cc Mr G. Cruise - Copy No. 9 (taken from Copy No. 8).

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RA - Airbus

COPY NO. 8 OF 8

Paul: This is the most recent internal DTI paper I have on airbus. The pencil comments are mine. George

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To: **PS/CHANCELLOR OF THE DUCHY**

cc PS/Secretary of State
Sir Brian Hayes
Mr R Williams
Mr Durie FRM
Mr Mallinson Sols
Mr Bowder Air 2

From: **M J MICHELL**
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5 April 1988

BRITISH AEROSPACE: FINANCIAL POSITION

Mr Bowder and I met British Aerospace (Mr Friend and Mr Eustace) on 30 March for yet another "informal discussion" of the financial position on Airbus. We were shown (but were not permitted to keep) projected figures on Airbus displaying a cumulative negative cash flow position by 2000 of between £3bn and £4bn, with little hope of subsequent recovery of the situation. These figures have not yet been to the Board, but the two Finance Directors took the view that the Board could not responsibly accept this situation. They suggested that the Board might conclude that, in the absence of further assistance from the Government, BAe would be forced to withdraw from the A330/340.

No company can predict its 12 year cash flow with any accuracy at all. The figure can be made vast in either direction by taking extreme assumptions.

2 The Finance Directors considered that BAe were unlikely to be ready to put the issue more formally to the Government before the latter half of May. However, it seems clear they are under some pressure from the Chairman to accelerate this timetable.

This may be a scheme of Roland Smith to link this issue to Rover deal.

Detail

3 The Chancellor will recall that he met BAe on 15 December 1987. Sir Brian Hayes met them again on 15 February 1988, and I have also had a number of discussions with them. At all these meetings we have conveyed the same basic message:

a that the Government is very unlikely indeed to be prepared to give further support; but

b if BAe wish to put forward a detailed case, it would of course be considered, but it would need to show the position right across the company's activities (now assumed to include Rover Group) not just for Airbus alone.

This invitation is unfortunate.

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4 BAe have not yet produced such an analysis and the Chancellor agreed we should not press them to do so, to avoid giving them any opportunity to put pressure on the Government before publication of their (poor) results for 1987.

BAe's Present Projections

5 BAe's projections show a serious position on all Airbus projects. While the projections of costs remain similar to those on which the launch aid decisions in 1984 and 1987 were based, the projections of sterling revenues are sharply down because of the exchange rate and the tight competitive situation in the market. The result is that the projections show cash requirements, instead of peaking in a containable manner some 2-3 years after each project enters commercial service, accelerating in a manner that quite rapidly becomes uncontrollable and irreversible. In such circumstances BAe's recent accounting provision of £320m (which does not cover the A330/340 situation at all) would certainly be insufficient.

6 The projections assume

i that the £/$ exchange rate weakens steadily to $1.30 or below by the late 1990s

ii that the target cost-cutting and productivity improvements initiated by Sir Raymond Lygo are "mainly" achieved.

7 However, BAe were unable to tell us what the key "sensitivities" in the calculations were eg by how much would the exchange rate, achieved prices, volume of sales, costs (or some combination of all these) need to improve further in order to have an appreciable effect on the situation. I said this was information we would need if we were to examine any case. I also repeated the points at paragraph 3 above.

crucial info. amazing BAe doesn't have it.

BAe's Possible Actions

8 The projections we were shown have not yet been put to the Board, although I am sure the Chairman is aware of them.

9 BAe's first line may be to attempt to claim that the Government has a legal liability to fund the company's losses on Airbus. We are clear this is not so, and have now told the company so. They appear to have received different legal advice. They may decide to press this point, though I am inclined to doubt it.

10 Their second line is likely to be to formalise the request for additional support. This is likely to be in the form of a

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request to vary the terms of existing launch aid commitments rather than a demand for new money as such. Suggested options may include:

These are just mechanisms. What they are after is more money.

i Reduction of HMG target rates of return on the £700m launch aid committed to A320 and A330/340 to 4% (ie a projected real rate of return of around nil) or to zero (implying a return of principal only) or even below zero (implying a forgiveness of levy obligations).

ii Rescheduling of repayment obligations so as to reduce the burden on BAe in the early 1990s.

We should push this in dealing with BAe.

Apart from the manifest unattractiveness of any of these options, any loosening of agreed launch aid terms of this kind is of course one of the principal targets of the US Government in the current trade talks on civil aircraft. If HMG acted on any of the options suggested above, there must be a strong risk that the US Government would break off the talks and initiate a trade action. BAe are aware of this.

They must not be allowed to blackmail the DTI with this argument.

11 BAe's <u>third</u> line may well be to conclude they have no alternative to withdrawing from the A330/340. My impression is they would restrict their decision to these projects and would attempt (subject to the agreement of their partners) to stay in the A320 as well as the earlier programmes.

12 → What about Joint venture with McDonnell-Douglas (their chairman has told me that he would contemplate this provided MD11 is not set back)

<u>Timing</u>

12 Mr Friend and Mr Eustace thought they would not be in a position to prepare a comprehensive case for additional support before the latter part of May, and did not envisage matters coming to a head before then. I am not so sure about this. My impression is the Chairman may wish to accelerate the timetable. I would have some sympathy with this: in general terms, if there is going to be a major row with European partners about the A330/340, it might as well be sooner rather than later, since the development programme is still at a relatively early stage (BAe have to date spent around 4% of their total estimated development costs).

