David

We spoke

With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

Tony

Treasury Chambers,
Parliament Street,
S.W.1.

CONFIDENTIAL

FROM: T U BURGNER
DATE: 1 May 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck o.r.
Mr Turnbull
Mr Robson
Mr G M White
Mr Bent
Mr Hughes
Ms Huleatt-James
Mr Tyrie

BAe LAUNCH AID APPLICATION FOR A330/340

We have been told that Mr Channon will be writing to a small group of colleagues today reporting on the position he has reached in negotiations with BAe and making recommendations for further concessions. We have not yet seen his letter. There is a risk that the Prime Minister may want to discuss Mr Channon's minute following the discussion on Mergers Policy at No.10 on Tuesday, although Mr Channon himself will not suggest this. This briefing, based on an oral report by DTI, is intended to deal with that contingency.

State of Negotiations

2. As you will recall, DTI have made an offer of £400m in response to BAe's request for £750m launch aid, with authority to go up to £420m. DTI have now reached the position where they believe they can do a deal with the company on the basis of £450m but with terms and conditions a good deal worse than the Government has been seeking. Alternately there are possible deals at either £420m or £500m but these look even worse.

3. DTI believe that they have taken the negotiations as far as they can and that further improvement is not likely to be forthcoming.

A £450m Deal

4. The main characteristics of a deal at this level would be as follows:

The £450m launch aid would be front end loaded and would be paid on the basis of:

£ million

1987-8	1988-9	1989-90	1990-91
55	107	157	131

This gives a total launch aid of something over 53%.

5. The Government would receive a 7% monetary return spread over 610 sales, the first 125 being levy free. No fixed (lump sum) repayment would be incorporated. The company return would be 13.4%. They will not accept the proposition that the Government's rate of return should be equal with theirs, arguing that they are carrying the greater share of the risk (including on the exchange rate and the selling price). For sales over 610 the Government would receive royalty payments, the amounts still to be negotiated. Depending on sales, this could improve the Government's rate of return but probably by less than 1%. (The 7% nominal rate of return is the same as for the A320. For the A320 this was intended to yield 2% real; for the A330/340 lower inflation should mean a higher real return.) DTI's confidence in the sales total has strengthened and they now think that their own estimate of 675 is somewhat conservative.

6. Among the terms and conditions which have not so far been secured are:

(i) Accelerated repayment if BAe's profits are 10% higher than the company's forecast. The company do not apparently have objections in principle, but DTI and MOD are concerned about enforcing this and have clearly not pursued it with any enthusiasm.

(ii) The company accept greater monitoring in principle "commensurate with the Government's stake" and details have still to be agreed. This seems to leave considerable scope for company back-sliding.

(iii) Recourse - there is no agreement on any right of recourse to the company if the guarantees on this project are called. BAe object both in principle, arguing that the guarantees to AI are part of the Government's share of the risk; and also on the grounds that recourse would feature as a contingent liability in their balance sheet.

A £420m deal

7. The level of launch aid is slightly reduced, but the Government's rate of return falls from 7-5% nominal. Alternatively the company would want the A320 contract reopened to remove the fixed repayment which BAe are due to make in 1991 and 1992 or to have this fixed repayment recycled as launch aid for the A330/340. Both these alternatives are extremely unattractive. This option is not worth pursuing.

A £500m deal

8. The additional £50m of launch aid would purchase a fixed repyament of £75m to the Government over 3 years 1996-98 but the target rate of return for the Government would still be 7% nominal. This is even less attractive: not worth pursuing.

Assessment

9. Ministers will be under considerable pressure to agree a deal of some kind. Mr Channon will argue that DTI have bought the company a long way (from its opening bid of £750m and its more recent position of £600m) and that the gap between what was previously agreed and what is available is now a small one.

10. But this is misleading in two important respects.

(i) The front end loading of the £450m means that the outflow in the PES period will be considerably higher under the £450m deal, vis

	£m	
	420	450
1987-88	50	55
1988-89	76	107
1989-90	80	157
1990-91	76	131
1991-92	75	-
1992-93	55	-
1993-94	8	-

In terms of PES there is a distinct deterioration. If we could get the company to spread the figures more evenly <u>by dedicating launch aid to design and development costs</u> the effect would be improved.

(ii) The overall rate of return to the Government is distinctly worse than we wanted (7% as against 9.4%.) While it would be possible to defend 7% at the PAC (as the DTI have recently done for the A320), it is arguably a poor return for the risk that the Government is carrying. If the plane is not a commercial success, the Government will not achieve 7%. If it is highly successful, the rate of return will improve relatively little above 7%.

<u>Possible ways of improving the deal</u>

11. There are a number of possible ways in which the deal could be improved. A possible line would be to indicate readiness to accept £450m launch aid if some or all of the following improvements could be made in negotiation.

(i) The launch aid to be dedicated to design and development costs - see above. This smooths the payments and brings worthwhile improvements during the PES period.

(ii) Negotiate better royalty payments above 610 sales than have been agreed for the A320. If the plane is a runaway success, the Government's rate of return ought to be substantially higher than 7%.

(iii) Insist on accelerated repayments if BAe's profits are above 10% better than forecast. It is DTI and MOD who are against this rather than the company. The fact that Government action may affect BAe's profits is not an argument against. If Government action improves BAe's profits, we shall only be getting back a small part. If Government action depresses BAe's profits we as well as they will be the losers under this formula.

(iv) Levies should accrue for the first 125 sales, rather than their being levy free. But in order to help the company's cashflow, the accrued levy would be paid in one or more lump sums after the 125 sales point has been passed.

(v) We need to get a proper monitoring package agreed as part of the deal, not as something to be negotiated after the deal has been struck. We should not allow BAe to get away with weasel words about a monitoring package "commensurate with the Government's stake".

(vi) We should try, if at all possible, to get some degree of recourse to the company for the new liabilities to AI that the Government is taking on. The Government has a large and unquantified contingent liability in relation to AI and we do not want to see it grow with the new launch aid agreement. This is a point that has exercised the PAC.

12. A number of these points have the effect of improving the likely rate of return for the Government which appears to be a sticking point for the company. Even if one accepted the company's principle about unequal rewards being appropriate, there is nothing sacred

about the present gap. But it is clearly a matter of judgement how far these negotiating points are attainable within the framework of a £450m deal. As a minimum, I would be inclined to insist on a good rate of royalties for sales above 610; accelerated repayment if BAe's profits are higher than expected; and a water-tight monitoring package. But it would be good to get more than this if possible.

13. I understand that Mr Channon's minute will refer to a tax problem that BAe have with the Revenue. Apparently a deal is dependent on getting an assurance from the Revenue about the tax treatment of BAe's involvement in Airbus. DTI are separately in contact with the Revenue about this. Any discussion on this point ought to be avoided at your meeting.

Latest background on A330/340 position

14. According to DTI the position on options and firm orders for the two aircraft is generally satisfactory - a total of 128 orders or options for the two aircraft involving 9 airlines. In a number of cases the airlines have yet to indicate that they will take the CFM 56 engine in place of the IAE which has been delayed, but DTI seem confident that they will. Any launch aid offer is conditional on there being a satisfactory market position but that criterion seems likely to be met.

15. Both the French and the Germans are apparently moving to a position to announce their launch aid proposals in the next 3-4 weeks. The Germans are likely to award 90%. The French position is more complicated because they will be giving part of their aid in a form that will help to prepare Aerospatiale for privatisation. Their total package of assistance may be around 75% with the launch aid element somewhat less than this.

TB

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