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Prime Minister 2

I suggest await Treasury comments. (Treasury Ministers are being advised to accept the £450m package but only if the conditions are improved.)

DRN
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PRIME MINISTER

AIRBUS

1 Since your meeting on 26 February, I have been in close touch with British Aerospace (BAe) and with our French and German partners about the A330/340 projects.

PRESENT POSITION

2 On the Commercial front, the position has improved since February. A detailed assessment is at Annex A, but I now consider that the requirement for a reasonable launch base for the aircraft has been ~~set~~ met. BAe accept, however, that any offer of launch aid should be conditional on a final review of the market position with BAe and our French and German partners.

3 All the signs are that the French and German Governments are moving towards a positive decision within the coming weeks. The German Government will advance 90 per cent launch aid. The French Government may end up with a broadly equivalent scheme involving less launch aid but coupled with equity and guaranteed bond finance. Since Aerospatiale is nationalised, any contribution it makes from its own resources is in practice guaranteed by the French Government.

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BRITISH AEROSPACE

4 You will recall that the total estimated risk finance required by BAe for the project is £1120m, of which £840m is for launch costs and £280m for production finance. BAe requested launch aid of £750m and quickly came down to £600m. We have been exploring ways of bridging the gap between this and our offer of £400m. BAe have made clear the problem was not the financing of the projects as such, but the level of risk to the company implied by £400m launch aid.

5 BAe argue that if the Government's return was calculated in terms of fixed sterling amounts the Government was insulated from most of the major areas of commercial risk such as exchange rates, selling prices and cost increases. On this basis BAe cannot accept our proposal that the rate of return to the Government and the company should be set at equal levels.

6 Officials argued that £400m launch aid would protect BAe's key forward financial ratios at reasonable levels and BAe have now accepted parts of our argument. Without conceding the point, we have recognised that our offer would in fact leave BAe somewhat exposed on key financial ratios, particularly the likely trend of profits in the early 1990s.

Their ratios would have been better without Royal Ordnance

7 Clearly there is a relationship between the amount of launch aid and the terms on which it is offered, and by varying the terms we have been able to persuade BAe to reduce substantially their original demands. As a result we have identified three possible packages of support, all subject to formal endorsement by the BAe Board. First, BAe would accept £450m on the following conditions:

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a that the launch aid is fully front loaded (as for the A320)

b that the target rate of return to the Government should be set at per 7 cent in monetary (money) terms, the same figure as for the A320, but now representing a better real return turn to HMG than when the A320 deal was struck. BAe's rate of return would be 11.36 per cent in monetary terms on an assumed long-term exchange rate of £1 = $1.30.

c that the Government's return should be by way of fixed sterling levies on sales over 610 aircraft on a sliding scale, the first 125 being free of levy. When the government's target rate of return has been achieved further royalties would be payable ensuring that the Government benefits from a successful programme.

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8 Alternatively, the BAe Board might accept £420m launch aid if the Government's target rate of return was reduced to 5% in recognition of the increased risk to the company. Even so, Sir Austin Pearce tells me he is doubtful whether his Board would give formal endorsement to this option. But if it were our preferred course, the Board would no doubt take that into acocunt.

9 As a third option, if launch aid were increased to £500m BAe would offer to guarantee £75m of their repayment obligation as fixed repayments, spread over three years from 1996-98, irrespective of aircraft sales.

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10 A fixed repayment element would of course be an attractive feature. Such a feature was incorporated for the first and only time in the A320 launch aid contract. However, unless colleagues disagree, I feel it is not worth increasing launch aid to £500m (para 10) in order to get this. We are sufficiently confident that 610 sales will be exceeded to make it in my view reasonable to accept that our return should be by way of levies over that number. BAe consider there is a 75% probability that 610 sales will be exceeded.

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11 Launch aid of £420m (para 9), amounting to 50% of launch costs, would obviously be attractive for other reasons but I do not think it right to reduce Government's target rate of return below 7%.

12 If we are to give launch aid, my own view is that the £450m option is the best available course. This represents a marginally lower percentage of the estimated launch costs than our support for the A320 (53½ per cent as compared with 54 per cent). The absence of a fixed repayment element is regrettable, but does not of course affect the target rate of return to HMG.

13 As to the proposed difference in target rate of return to HMG and BAe our own independent advisers argue that it is unreasonable to insist on an equal rate of return when the risks faced by the two parties are so different. The Government's only risk is that 610 aircraft will not be sold on the projected schedule. The company takes all the commercial risk on costs, prices, and exchange rate (assumed to be £1 = $1.30) and I have rejected suggestions that the

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government should share in this risk. In the three years since the agreement on the A320, the Government's prospective rate of return has increased while BAe's has reduced.

