreement's existence.

If both carriers are completed the cost will be £5.25bn. If Prince of Wales is cancelled, the direct cost of the programme will be £4.8bn. However, in these circumstances, and under Treasury rules and the agreements I have outlined, there will be consequential costs, including those related to rationalisation, which we estimate would amount to £690m. Some of these costs would have been incurred by MOD in any event. But the cancellation of PWLS would pull rationalisation costs forward by at least three years, into 2012/13, whereas, under the current plan, these costs would have been funded through the savings we would make under our agreement with MOD. Of course, if Prince of Wales were cancelled you would make the long term savings from operating only one ship.

The cancellation of Prince of Wales would mean that production in all BAE Systems shipyards would cease at the end of 2012. There is no further production work planned until steel is due to be cut on the new frigate programme in 2016. This means that the business would be unsustainable, and all three yards would have to close by early 2013, with the loss

IN STRICT CONFIDENCE

of more than 5,000 jobs in BAE Systems and many more across the UK in hundreds of companies in the supply chain. In practice, that means the end of the UK's capability in complex warships, and would bring the sector to a halt. Significant additional rationalisation costs would also result for MOD, the BAE Systems element alone of which would be £250m. And a potential termination liability under our agreement with MOD would also arise.

It might be possible to ameliorate this position through the direct award of new work to BAE Systems. With fuel tankers, an ice capable ship, and the acceleration of the frigate programme, it would be just about possible to sustain the Key Industrial Capabilities set out in the BAE Systems agreement with MOD. But the speed at which these decisions would have to be made in order for us to be in a position to cut steel of any sort by 2013 has never been achieved in defence acquisition before on a programme of this sort, and would mean significant cash funding being brought forward in to the next 2-3 years of the programme. We would of course do everything we could to make sure this worked, but we really do need a reality check here to ensure that the business and the future of the sector is not put at unacceptable risk. We have had a week to consider how this would work.

In any event, all of this activity would not overcome a production gap, which would still see the yards empty for six to nine months. It would be a huge challenge, managerially and financially, to sustain our highly skilled workforce in those circumstances, and it would give rise to very significant industrial relations and political issues.

So, in practical terms, and even after the potential amelioration, the cancellation of Prince of Wales would cause the abrupt rationalisation of the industry over the next 2-3 years, which will precipitate the closure of at least one of the BAE Systems shipyards, and the lay off of production staffs at the others. We anticipate that this will require at least 2,500 job losses in BAE Systems in Scotland and on the South Coast of England, as well as several thousands in the wider supply chain.

There are then real risks for the sector if the Prince of Wales is cancelled. As you know, the sector represents one of the highest technology, advanced manufacturing sectors in the British economy. It has delivered £2bn in exports over the past 10 years, even when there were few exportable products in the portfolio. With the prospect of a new exportable frigate as part of the current plan, the potential for the industry would be extremely bright. By contrast, the cancellation of the Prince of Wales would put the future of the sector seriously at risk.

I have no doubt that there may be scepticism about some of this analysis. But I fully stand behind it and would welcome the opportunity, which we have not had, to present this to you, and allow you to question any aspect of it before reaching a fully informed decision. There are key issues too which we should discuss about the future of the military aerospace sector, which will also be profoundly affected by the outcome of the SDSR.


IN STRICT CONFIDENCE

IN STRICT CONFIDENCE

We fully understand the pressure which the Government is under in addressing the fiscal deficit, and we are committed to doing what we can to help you in this. We have proposed to MOD how we might contribute to significant savings in the Defence budget over the next 10 years, and we stand ready to do more to help, in the context of a sustainable long term programme in which the industry can continue to deliver capability to the front line

In addition to NSC members, a copy of this goes to Vince Cable and Michael Moore.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Ian G King', with a stylized, looped 'I' and 'K'.

Ian G King

IN STRICT CONFIDENCE

