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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB COMMITTEE ON DISPOSAL OF PUBLIC SECTOR ASSETS

BRITISH AEROSPACE: INTRODUCTION OF PRIVATE SECTOR CAPITAL

Memorandum by the Secretary of State for Industry

1 Colleagues agreed in July (E(DL)(79)4th meeting) the principle of my proposals for introducing private sector capital into British Aerospace (BAe), provided satisfactory agreement could be reached on the definition of the future relationship between the Government and the company; and approved the preparation of legislation. Instructions have accordingly been sent to Parliamentary Counsel for the preparation of a Bill whose essence will be that the Secretary of State will be empowered to transfer BAe's business by order to one or more nominated companies, shares in which will be owned initially by the Government, which will have power to sell them.

2 This paper deals with the relationship between the Government and the new company (BAe Ltd) after a private sector shareholding has been established, and seeks colleagues' agreement on the outstanding policy issues. The proposals have been considered by the Official Committee on Nationalised Industry Policy.

3 My starting point is the wish to establish an arms length relationship with the new company, and to make clear that the Government will not intervene in the company's commercial decisions. I am advised that this is essential if BAe Ltd is to be an attractive private sector investment. It is equally necessary for our own purposes: management and shareholders must have no basis for believing that the Government will stand behind the company. If these two conditions are met, I see no reason why the company should not be classified as being in the private sector, with the effect that its borrowings do not count against the Public Sector Borrowing Requirement. Some special and unavoidable relationships

will exist between the new company and Government: the Government will have special obligations in relation to Airbus Industrie and towards certain existing and restricted liabilities, and it will be the company's largest single customer. My approach is based on the need to keep these special relationships, and the underlying inter-dependence they reflect, separate from the Government's relations with the company as principal shareholder.

#### THE GOVERNMENT'S OBLIGATIONS TOWARDS BAe LTD

4 There are two areas in which the Government will have to have special obligations towards BAe Ltd:

- (i) Liabilities undertaken by BAe while a nationalised industry. The creditors of BAe as a public corporation, including in particular its overseas customers, have acted on the understanding that in the last resort the Government stands behind the debts of the Corporation; and this position has been reiterated by the Government. This will no longer be the case after BAe's business has been transferred to a limited liability company, and I therefore consider it necessary to include in the Bill a general provision guaranteeing liabilities which were undertaken by BAe as a statutory corporation. The guarantee, which would apply to self-liquidating obligations, would be effective only in the event of the new company being wound up. The Secretary of State for Trade has expressed the view that such a guarantee is not necessary for British Airways: the reasons why I do consider one necessary are set out fully in my letter of 18 September;

- (ii) Liabilities of BAe Ltd to Airbus Industrie.

In strictly legal terms, it is unlikely that the Government's obligations towards the Airbus programme will extend further than underwriting a predetermined part of the development budget for the A310. However, in terms of relationships with our main European allies, it will be politically essential to ensure that all BAe's obligations towards the programme are discharged. We shall need information for this purpose.

I expect to be able to agree with the company what information, about both the Airbus programme and its wider activities that might impinge on its ability to discharge its obligations to the Airbus programme, they should provide, as a separate agreement between Government and the company.

#### THE GOVERNMENT AS CUSTOMER

5 The Ministry of Defence (MoD) is BAe's largest single customer: in 1978 it accounted for around one third of the Corporation's sales. Since nationalisation the Government has kept quite separate its role as customer and as financial sponsor, which is roughly equivalent to that of banker-cum-shareholder. I consider it highly desirable to keep the Government's relations with BAe Ltd as customer and shareholder quite separate, and see no reason why this should not be done. For example, the decision whether to proceed with a particular military aircraft project should be a commercial one for the company: it is up to MoD, as with any other customer, to pay the necessary price or to find an alternative suppliers. BAe Ltd will thus be in the same position vis-a-vis MoD as the aerospace companies were before nationalisation, and as private sector defence contractors are now.

6 I see no need, and possible harm, in imposing on the company the sort of statutory duty now laid on BAe, to have full regard to the requirements of national defence; and to design and produce military aircraft and guided weapons. The Government will be able to obtain what it wants as a customer - as it did before nationalisation, and as it now does from private sector companies whose products are of strategic importance.

