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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

NB not at this stage.

26th March 1987

Dear Paul,

AIRBUS A330/A340: IMPLICATIONS OF BAe BID FOR ROYAL ORDNANCE (RO)

As you are aware, BAe are one of the two companies now in negotiation with the Ministry of Defence for the purchase of RO. I have been considering the possible implications for your negotiations with BAe on launch aid.

Clearly the final decision on which company we should sell to must be decided on the basis of the price and terms offered. If BAe emerge as the clear winner then they must be the preferred purchaser.

However, we must be alive to the impact on BAe's case for launch aid. As you know, this is based on a number of key financial criteria/ratios, two of which would be significantly affected if BAe were to buy RO. These are dividend cover and gearing. On the basis of 50 per cent launch aid (i.e. our agreed negotiating ceiling) and assuming, for illustrative purposes only, a purchase price of around £200 million is financed at the margin by additional borrowing, the effects of the BAe bid for RO could be as follows:

	1987		1988		1989	
	CURRENT	WITH RO	CURRENT	WITH RO	CURRENT	WITH RO
. DIVIDEND COVER	2.2	2.5	1.4	1.6	2.0	2.3
. GEARING (%)	9	20	20	29	21	30

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The effect on dividend cover is helpful to our case because of the positive impact of the RO acquisition on BAe profits, Gearing is increased substantially, but remains within the one-third criterion which the company regard as the maximum acceptable in their circumstances.

BAe are not slow to use all available negotiating tactics (including extensive media briefing) so I would not be surprised if BAe sought to make negotiating capital out of this issue. I am sure that you will agree, however, that we should respond very robustly should there be any suggestion by BAe that we should increase our launch aid offer on this account. There are three key points to be made:

- BAE's decision to purchase RO is a commercial matter for them and highlights their ability and willingness to finance investment. There can be no question of the Government effectively being asked to pick up the bill for this via launch aid;

- the acquisition should serve to improve their dividend cover and, in two out of the three years, take it above the threshold of 2.2 the company have set themselves. And though gearing increases substantially it still remains below the BAe ceiling of one-third.

- Any higher level of launch aid (e.g. the figure of £600 million reported in your minute to the Prime Minister of 10 March), would not change the dividend cover and gearing ratios for the first three years. This is because higher assistance will not be reflected in higher payments in the early years as the launch aid baseline figures already assume 100 per cent front-end loading.

I am copying this letter to the Prime Minister, George Younger and Sir Robert Armstrong.

Yours ever,

John

JOHN MacGREGOR

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