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cc B/UP

PRIME MINISTER

8 May 1987

AIRBUS

I have had the DTI calculate some net present values (NPVs) to show how the former £600m aid programme compares with the proposed front-loaded figure of £450m.

The value to the Government of the £600m deal is minus £20m, when discounted at 10%, and a worse figure of minus £80m for the £450m deal! The explanation is that the lower target rate of return is far more important in deciding the overall cost to Government than the quantity of aid. Nevertheless, the immediate pressure is for the total amount to be kept down and the best way of doing this is to yield on the target rate of return. It is the total sum provided which will hit PSBR over the next few years.

The NPV analysis shows what a topsy-turvy world launch-aid is. If the Airbus investment made any sense in commercial terms, the banks would be clamouring to provide project finance and there would be no need for any Government involvement. The indicated Government rate of return for every case is less than the Treasury bill discount rate, currently around 9.75 per cent. It is therefore unsurprising that, if the target rate of return is reduced from 9.4 to 7 per cent, even a lower initial sum is going to have a worse net present value to Government.

The positive side of what the DTI have negotiated is that, because the initial exposure is lower, the ultimate downside risk is less. If the target sales volume of 610 aircraft is not met we will lose less money by putting up £450m than by putting up £600m. Measured by negative NPV to the taxpayer the present £450m deal is worse than the earlier £600m when 610 aircraft sales are achieved. However, if actual sales fall short by 25% the NPV of both cases become approximately equal at minus £130m. Any further downside would therefore be protected by the £450m deal.

Conclusions and Recommendation

Our negotiators, led by Mr Channon, tell us that the £450m launch-aid programme, front-loaded and with a target return of only 7%, is the best deal they can make. If that statement is true, then the choice we now have is to accept it, or to turn down Britain's participation in Airbus. The course which the Treasury advocates, namely that our negotiators be told to go away and do better, pre-supposes that they have not squeezed the orange dry and that a better deal is available. However, a £450m settlement will be seen as a major Government victory since it is generally known that Pearce and Lygo originally asked for £750m and then claimed that nothing less than £600m could possibly work.

I do not support the Treasury's proposal that the whole thing should be re-negotiated in order to reduce the front loading. Government will gain a lot of mileage from securing the Airbus project at £300m less than BAe originally asked and external commentators are unlikely to focus on the rate of return targets or the front-end loading. Given, therefore, that it is politically desirable to go ahead with Airbus, I would support the £450m proposal as presented by DTI and not send the negotiators back. It would then follow that the earlier an announcement were made the better.

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