#### GOVERNMENT FINANCE

7 The objective of the Government's policy is that BAe Ltd should be able to raise all the money it requires from commercial sources and our preliminary financial advice is that it should be able to do this. I have however considered whether the Government should have power to provide finance to the company, either in the form of equity or loans.

- (i) Equity We must provide for the possibility that the Government will wish to retain its proportionate stake in the equity for some time. To do this it will need a power to subscribe for shares in a rights issue; in logic it should also have the power to acquire shares. These powers should be limited to what is necessary for the Government to maintain but not increase its percentage shareholding at any time, thus dispelling any fears that the Government might increase its stake.
- (ii) Loans This Department's financial advisers, Kleinwort, Benson, have argued that it would be unwise for the Government to deny itself the power to make loans to the new company. Other shareholders will be able, for example, to provide loans through taking up debenture issues whereas the Government, unless it takes a specific power, will be debarred

from so doing. Kleinworts believe it is desirable to convince investors that the Government will act towards the company as far as possible in the same way as any major private sector shareholder. I accept the force of their advice, but I recognise that such a power might be seen as infringing the arms length relationship which we must establish; I therefore propose that the Government's power to make loans should be restricted to the power to take up convertible loan stock, but always limited to its current proportionate holding.

## GOVERNMENT CONTROL

8 It is essential that the principle of non-intervention in commercial decisions should be elaborated clearly and unequivocally on second reading and in the prospectus; and that we should accept as a consequence that there will be no counterpart with BAe Ltd to the close monitoring which the Government undertakes of BAe's affairs as a nationalised industry. On the other hand the Government will be a substantial shareholder in the company, and Ministers will be answerable to Parliament for their exercise of the rights conferred by that shareholding. The following paragraph discusses the very limited powers which I consider the Government should exercise.

9 a) Government shareholding: the merchant banks advise that the Government shareholding should be between 40 and 60%. I believe that the Government's position would be effectively the same with any shareholding within the range: the question whether the holding is a majority or not is not critical from the point of view of control. In deciding precisely what holding to retain I therefore intend to be guided by financial advice nearer the time, and by political considerations. If, for example, it seemed that to keep a majority holding would significantly lessen threats of renationalisation, this would be a strong argument for doing so. It would be wrong and nonsensical for the Government, as the largest single shareholder, to renounce its voting rights altogether; but the Government should make clear that it will exercise the powers conferred by its shareholding only in the same way as any commercial investor. A draft of the statement to be made on second reading is at Annex A.

b) Power of Veto: our financial advisers would prefer the Government directors to have no power of veto: if there is to be one it should be very strictly limited to matters affecting national defence, and should not apply to commercial decisions. It is very difficult to see how this distinction is to be drawn. The distinction is rather between commercial decisions which do not affect national defence and ones which do. I therefore do not propose to

take any reserve powers to overrule the Board of the company. Nor do I expect to be consulted about the Board's decisions.

c) Government directors: Kleinwort, Benson have strongly advised that the Government should have a continuing power to appoint one, and preferably two, directors. Any private sector organisation with such a large shareholding would expect Board representation; they consider that this is the only way for the Government to assess directly the quality of the direction and management of the company; and thus enable it to exercise its voting rights appropriately in the company's commercial interests; and investors might well consider it odd if the Government did not appoint directors. I therefore propose to include in the Articles of Association a provision to enable the Government to appoint two directors, who would need to be identified in the Prospectus. They would of course, otherwise rank equally with other Directors and have the same duties. As and while appointees of Government they would be non-executives and could not hold the position of Chairman or deputy-chairman.

d) Foreign Ownership: I propose to include a provision in the company's articles to limit and possibly to prevent foreign ownership. To be effective in relation to EEC countries, such a provision will have to be drafted to make clear that its purpose is to protect national defence interests. This provision would be backed-up by the power in Part II of the Industry Act 1975 which enables the Secretary of State to prevent foreign residents acquiring control of important manufacturing undertakings in the UK. Its effectiveness would also be reinforced by the Government's power as the major shareholder to prevent the election to the Board of representatives of foreign interests.