MONITORING ARRANGEMENTS

14 BAe have accepted in principle that our monitoring arrangements will need to be commensurate with the level of our investment. We shall of course retain our right to appoint a director to the Board. Our present director has recently retired and I am considering appointing in his place Mr Brandon Gough, Senior Partner of Coopers and Lybrand.

PUBLIC EXPENDITURE

15 At £450m, our launch aid would be payable approximately as follows:

	£M
1987/88	55
1988/89	107
1989/90	157
1990/91	131
	450

16 As I indicated in my note of 24 February, established Treasury procedures prevent any provision being made for A330/340 launch aid in my Department's PES figures, so it would be impossible for the DTI to accommodate any agreed support within its PES baselines.

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ROYAL ORDNANCE

17 The purchase of Royal Ordnance by BAe for £~~180m~~ 190 might suggest that their position on the A330/340 is unreasonable. In fact, BAe have always made clear that raising the finance for the A330/340 is not in itself a problem. It is the risk attached to the A330/340 including exchange rate and theprices obtained, which BAe find unacceptable as a plc, and this is not affected by the RO purchase. In BAe's perception, RO is a relatively low risk investment, involving none of the international commercial risk (including exchange risk) that characteries a civil aircraft project.

INLAND REVENUE

18 I understand the Inland Revenue have recently been reviewing the tax position of BAe's work on Airbus. Clearly a significant change to the current arrangements could have an adverse effect on BAe and my recommendations assume that it will be possible to give BAe a satisfactory assurance on this tax point.

RECOMMENDATION

19 I am satisfied that the three options set out above represent the limit of what BAe will accept. I have had several meetings with Sir Austin Pearce and Sir Raymond Lygo and have impressed on them as seriously as I can the difficulty for us in going beyond £400m on the terms I originally offered. However, I am persuaded that this would imply an unreasonable level of risk for BAe which, quite apart from their unwillingness to take, it would be unwise on

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our part to drive the company to accept. I will be in a position to report further on the views of the BAe Board early on 5 May.

20 I have told British Aerospace that I will consider these proposals and will consult my colleagues but of course have given no indication of our likely attitude. My view is, however, that on both political and industrial grounds we should accept one of the 3 options. My own preference is for launch aid of £450m.

21 I am copying this minute to Willie Whitelaw, Nigel Lawson, Norman Tebbit, John Macgregor and to Sir Robert Armstrong.

P.C.

PAUL CHANNON
1 May 1987

DEPARTMENT OF TRADE & INDUSTRY

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ANNEX A

COMMERCIAL PROSPECTS

In March Airbus Industrie announced that they had obtained nine airline commitments for 104 A330s and 340s. Since then one small airline (Finnair) has withdrawn. But this has been more than offset by the addition of a conditional commitment from Northwest Airlines of the US for 30 aircraft. This breakthrough into the US market, if confirmed, would be very encouraging for Airbus. Meanwhile the competition, represented by the McDonncll Douglas MD11 has secured some 115 commitments, inevitably benefiting from its status as a formally launched project.

2 Publicity has surrounded the deferment of the planned development of the V2500 Superfan engine for the A340 by International Aero Engines (IAE), in which Rolls Royce has a 30 per cent share. The programme has not been cancelled; indeed IAE are still in close consultation with Airbus about it. However IAE decided they could not prudently guarantee their previously suggested delivery date of 1992. The A340 will therefore be offered initially to airlines only with an improved version of the GE/SNECMA CFM 56-5 engine, with the possibility of the V.2500 Superfan being offered at a later stage as an alternative. Rolls Royce have for the time being withdrawn their request for launch aid for the V.2500 Superfan.

French

4 Provided the airlines with A340 commitments accept the offer of the improved CFM 56-5 engine (which we expect to be confirmed shortly) I now consider that the requirement for a reasonable launch base for the aircraft has been met. Our French and German colleagues are likely to be of the same

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view. We had originally jointly suggested to Airbus Industrie a launch criterion of 50 orders for the A340 and 30 for the A330, including orders from one US airline.

5 Overall, the encouraging commercial developments of the last two months have tended if anything to increase my advisers' confidence that a "most likely" total sales figure for the A330/340 might be 675. Indeed this should now probably be seen as a relatively conservative figure.

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