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PRIME MINISTER

AIRBUS

I have seen John MacGregor's minute of 6 May responding to mine of 1 May.

2 I entirely agree, of course, with John MacGregor's objective of securing the best deal we can for the Government and if I thought we could get better terms by continuing the negotiations as he proposes, I would endorse his proposals. However, I am satisfied that we shall not in fact get better terms, particularly in present circumstances. We have after all reduced BAe's demands from £750m to £450m.

3 I too believe the monitoring arrangements are important. I agree with John that if we make an offer of £450m it should be conditional on the company accepting satisfactory arrangements to enable us to monitor both the physical and financial progress of the projects and the overall financial health of BAe. My appointment of Mr Brandon Gough as Government Director would be part of that process. Unfortunately, BAe will not accept a specific right of recourse, but with the monitoring arrangements, I am satisfied that the position is adequately covered.

JF4AVD

4 The front-end loading of launch aid, and the reduction of the Government's target rate of return to 7 per cent, were cardinal features in the overall package enabling me to negotiate BAe down to £450m. I have pressed them very hard and am satisfied that they will not accept any variation of these terms without a corresponding increase in the £450m. Indeed the Board has not yet formally endorsed the £450m package because of some remaining concern that the terms are too onerous to the company, although Sir Austin Pearce believes he can get a formal Government offer through the Board.

5 Precedent is on BAe's side in that front-end loading and a 7 per cent target return to the Government were features of the A320 launch aid agreement. Indeed 7 per cent now represents a higher figure in real terms for the Government than when the A320 deal was struck in 1984.

6 The table at paragraph 2 of John's minute shows only the public expenditure position up to 1990/91. Under my proposal (his right hand column) there would be no further outlay after 1990/91. Under his preferred scheme, there would be a further outlay of £159m after 1990/91.

7 John's point that the Government would bear a higher share of sales volume risk because our return does not start to flow until the 126th aircraft is sold implies that the situation would be better on the £500m option. But this is not so. As my minute of 1 May made clear, the only difference between the £450m and £500m options is that under the latter BAe would guarantee to repay £75m irrespective of the level of sales achieved.

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8 I believe the key point here is our level of confidence in the achievement of the 610 sales, over which the Government's target rate of return will be set. Our current projections indicate good prospects that this level will be achieved. Since I minuted on 1 May, Airbus Industrie have confirmed the valuable preliminary purchase agreement with Northwest Airlines of the US, bringing the total number of orders and options to 128.

9 Again, I accept that there will be additional risks and costs associated with export support, if our present arrangements continue, but the situation here will be the same for each option before us.

10 As to BAe's rate of return, I believe it is reasonable that the company should have a prospective rate of return higher than the Government in recognition of the unequal balance of risk between the parties. As under the A320 launch aid contract BAe will take all the risk on exchange rates, selling prices and production costs. We have seen how on the A320 this has led to a significant shortfall in the company's rate of return below target while our own prospective return has increased.

11 I can understand the argument that one should take into overall account the £150m of estimated costs to BAe of redundancies and plant closures if they do not participate in the projects, and the positive benefits to the company's other business of participation. I believe this has been done by BAe accepting a prospective rate of return as low

as 11.4 per cent. As I implied in my earlier minute, I think it should be a matter of concern to us if BAe accepted a prospective rate of return any lower than this on such a major high-risk project, given the company's national strategic importance. BAe originally indicated they would want a prospective rate of return of over 15 per cent, and have been negotiated down from that level.

12 On timing, the French will undoubtedly want to make an announcement during the Paris Airshow which starts on 11 June. Indeed not to do so could damage the commercial prospects of the project. The German Cabinet will meet on 3 June and will be pressed by the French to decide. There is no doubt that the Germans will give launch aid of 90 per cent and by no means clear that the German Treasury's arguments for delay will win the day.

13 My own view is that we should conclude a £450m deal with British Aerospace on the terms set out in my minute of 1 May. We shall come under great pressure from our supporters, many of whom have considerable constituency interests. They would find it difficult to understand a delay in our decision, particularly as BAe are prepared to accept such a reduction on their original request. I believe we can gain both political and diplomatic advantage from an early decision and could be disadvantaged by delay. We would of course make clear that our support for BAe was conditional on the French and German Governments also giving their support.

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14 I am copying this minute to Willie Whitelaw, Geoffrey Howe, Nigel Lawson, Norman Tebbit, John MacGregor and to Sir Robert Armstrong.

PC

PAUL CHANNON

7 May 1987

DEPARTMENT OF TRADE AND INDUSTRY

JF4AVD

AEROSPACE: Airbus pt 2