Remuneration report

Rolls-Royce operates in a highly competitive, international market. Its business is complex, technologically advanced and has long time horizons. The improvement in performance to which the Group is committed depends crucially on the individual contributions made by the executive team and by employees at all levels. It is for this reason that the Board strongly believes that an effective remuneration strategy will continue to play a crucial part in the future success of the Group by providing keen incentives and creating a close identity of interest with shareholders. This report also describes how the principles identified by the Combined Code in relation to executive directors' remuneration are applied by the Company.

The remuneration committee

In line with the requirements of the Combined Code, the remuneration committee (the committee), which operates within agreed terms of reference, has responsibility for making recommendations to the Board on the Group's general policy towards executive remuneration. The committee determines, on the Board's behalf, the specific remuneration packages of the executive directors and a number of senior executives.

The membership of the committee consists exclusively of independent non-executive directors. The members are Sir Robin Nicholson (Chairman), Mr P J Byrom, Lord Moore of Lower Marsh, Mr C G Symon and Sir John Weston.

The committee meets regularly and has access to professional advice from inside and outside the Company. The Chairman of the Company, Sir Ralph Robins, and the Chief Executive, Mr J E V Rose, generally attend meetings by invitation but are not present during any discussion of their own emoluments.

Compliance

The Board confirms that the Company has complied throughout the year with the provisions of the Combined Code relating to directors' remuneration.

The framework of remuneration

The Board has adopted, on the recommendation of the committee, a remuneration policy reflecting the following broad principles:

i) The remuneration of executive directors and other senior executives should directly reflect their responsibilities and contain incentives to deliver the Group's performance objectives;

ii) A significant proportion of total remuneration should be based on Group and individual performance, both in the short and long term; and

iii) The system of remuneration should encourage a close identity of interest between senior management and shareholders.

Within this framework of remuneration, the committee keeps under regular review the competitiveness of the Group's remuneration structure.

The main components of remuneration

The emoluments of executive directors and senior executives currently comprise the following elements: a base salary, an annual performance related award, long-term incentive arrangements, pension contributions and other benefits. The policy takes into account pay levels elsewhere in the Group.

Base salary

The committee believes that in order to attract and retain executive directors of the right calibre and to provide them with adequate incentives to deliver the Group's objectives, the Group should pursue a policy of offering median-level base salaries for its executive directors and senior executives, and through the performance-related schemes, the opportunity of upper quartile earnings for upper quartile performance.

Annual performance related award scheme

Executive directors and senior executives participate in an annual performance related award scheme. The scheme enables a maximum performance award of up to 60 per cent of salary to be paid to executive directors and a small number of senior executives for exceptional performance against pre-determined targets based upon return on capital employed, with a tapered and reducing scale of maximum percentages for other senior executives. The targets are set by the committee based upon the Group's annual operating plans. Such payments do not form part of pensionable earnings.

One third of any awards made are paid in Rolls-Royce shares which are held in trust for two years, with release normally being conditional on the individual remaining in the Group's employment until the end of the period. The required shares are purchased on the open market. This arrangement provides a strong link between performance and remuneration and helps to promote a culture of share ownership amongst the Group's senior management. The first Rolls-Royce shares delivered under the deferred share arrangements were purchased in the market on behalf of participants and put into trust in March 2000.

Long-term incentives
The Company has operated a long-term incentive plan (LTIP) since January 1, 1997. Following a review by the committee of long-term incentive arrangements, it introduced with shareholder approval a new executive share option plan in 1999. The committee made clear at the time that no director or senior executive would receive a grant under both schemes in the same year.

The committee is aware that the nature of long-term incentives offered is subject to change. It will therefore continue to review market practice and develop plans which provide competitive rewards for performance, align executive and shareholder interests and reflect the nature and requirements of the business.

