SECRET

PRIME MINISTER 23 May 1988

AIRBUS

OVERVIEW

Large civil aircraft capacity in the Western World is provided by Boeing, McDonnell-Douglas and Airbus. Market projections over the balance of the century indicate insufficient volume to provide all three manufacturers with an adequate profitability without some form of collaboration. McDonnell-Douglas favour cooperation with Airbus provided it does not jeopardise their MD 11 programme due to enter the large long haul aircraft market in the early 90s. Aerospatiale, the state-owned French participant in Airbus, have always argued for a European Government-backed independent aircraft industry as exemplified by Airbus, with profitability subordinated to national prestige.

The French however generally provide the avionics for Airbus models on contracts which assure profitability. Furthermore AI is located in Toulouse with final aircraft assembly. In these respects the French position is not symmetrical with those of the British and German partners who make aircraft components within the overall cost structure for the Airbus hull excluding avionics and engines. Again, the German position is special because of the role of F J Strauss as Chairman of Airbus. Those in Germany who depend upon his political support will not lightly show hostility towards the Airbus concept by attacking its profitability.

The recent Wise Men Review:

Britain is therefore isolated and without much European sympathy for its attempts to improve the financial good behaviour of Airbus Industrie. Nevertheless, Jeffrey Sterling's group of 'wise men' has come up with generally sensible proposals for setting up an 'Airbus plc' which would have to subject itself to the rigours of a public company. Significantly, however, the wise men were unable to agree whether the chief financial officer should report to the chief executive officer of the new Airbus or directly to the supervisory board. Resolution of this issue is essential before there can be any sensible management structure in Airbus which will begin to achieve the wise men's objectives of ultimate accountability and transparency of the individual participants profit share.

The Threatened Losses on Airbus

Even if it were possible to achieve the above, the ultimate issue is whether aircraft can be made and sold for profit and if there had been any strong expectation of this there would have been no case for launch aid! It would help if Airbus got its house in order with proper accounts. But if the basic business isn't there, losses will continue however splendidly they are accounted. British Aerospace now tell us that the consequence of participation in the Airbus programme will generate cumulative negative cash flows of between £3 and £4 billion by the year 2000. They argue that this derives from the strength of sterling which was not anticipated when the A320 was agreed with launch aid of £250m in 1984 (£1 = $1.3) or the A330/340 last year with launch aid of £450m (£1 = $1.5).

The Case from BAe

Although we have no formal view from the BAe Board, discussions with Smith and his finance directors indicate that the Board could not responsibly accept this situation and that without further Government assistance BAe will be forced to withdraw from at least the A330/340 programme. There will therefore be a plea for Government to help them further by some technical mechanism such as rescheduling the repayment obligation away from the early 90s or reduction of the target rates of return on the £700m so far committed. A further ingenuity would be for HMG to set up a financing vehicle, underwritten by Government, which would buy the wings from BAe at a profit and then sell them to AI at a loss; a proposal to set up a new nationalised industry with loss-making built into its charter!

Whatever mechanism they favour, the basic plea is for more taxpayers' money. Although it was originally made clear that any help sought on Airbus must be treated quite separately from the Rover deal, I am greatly suspicious that Smith and Lygo are pushing for Airbus aid now because the commission is about to agree on Rover and thereby trigger their EGM. This is a clear attempt to link the two deals.

SPECIFIC ARGUMENTS AND THEIR REBUTTALS

1. BAe stand to lose cash flow of £3 to £4 billion by the year 2000 by remaining in Airbus.

   No company can forecast its 12 year cash flow with any accuracy . The vagaries of inflation, interest rates, exchange rates etc make this quite impossible. Such a figure can be made vast in either direction by taking extreme assumptions.

BAe have been unable to specify the key sensitivities in their calculations. They have not estimated how much improvement in exchange rates, prices, volumes or costs, would be necessary to redress the situation. They had no answer to these questions other than gloomy looks and clearly had not run the numbers. It is outrageous that they should come to Government without such crucial information which is a matter of straightforward calculation by their financial planning staff.