<u>Implications of a Withdrawal by BAe</u>

13 Mr Friend and Mr Eustace were not very clear about the precise implications for BAe of a withdrawal from the A330/340. Clearly there would be a major row at the industrial level. It is possible BAe could be legally vulnerable under agreements signed with their partners. Apart from this, it is a matter of speculation what Airbus Industrie and the other partners would

It is essential that this be clarified before Govt has any serious discussion with BAe. There is no point speculating about ascertainable fact. DTI must get its <u>own</u> legal advice and not simply rely on what BAe tells them!

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do. The French would undoubtedly wish to carry on with the A330/340. They might conclude that they could not do so without BAe (at any rate without unacceptable delay) and could conceivably contract with BAe to continue developing the wing on a non- or reduced-risk basis. This is what happened in 1969 when the UK first withdrew from Airbus, and it would probably represent in financial terms a highly satisfactory outcome for the UK. For that reason alone, I have no doubt the French and Germans would make every effort to avoid doing it again.

14 Possible alternatives would include MBB taking on the wing development (which they are probably technically capable of doing, although there might be some delay and addition to costs, and the German government would face a very unwelcome financing problem); or contracting with a US company. There would probably be a legal battle about design rights.

? Are they not separate agreements

15 Whether the partners would be prepared to tolerate BAe continuing to participate in the A320 is unclear. The aircraft is now in full production and initial deliveries have been made to Air France and British Airways. It would be difficult to change the wing supplier without disrupting the programme unacceptably. There could also be legal difficulties for the partners in excluding BAe if the company continued to fulfil its obligations.

This is defeatist waffle! Each project will be judged and invested in upon its own merits. We withdrew in 69 and it didn't preclude future projects.

16 If BAe withdrew from the A330/340 it is unlikely the company would be accepted as a partner in any future Airbus project. BAe could conceivably join with a US partner for future collaborative projects. This would provoke a further and probably final break with Airbus. The more likely outcome is probably that BAe (and therefore the UK) would cease to be a manufacturer of large civil aircraft after current programmes were completed.

17 The implications of this for the UK aircraft equipment companies would be potentially serious. Rolls-Royce, however, would probably not be greatly affected: for many years the links between BAe and RR on the civil side have been weak.

Implications for Government

18 The issue would of course very rapidly become an inter-Governmental one, particularly in view of the electoral situation in France. There is little doubt HMG would come under strong pressure to do whatever was necessary to persuade BAe to carry on.

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19 On the legal level, as the Chancellor's recent paper to colleagues made clear, the inter-governmental arrangements for the A330/340, which would contain the normal inter-governmental guarantees, have not yet been signed (or even drafted). However, the extent to which a moral obligation exists to the partner governments (based on the expressions of commitment contained in the 1979 "Principles of Co-operation" and the 1987 memorandum governing the A330/340) would be a major political issue.

20 The extent to which the inevitable row would spill over into other issues (eg EFA but also more widely) is difficult to judge at this stage. There must certainly be a risk of it.

Line of Action

21 I suggest our line with BAe should be as follows. I do not think we should say to them that this is entirely a commercial matter for them and is nothing to do with the Government. It is obvious there are major political issues involved, and I do not think it would help to pretend otherwise.

22 I suggest, therefore, that we indicate to BAe that the Government would wish to be consulted before the company takes any action. But we should also indicate to the company that it is for the Board initially to reach a view.

23 To avoid BAe believing too readily that they can force the Government into advancing extra support, I think we should also continue to indicate as necessary that the Government is most unlikely to agree to this. As necessary, we should I believe also indicate at this stage that the Government is unlikely to seek to overturn any decision by BAe to withdraw from the A330/340. Our tactics, I think, should be to make the Board take that decision with a full sense of its potential implications for the company and without any sense that the Government is likely to relieve them of their responsibility. ✓

24 Internally, the Chancellor may wish to inform colleagues of the situation, though I do not think there is an immediate urgency to do this. If the Chancellor agrees, I would propose to continue to keep Treasury officials informed, as I have done up to now.

25 On the specific issue of the launch aid contract, I continue to believe it would be to the Government's advantage to sign the contract. Although this would have the apparent disadvantage that we would have to make an immediate payment to BAe of some £30m (the value of work done so far) we would in any event have a strong moral obligation to make this payment. It is of course

This logic needs careful testing. If signature crystallises legal obligations which would otherwise be dubious (whatever the moral obligation) it merely plays into Lygo's hands to sign up first and haggle later!

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budgeted for. The advantage of signing the contract is that it creates obligations from BAe to the Government which the company would breach by a unilateral decision to stop work. This could be helpful in subsequent exchanges.

26 I suggest, therefore, that the Chancellor maintains the line already taken with Sir Raymond Lygo viz. that he is prepared to have an early meeting with a view to settling the outstanding points. If BAe are not prepared to do this, or are not prepared to accept the reasonable compromise the Chancellor is briefed to offer, that too could help our tactical position.

M J MICHELL

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