Executive share option plan
Depending on performance, executives are eligible to receive options on an annual basis. Options are granted at the mid-market price on the day before the day of issue and normally have to be held for a minimum of three years before they are capable of exercise. They expire after ten years. In line with the committee's view that an increasing proportion of remuneration should be performance related, the exercise of options is subject to a performance condition that the Group's growth in earnings per share (EPS) must exceed the UK retail price index by three per cent per annum, over a three-year period. The committee wishes to retain flexibility in the use of existing or new issue shares to fund the scheme, but has a general preference in favour of existing shares.

The first grants of options to UK executives under the new executive share option plan were made in March 2000. A further grant was made to a small number of newly recruited executives in September 2000. (See note 24 on page 60).

Long-term incentive plan
The LTIP involves the grant of awards which can be realised in the form of shares in the Company and cash if demanding performance targets are met. The maximum value of an award is 60 per cent of salary at the time of grant.

The percentage of the award which is realisable depends upon the Company's total shareholder return (TSR) over a three-year period, compared to that of a group of comparator companies comprising other leading engineering and industrial companies. In addition, no award can be realised unless the average growth in the Group's EPS over the three-year period is at least two per cent per annum greater than the average increase in the UK retail price index over the same period.

If a company drops out of the comparator group (eg as a result of a take-over), it is not replaced. An adjustment is then made to the rankings which determine the extent to which any awards can be realised.

There are currently 15 companies in the group. 100 per cent of the award is realisable for a first or second ranking, within the comparator group. 40 per cent of an award is realisable for a seventh place ranking. The percentage of an award realisable for rankings between second and seventh place is calculated on a sliding scale. No award is payable if the company's TSR ranking is eighth or below.

The performance period for the 1998 LTIP grant ended on December 31, 2000 and no awards were realised.

In line with the committee's stated policy, no grants under the LTIP were made in 2000.

All employee incentives
The committee believes that share based schemes, described in more detail on page 60, make a significant contribution to the close involvement and interest of all employees in the Group's performance. The Company introduced an approved profit sharing share scheme for UK employees in 1999. The first shares delivered under this scheme were purchased in the market and put into trust in April 2000, with 22 per cent of UK employees electing to participate.

The Finance Act 2000 enabled companies to introduce more tax effective All Employee Share Ownership Plans (AESOP). In common with many other companies, Rolls-Royce is seeking a general authority from shareholders at the 2001 Annual General Meeting to enable it to introduce an AESOP. At the same time, approved profit sharing share schemes, such as the current scheme operated by the Company, are to be discontinued.

Pensions
Mr J M Guyette participates in pension plans sponsored by Rolls-Royce North America Inc.

All other executive directors under their normal retirement age are members of the Group's UK pension schemes. These schemes are funded and approved final salary pension schemes providing, at retirement, a pension of up to two thirds of final remuneration, subject to Inland Revenue limits.

The Company also operates the Rolls-Royce 1994 Senior Executive Retirement Scheme (SERS). The purpose of the SERS is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes under the 1989 Finance Act. Membership of the scheme is restricted to executive directors and to a limited number of senior executives. The scheme is administered by three trustees, under the Chairmanship of Lord Moore of Lower Marsh, none of whom has a beneficial interest in the scheme. The members of the scheme include Mr P Heiden and Mr R T Turner. They joined the Group after the introduction of the earnings cap and their terms and conditions on joining the Group included a commitment to provide pension and life cover based on total salary, in line with other directors and senior executives. The committee believes that for these executive directors, a funded arrangement is in the best interests of shareholders and avoids the build up of unfunded liabilities for the future.

During the year, special bonus payments were made to Mr P Heiden and Mr R T Turner to cover the income tax liability incurred by them on the contribution payments made by the Company into the SERS. These payments amounted to £29,415 (1999 £11,500) in the case of Mr P Heiden and £41,018 (1999 £37,000) in the case of Mr R T Turner.

The Company does not make any pension contributions in respect of Sir Ralph Robins, who reached normal retirement age in June 1994.

Details of the pension benefits, which accrued over the year in the Group's approved UK pension schemes are given below[1,4].

