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CHIEF SECRETARY TO THE TREASURY

FROM: CHIEF SECRETARY
DATE: 6th May 1987

PRIME MINISTER

AIRBUS

I have seen a copy of Paul Channon's minute to you of 1 May reporting on the present state of play of negotiations with BAe on their application for launch aid for the A330/340. I understand that the BAe Board have now rejected the £420 million package so that the choice currently lies between £450 and £500 million.

2. It is encouraging to note that BAe have now been brought to a more realistic appreciation of the sums the Government is prepared to commit to this programme. On general public expenditure grounds I would be totally opposed to increasing our launch aid offer above £450 million. But, as Paul's minute also makes clear, the deal currently on offer at that figure is disadvantageous to us in a number of very important respects:

(i) because of front-end loading, the spending profile involves substantial outlays over the PES period which could be significantly reduced if launch aid were dedicated to design and development costs only. Broadly, the difference is:

	DEDICATED TO DESIGN & DEVELOPMENT	FRONT END LOADED	DIFFERENCE
1987-88	50	55	+ 5
1988-89	78	107	+ 29
1989-90	87	157	+ 70
1990-91	76	131	+ 55

(ii) the Government is bearing a higher share of sales volume risks because our return does not start to flow until the 126th plane is sold. (We should also, of course, be carrying the risks and substantial subsidy costs associated with providing export credits on sales of Airbus on pure cover terms.)

(iii) The overall target rate of return to the Government is distinctly worse than we have been aiming for (7% as against 9.4%): even if the project is highly successful our return will not rise much above 7%. This contrasts with the return on the project to BAe of over 11%. This figure rises to well in excess of 20% at the company level if account is taken of the avoidance of some £150 million reorganisation costs and the positive cash flow benefits to the remainder of BAe's civil aerospace business associated with their continuing involvement with Airbus. Thus, even if we were to achieve equal returns to the Government and the company on the project, BAe at company level still stand to earn a much higher return on their investment.

3. There are too other important outstanding points, notably on specific recourse to BAe in the event of their default in their obligations to AI and the nature of the monitoring arrangements.

4. Given these unsatisfactory elements I consider that we should continue to press for improvements in the negotiations and I would therefore be against closing a deal with BAe on these terms. In particular I believe that we must continue

to press for the dedication of launch aid to design and development costs so as to achieve a more even spread of public expenditure in the PES period and beyond. We should also seek some increase in our rate of return, either by way of levies starting at an earlier stage (if necessary paid in a lump sum after a certain number of sales have been achieved to assist company cash flow) and/or accelerated repayments of launch aid if BAe's profits are, say, 10% above forecast.

5. On monitoring I note that Paul is considering appointing Mr Brandon Gough as Government director on the BAe Board. The Treasury view is that he would indeed be a good choice. But given the inadequate information about AI's operations hitherto, I would like to be sure that a satisfactory monitoring package has been agreed in detail with the company as part of the launch aid negotiations and not left till afterwards.

6. As far as timing and tactics are concerned, we have avoided being rushed into a decision, despite being presented by AI and BAe with a number of false deadlines. Our latest information on the position of the other Governments is that the Germans at least are unlikely to reach final decisions until the end of June at the earliest. I therefore see a strong case for not reaching final decisions before then. Instead we should continue to press the company to accept a maximum of £450 million conditional on a more even spread of payments and an improved return to the Government. This extended timing would also enable us to sort out any remaining points like the monitoring package referred to above.

6. I am sending copies of this minute to Willie Whitelaw, Paul Channon, Norman Tebbit and to Sir Robert Armstrong.

JM

JOHN MacGREGOR

AEROSPACE: A320 Pt. 2