

Mr Dyson

Prime Minister



The Chancellor is, after all, prepared to go along with vesting on 1 Jan. But if flotation is delayed by more than 6 months, he considers that new financing arrangements should be devised (see on

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

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last page). Also, he wants the Hs 146 to be re-considered in

E - since cancellation would mean a bigger net return from flotation.

A decision is needed by tomorrow when the BAE Board are meeting.

to vesting
Should we say "yes" / subject to the Chancellor's riders?

T Lankester Esq
Private Secretary
Prime Minister's Office
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Dear Tim,

BRITISH AEROSPACE

Yes not with TL?

You told me that the Prime Minister had asked for the Chancellor's comments on the Secretary of State for Industry's minute of 12 December reporting on the discussion in E(DL) on 11 December, and the majority view that it would be right to vest the BAE assets in the successor Companies Act company on 1 January. The Prime Minister was particularly concerned about the apparent need for a capital injection of £100 million to strengthen the Company before a subsequent flotation.

TL
15/12

The Chancellor, who is now in Brussels, saw Sir Keith Joseph's minute over the weekend. I know that he is worried that the prospects of a successful flotation now look slim. It seems clear from what the Defence Secretary said in E(DL) that uncertainties about future Defence orders for BAE will probably preclude a flotation before the Spring or Summer. Net receipts then may be still lower than they would have been in February, and the Chancellor and the Chief Secretary both felt that to sell in February 50 per cent of BAE Ltd for only some £15 million net would evoke sharp criticism; and that there would be a risk of discrediting the manifesto commitment to privatisation if it were fulfilled in such an unsatisfactory way.

The Chancellor understands that the requirement for a capital injection of some £100 million springs from advice from the merchant bank involved, Kleinwort Bensons, about the need to establish the company on a basis which would enable it to survive the failure of the 146 project in 1983. The Bank of England, who are not now directly involved

/in planning



in planning for the flotation, endorsed in the early Summer the need for a substantial capital injection prior to flotation. Without it, and assuming that the 146 has not previously been cancelled, officials do not believe that a flotation would be possible in this Parliament.

For this reason, the Chancellor does not entirely share Sir Keith Joseph's view that the 146 project is a separate issue which is not immediate. He believes that if the 146 were cancelled now there would be a prospect of floating the Company for a very much larger net sum. As a minimum, therefore, he thinks that E Committee should consider the possibility of cancellation now.

With flotation in serious doubt, the Chancellor has considered whether it would be right to vest on 1 January. He agrees with the Secretary of State for Industry that the political arguments do not all go one way: vesting without an early subsequent flotation seems a rather empty gesture, since BAe would remain in the public sector and under full Government control. But he recognises the force of the argument that vesting is what BAe want, and that the Government will be expected to make use before long of some of the powers taken in the British Aerospace Act. Moreover, he is inclined in principle to favour moves away from the traditional Morrisonian structure and in the direction of market-place structures.

Treasury officials have drawn his attention to two problems which would arise in the case of BAe if, contrary to what was intended when the Act was drafted, the gap between vesting and flotation were protracted. First, there might be criticism of the virtually complete waiver of remuneration on the corporation's commencing capital - which has to be extinguished before vesting - if the balancing financial advantage to Government - which would accrue only on flotation - were long deferred. Secondly, the Act makes no provision for interim financing. The terms of the bank loans which BAe have negotiated, and on which they would have to rely, though appropriate to a private sector Companies Act company, are inappropriately onerous for a public sector company. Knowledge of them would bring criticism at home eg from the PAC, and would damage the Government's credit standing abroad.

/The Chancellor



X // The Chancellor has noted these difficulties, but does not regard them as over-riding, and would not wish to dissuade the Prime Minister if she were disposed to go along with the E(DL) recommendation on vesting. He has however asked me to mention that officials here believe that it would probably then be essential that the Department of Industry should accept that, if flotation has not in fact taken place within about six months after vesting, more satisfactory long-term arrangements would have to be devised. One solution would be to take new powers to guarantee borrowing by BAe Ltd, though we would also have to ensure that the terms of BAe's existing loans could at that point be renegotiated to reflect such a guarantee. This would reduce the risk of damage to the Government's own credit standing, which would otherwise grow as the period between vesting and flotation lengthened.

Copies of this letter go to the Private Secretaries of members of E, of the Secretary of State for Defence, the Minister of Transport and the Financial Secretary; and to Sir Robert Armstrong.

Yours ever

Peter.

P S JENKINS
Private Secretary