	Additional pension earned in excess of inflation during year ended Dec 31, 2000 £000 per annum	Transfer value[2] of additional pension earned in excess of inflation during year ended Dec 31, 2000 £000	Total accrued pension entitlement at the year ended Dec 31, 2000 £000 per annum
Mr J E V Rose	41	821	214
Mr C H Green	22	490	210
Mr P Heiden	2	17	16
Mr P C Ruffles	34	588	216
Mr R T Turner	2	19	14

Details of the retirement benefits, which accrued over the year in the SERS and the plans sponsored by Rolls-Royce North America Inc., are given below[5].

	Additional retirement lump sum earned in excess of inflation during year ended Dec 31, 2000 £000	Transfer value[6] of additional retirement lump sum earned in excess of inflation during year ended Dec 31, 2000 £000	Total accrued retirement lump sum entitlement at the year ended Dec 31, 2000 £000
Mr J M Guyette[3,7]	194	110	876
Mr P Heiden	160	78	453
Mr R T Turner	101	77	484

Notes

[1] The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year.

[2] The transfer value stated represents liabilities of the Rolls-Royce sponsored pension schemes and not sums paid to the individuals. The transfer value has been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11, less the director's contributions. Actuarial Guidance Note GN11 covers individual transfer calculations and the above figures have been calculated using assumptions certified by the Actuaries as being consistent with GN11.

[3] Benefits are translated at US$1.52 = £1.00.

[4] Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.

[5] The lump sum entitlement shown is that which would be paid on retirement based on service to the end of the year.

[6] The transfer values have been calculated on the basis of actuarial advice.

[7] Mr J M Guyette is a member of two defined benefit plans in the USA, one qualified and one non-qualified. Mr J M Guyette is also a member of an unfunded non-qualified plan in the USA. He accrues a retirement lump sum benefit in all three plans. The aggregate value of the three plans is shown in the second table. In addition, Mr Guyette is a member of two 401(K) Savings Plans in the USA, one qualified and one non-qualified, to which his employer, Rolls-Royce North America Inc., contributes. During 2000 the employer's contributions amounted to £19,136.

Terms and conditions

Service contracts

Sir Ralph Robins has a one-year rolling contract, which provides for 12 months' notice in event of termination by the Company. He works for the Company at the equivalent rate of three days a week.

Mr J M Guyette has a contract with Rolls-Royce North America Inc., drawn up under the laws of the State of Virginia. It is for an indefinite term and provides that on termination without cause he is entitled to one year's severance pay without mitigation.

In the light of the Combined Code, the committee has reviewed its previous policy of offering UK executive directors two-year rolling contracts. It has concluded that new appointees to the Board will be offered notice periods of one year. The committee recognises that in the case of appointments to the Board from outside the Company, it may be necessary to offer a longer initial notice period, which would subsequently reduce to twelve months after that initial period.

Mr J E V Rose, Mr C H Green, Mr P Heiden, Mr P C Ruffles and Mr R T Turner have two-year rolling contracts which provide for 24 months notice in the event of termination of employment by the Company. These contracts were entered into before the change in the policy described above.

The non-executive directors do not have service contracts.

Compensation and mitigation

The committee has a defined policy on compensation and mitigation to be applied in the event of a UK director's contract being prematurely terminated. In these circumstances, steps are taken to ensure that poor performance is not rewarded. When calculating termination payments, the committee takes into account a range of factors such as age, years of service and the director's obligation to mitigate his own loss.

Non-executive directors

The fees paid to non-executive directors are determined by the executive directors who are informed by independent market surveys. Each non-executive director receives an annual fee of £25,000. In addition, fees of £5,000 per annum are paid in respect of membership of the audit and remuneration committees and £7,500 per annum to the chairmen of these committees. (Membership of the committees is reported on pages 27 and 30).

Lord Moore of Lower Marsh is Chairman of the Trustees of the Rolls-Royce Pension Fund and receives an annual fee of £10,000 for performing this role.