e) Accountability to Parliament: the basis of Ministers' replies in Parliament will be the statements on second reading and in the prospectus that the Government does not intend to intervene in the company's commercial decisions. Similarly questions about BP are answered on the basis of repeated statements that the Government will not intervene in its affairs: only questions dealing specifically with Government directors are answered substantively. I would hope that the PAC would treat the new company as it has treated BP in the past, and not concern itself with the Government's shareholding. In order to reinforce the fact that Ministers are not answerable in Parliament for the

commercial conduct of BAE Ltd and to demonstrate the separateness of the Government's position as shareholder from that of industrial sponsor or customer, I see considerable presentational advantage in placing the Government's shareholding with the Treasury Solicitor.

f) General duties: there will undoubtedly be pressure during the Bill's passage through Parliament for BAE Ltd to be subject to duties, imposed by statute, analogous to those imposed on BAE. The most obvious example is industrial democracy. I believe that pressure of this sort should be resisted as strongly as possible. If BAE Ltd is to be accepted as a genuinely commercial company, it should be subject only to restraints imposed on all companies by general legislation. Any exceptions to this, however desirable the object, are likely to place BAE in a separate category from other companies and hence run the risk of weakening the effect of its return to the private sector.

#### RELATIONS WITH A COMPANY WHOLLY OWNED BY THE GOVERNMENT

10 Initially a company to which BAE's business is transferred will be wholly owned by the Government. I believe the Government should have power to make loans and give guarantees to such a company, which would of course be classified as within the public sector. If sale of shares in a company carrying on the whole of BAE's business proves feasible the transitional period when the company is wholly Government owned should be very short indeed. If however it proves necessary to divide the business, we might be left with a wholly owned aircraft company for some considerable time. I do not believe the Government's ability to control such a company would be significantly different from its ability to control a public corporation: indeed in some respects control would be easier. The alternative, of leaving the aircraft business in a public corporation with revised duties, would make the legislation very much more complex; its passage through Parliament would therefore take longer; and new legislation would be needed before sale of shares in an aircraft company was possible. By transferring the aircraft business to a company straight away we would signal our intention to sell shares in it when circumstances permitted, and put ourselves in a position to take immediate advantage of any favourable market opportunity.

#### CONCLUSION

11 I invite my colleagues to agree to the general approach set out in this paper; to the following specific proposals:

- (i) liabilities undertaken by BAE while a nationalised industry should be guaranteed by the Government in the event of a winding up (paragraph 4(i));

- (ii) the Government should be able to subscribe for or acquire shares in the new company, provided it does not increase its proportionate shareholding from any current level (paragraph 7(i));
  - (iii) the Government should have the power to subscribe for convertible loan stock (paragraph 7(ii));
  - (iv) a statement about the Government's exercise of its voting rights should be issued on the lines of that at Annex A (paragraph 9(a));
  - (v) the Government should appoint two representatives to the Board, but they should have no special powers (paragraph 9(b) and (c));
- and that on this basis the new company will be classified as within the private sector.

Department of Industry  
2 October 1979

KJ

## THE GOVERNMENT'S SHAREHOLDING IN BRITISH AEROSPACE LTD

The Government will initially own about half the shares in the new company. It will be prohibited from using the powers in this Bill to increase its proportionate shareholding from the current level at any time. Whatever the size of its holding after the issue of shares to the public, the Government does not intend to control the company or to intervene in its commercial decisions or administration. It will have no powers of direction in relation to the company. By the same token, it will not stand behind the company. The company will stand or fall by its own efforts. This must be recognised by all concerned: shareholders, those who trade with the company and those who work for it.

2 The Government, like any other shareholder in the company, will have the normal rights of shareholders,

Its sole concern will be for the commercial well-being and strength of the company. To enable the Government to discharge this duty, and to reflect the size of the Government's shareholding, the company's articles of association will provide for two Government directors to be appointed to the company's Board. They will have no powers of veto but will, subject to the approval of the Board, be able to discuss the affairs of the company with the Government. They will be debarred from voting on any matter affecting contracts between the Government and the company. The provision for these directors is no more than any major private sector shareholder would expect. I intend to appoint directors who will contribute - and will be recognised as contributing - to the independence and strength of the new company.

3 The Government will of course remain a major customer of the new company, but the Government's role of customer, performed by the Ministry of Defence, will be kept quite separate from its role as shareholder, performed by the Treasury and Department of Industry.

The Ministry of Defence will deal with the company as it would with any other private sector supplier; and the company will have no statutory duties in respect of defence.