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PRIME MINISTER

AIRBUS

(Meeting of Ministers at 9 am on 13 May)

(Minutes to you of 1 and 7 May from the Trade and Industry Secretary, and of 6 May from the Chief Secretary, Treasury)

## CONCLUSIONS

1. You will need to decide:

a. whether a decision to provide British Aerospace (BAe) with launch aid for the Airbus A330 and A340 projects, should be taken and announced this week;

b. if so, what level of aid, and on what conditions, should be offered.              

## BACKGROUND

2. BAe originally requested launch aid support of £750m, on total launch costs of £840m (plus £280m for production). At your meeting on 26 February you agreed the Government's opening offer should be set at £300m; but that Mr Channon could go up to £420m (50%) subject to further reference to colleagues. The initial offer of £300m was firmly rejected and Mr Channon has conducted further negotiations on the basis that it would be extremely difficult for the Government to go beyond £400m.

Proposals

3. Mr Channon now proposes launch aid of £450m (53.5% compared with the 54% given on the A 320) on the following conditions:-

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- a. it is fully front loaded (as with the A 320);
  - b. the Government's target rate of return is set at 7 per cent in monetary terms (as with the A 320) compared with 11.36% for BAe on an assumed £1 = \$ 1.30 exchange rate;
  - c. the Government's return is through fixed sterling levies on sales of over 610 aircraft on a sliding scale, the first 125 being levy free.
4. He rejects 2 other possible options:-
- (i) launch aid of £420m with the Government's target rate of return reduced to 5 per cent; the BAe Board rejected this on 5 May;
  - (ii) launch aid of £500m, with BAe offering to guarantee £75m of their repayment obligation as fixed repayments over the years 1996-98, irrespective of aircraft sales. Both Mr Channon and the Chief Secretary are opposed to this.

MAIN ISSUES

(a) Timing of Decision

5. The first issue to settle is whether you wish to take and announce a decision this week. The Treasury argue that there is no need to do so before the end of June at the earliest and that in the meantime BAe should continue to be pressed to accept a deal more favourable to the Government. Mr Channon, on the other hand, maintains that an early announcement is necessary because the French and the Germans will wish to announce launch aid at the Paris Air Show starting on 11 June; and the German Cabinet are expected to agree to 90% launch aid on 3 June.

6. It would clearly not be impossible to defer the decision and the postponement need not be for very long. The other Governments would understand the difficulties arising from the calling of the election. On the other hand, if Mr Channon is correct, deferral

would leave the UK a little behind the game; and it is well known that the Government have been considering this for many months. You will clearly wish to take wider political considerations into account also in reaching this decision, but if launch aid is announced this week Mr Channon will need, for the sake of propriety, to be able to reassure the House that it is operationally necessary to take a decision of such magnitude so close ~~to~~ the election.

(b) Nature and Terms of Decision

7. Mr Channon argues that the proposal summarised in paragraph 3 above is the very best he can negotiate out of BAe and that (subject, of course, to the French and Germans confirming their support) we should say snap now and maximise the diplomatic and political credit for it. The Chief Secretary, however, argues that we should seek the following improvements:-

a. launch aid should be restricted to design and development and not front end loaded. This would change the spending profile over the PES period as follows:

|         | <u>Restricted to<br/>Design &amp; Development</u> | <u>£ million<br/>Mr Channon's<br/>proposal</u> |
|---------|---------------------------------------------------|------------------------------------------------|
| 1987/88 | 50                                                | 55                                             |
| 1988/89 | 78                                                | <u>107</u>                                     |
| 1989/90 | 87                                                | <u>157</u>                                     |
| 1990/91 | 76                                                | <u>131</u>                                     |
|         | <u>291</u>                                        | <u>450</u>                                     |

It would, however, leave £159m to be paid after 1990/91.

b. the rate of return to the Government should be increased either by reclaiming levies at an earlier stage or by accelerated repayments of launch aid if BAe's profits are above forecast.

8. There is no doubt that these conditions, if negotiable, would strengthen the Government's position. But the key question is whether they are negotiable. Mr Channon says flatly that they are not. There are also some reasonable arguments on the company's side. The DTI's 'independent' assessors, Morgan Grenfell, advise that it would be unreasonable for the Government to insist on a rate of return equal to that of the company, since the Government's risk is related to aircraft sales (ie that 610 aircraft will not be sold), and that of the Company to costs, prices and exchange rates (though ECGD will be providing export credits on Airbus sales on cover terms). Moreover the commercial prospects for sales of the A330/340s seem better - the latest estimate is 675 aircraft, which is said to be a conservative figure. The total number of orders and options actually so far arranged is 128 (including a preliminary purchase agreement with Northwest Airlines of the US for 30 aircraft).

9. You may conclude that the deal Mr Channon seems able to deliver - which is a considerable improvement on the BAe starting point - is the best the Government are now likely to get and that the Treasury are not really in a position to second guess it. A further consideration is that any significant change to the conditions proposed would almost certainly mean no announcement this week. Even if changes were acceptable to BAe, it would, as I understand it, require a further Board meeting of substance to consider it. But you may wish to probe Mr Channon on this.

#### TIMING OF ANNOUNCEMENT

10. If you decide in favour of Mr Channon's proposals, you will want to make an announcement very quickly. To do so on Wednesday afternoon would be a bit of a rush and would not allow time for more formal consultation with colleagues. (your 26 February meeting concluded that the issue should be brought to a Cabinet Committee when agreement with BAe was in sight). I suggest, therefore, that you aim for an announcement on Thursday afternoon, after clearance with Cabinet in the morning. This could be on the basis of an oral report by Mr Channon, to avoid circulating a very sensitive piece of paper overnight. It would also give Mr Channon

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a chance to circulate a draft for clearance to you and the other Ministers most closely concerned.

HANDLING

11. You will wish to invite the Secretary of State for Trade and Industry to present his proposals, and the Chief Secretary, Treasury to repond. The Lord President of the Council and the Chancellor of the Duchy of Lancaster may wish to comment on the political and Parliamentary implications.



J B UNWIN

Cabinet Office  
11 May 1987

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