Sir Robin Nicholson was appointed Chairman of the Company's Environmental Advisory Board in February 2000. During the year he received £1,250 for performing this role.

Non-executive directors do not participate in any of the Company's share schemes, performance pay arrangements or pension schemes.

Individual directors' emoluments

The individual directors' emoluments are analysed as follows:

	Basic salaries £000	Board and committee fees £000	Taxable benefits £000	Rolls-Royce plc Annual performance related award scheme[1] £000	2000 Aggregate emoluments excluding pensions contributions[2] £000	1999 Aggregate emoluments excluding pensions contributions £000
Sir Ralph Robins[3]	**345**	**—**	**23**	**89**	**457**	430
Mr J E V Rose	**539**	**—**	**18**	**132**	**689**	604
Mr C H Green	**314**	**—**	**23**	**76**	**413**	408
Mr J M Guyette[4]	**355**	**—**	**37**	**89**	**481**	453
Mr P Heiden	**322**	**—**	**15**	**82**	**419**	354
Mr P C Ruffles	**299**	**—**	**16**	**76**	**391**	330
Mr R T Turner	**247**	**—**	**17**	**62**	**326**	310
Mr P J Byrom	**—**	**37**	**—**	**—**	**37**	37
Lord Moore of Lower Marsh	**—**	**45**	**—**	**—**	**45**	45
Sir Robin Nicholson	**—**	**39**	**—**	**—**	**39**	37
Mr C G Symon	**—**	**30**	**—**	**—**	**30**	18
Sir John Weston	**—**	**30**	**—**	**—**	**30**	30
Sir Gordon Higginson[5]	**—**	**—**	**—**	**—**	**—**	12
Mr M Townsend[6]	**—**	**—**	**—**	**—**	**—**	907
	2,421	**181**	**149**	**606**	**3,357**	3,975

[1] One-third of the award was paid in Rolls-Royce shares (see page 30).
[2] Details of the directors' pensions are set out on pages 31 and 32.
[3] 40% of Sir Ralph Robins' taxable benefits for 2000 was reimbursed by Cable & Wireless plc, in respect of his position as non-executive Chairman of that Company.
[4] Mr J M Guyette was paid in US dollars translated at $1.52 = £1.
[5] Sir Gordon Higginson retired as a director with effect from May 27, 1999.
[6] Mr M Townsend retired as a director with effect from December 31, 1999.

Directors' share interests

The directors, including their immediate family, at December 31, 2000, had the following beneficial interests in the ordinary shares of the Company, including any shares held in trust under the annual performance related award scheme, the profit sharing share scheme, options and LTIP awards:

	Holdings January 1, 2000	Holdings December 31, 2000
Sir Ralph Robins	43,103	99,611
Mr J E V Rose	21,100	117,290
Mr C H Green	88,432	100,267
Mr J M Guyette	5,194	29,826
Mr P Heiden	17,179	31,739
Mr P C Ruffles	14,821	24,821
Mr R T Turner	12,349	22,349
Mr P J Byrom	21,094	31,129
Lord Moore of Lower Marsh	17,164	22,672
Sir Robin Nicholson	17,036	17,036
Mr C G Symon	2,500	2,500
Sir John Weston	2,050	2,120

Sir Ralph Robins, Mr C H Green, Mr J M Guyette, Mr P J Byrom, Lord Moore of Lower Marsh, and Sir John Weston took 1,454; 1,815; 527; 20; 400 and 37 shares respectively instead of cash dividends in January 2001. Otherwise there has been no change in the directors' interests between December 31, 2000 and March 1, 2001.

Directors' share interests continued

	Shares held in trust			
	Shares held in trust under the annual performance related award scheme[1]		Shares held in trust under the profit sharing share scheme[2]	
	January 1, 2000	December 31, 2000	January 1, 2000	December 31, 2000
Sir Ralph Robins	—	17,113	—	2,743
Mr J E V Rose	—	25,402	—	3,576
Mr C H Green	—	16,043	—	2,572
Mr J M Guyette	—	17,431	—	—
Mr P Heiden	—	15,241	—	2,443
Mr P C Ruffles	—	13,369	—	2,144
Mr R T Turner	—	12,567	—	2,015

[1] Under the annual performance related award scheme, shares vest after two years (see page 30).
[2] Under the profit sharing share scheme, shares vest after three years (see page 31).

Conditional awards granted under the LTIP to executive directors (and which were granted in 1999) are set out below. There were no awards granted under the LTIP in 2000. The extent to which the maximum number of shares comprised in an award (as stated below) is realised will depend on the satisfaction of demanding performance conditions (see page 31).

	LTIP
	Aggregate conditional share awards 1999
Sir Ralph Robins	69,880
Mr J E V Rose	101,205
Mr C H Green	67,470
Mr P Heiden	57,831
Mr P C Ruffles	55,422
Mr R T Turner	53,012

In addition to the individual interests in shares awarded under the LTIP shown above, each of the executive directors is, for Companies Act purposes, regarded as interested in all the 3,368,794 shares held by the discretionary trust linked to the share based incentive schemes, the 2,321,587 shares held by the qualifying employee share trust and the 1,449,652 shares held by the trust linked to the Inland Revenue Approved Profit Sharing Share Scheme. These shares are held for the purpose of satisfying awards granted under the LTIP, executive share option scheme, annual performance related award scheme, sharesave schemes and the profit sharing share scheme.

Directors' share interests continued

Options

	January 1, 2000	Granted in 2000	Exercised in 2000	December 31, 2000	Exercise price	Market price at date exercised	Aggregate gains 2000 £000	Exercisable dates
Sir Ralph Robins	126,407		126,407	—	172p	250p	99	—
	125,890		125,890	—	139p	250p	140	—
	7,438			7,438[1]	205p			2003
	499			499[1]	194p			2003
		164,737		164,737	194p			2003-2010
	260,234	164,737	252,297	172,674	194p[2]		239	
Mr J E V Rose	116,750			116,750	176p			2001-2005
	7,438			7,438[1]	205p			2003
	947			947[1]	194p			2007
		283,141		283,141	194p			2003-2010
	125,135	283,141		408,276	189p[2]			
Mr C H Green	67,250			67,250	176p			2001-2005
	8,633		8,633[1]	—	106p	194p	8	—
	4,756			4,756[1]	205p			2003
	4,053			4,053[1]	194p			2007
		154,441		154,441	194p			2003-2010
	84,692	154,441	8,633	230,500	189p[2]		8	
Mr J M Guyette	114,581			114,581	269p			2002-2009
	2,721			2,721[1]	194p			2002
		167,799		167,799	194p			2003-2010
	117,302	167,799		285,101	224p[2]			
Mr P Heiden	66,750			66,750	176p			2001-2005
	7,438			7,438[1]	205p			2003
	499			499[1]	194p			2003
		162,163		162,163	194p			2003-2010
	74,687	162,163		236,850	189p[2]			
Mr P C Ruffles	58,652			58,652	139p			2001
	80,685			80,685	125p			2001-2002
	66,750			66,750	176p			2001-2005
	4,600			4,600[1]	150p			2001
	2,894			2,894[1]	205p			2003
	1,098			1,098[1]	194p			2003
		154,441		154,441	194p			2003-2010
	214,679	154,441		369,120	166p[2]			
Mr R T Turner	105,750			105,750	176p			2001-2005
	6,900			6,900[1]	150p			2001
	1,697			1,697[1]	194p			2003
		120,979		120,979	194p			2003-2010
	114,347	120,979		235,326	185p[2]			

[1] Sharesave schemes.
[2] Weighted average exercise price of December 31, 2000 balance.

No director exercised any share options in 1999 and accordingly no gains were made.

All of the outstanding options awarded under the executive share option scheme were granted at the market value on the date of issue and no discount was applied. The closing market price of the Company's ordinary shares ranged between 161p and 261p during 2000 and was 198.25p on December 31, 2000.