2. <u>BAe may claim that HMG has legal liability to fund its Airbus losses</u>.

This argument derives from an interpretation of certain clauses in the BAe prospectus rather than from any formal commitment by Government in the launch aid agreements. DTI are adamant that their legal advice is that no such liability exists and have so informed BAe. Furthermore the last launch aid agreement on the A330/340 has not even been signed due to delay by BAe drafters.

3. <u>Without further launch aid they must withdraw from the A330/340</u>.

This is attempted blackmail and must be countered with the argument that they are now a private company, not part of the public sector, and must operate their business as they think fit. The directors are grown men who enter into agreements which they believe the company's balance sheet can stand. Otherwise they do not discharge their duties as directors.

Further launch aid by HMG would provide a marvellous target for the US Government in their current trade talks on civil aircraft. This would ultimately be to BAe's disadvantage. Far better for them to pursue the prospects of joint venture with McDonnell-Douglas either within or separately from Airbus.

BAe must not be allowed to present themselves as in a pincer between the French and the Americans with no way out except taxpayers money!

4. Withdrawal from the A330/340 will preclude BAe from partnership in any future Airbus project.

This is defeatist waffle. Each project will be judged and invested in upon its own merits. The UK withdrew in 1969 and it did not preclude future projects - it may be a great pity that it didn't!

5. HMG intransigence on Airbus will spoil the Rover deal.

This argument is both maddening and false. The Rover deal was advanced by Day and Young in early February as soon as it became clear that you would not accept yet another Rover plan which called for a capital spend of £1 billion over five years before achieving viability. Day ran for cover to BAe and, with Young's support, advanced an extremely generous privatisation proposal involving a net taxpayer contribution of £650m. Subsequent financial comment has emphasised the generosity of the deal towards BAe who are receiving £1 billion of assets for a net payment of £150m.

Such a deal presents an enormous prize for BAe given the certainty that a business the size of Rover with 47,000 employees can be managed in a more cash productive manner than their plan proposed. Both Young and Day were told and agreed that the Rover deal must be completely separated from any Airbus considerations. This was certainly communicated to BAe. It is therefore both disgraceful and dishonourable that they should come back now with their begging bowl while the EGM to approve the Rover deal looms a month away.

6. The EC Commission will reduce the Rover money which we should therefore give back to BAe in launch aid.

The European Commission may require the net contribution of HMG to the Rover deal to be reduced by between £100 and £200m. It will not be clear whether this is the case until this Thursday when Young meets Sutherland. In advance of that meeting, which ideally should have happened before we talk Aerospace tomorrow, it may be assumed that whatever the Commission try to cut down, BAe will claim as the minimum for further launch aid.

This may be a political resolution of the combined Airbus/BAe/Rover problem which would treat the whole matter as a zero sum game whereby any reduction on Rover goes into BAe via another pocket called launch aid. The disadvantages are the negative signals to the American Government and false promises to UK interests such as Rolls Royce that the launch aid concept is alive and well. It also gives the lie to the recent DTI White Paper forswearing Government expenditure on near market projects.

RECOMMENDATIONS

1. Stand firm against any acceptance of HMG liability for BAe's predicaments because of Airbus. BAe campaigned for Airbus. BAe obtained sub economic funding from the British taxpayer and as a public company made a financial judgement. If it chose to forego foreign exchange cover on future sales, that is not our fault.

2. Recognise that we do not wish to see BAe bankrupted, but that we cannot accept this as a serious risk until proper financial projections are presented which <u>include</u> sensitivities to variations in key parameters such as sales volumes, interest rates and exchange rates.

3. Emphasise that the Rover deal is quite separate from any launch aid consideration and that if BAe wish to advance any argument for the variation of existing launch aid arrangements, they must do so only after the Rover EGM is through. Others may tell you that this is a high risk strategy which courts the collapse of the deal. My instinct is that Smith, Lygo and Day have such an excellent deal which they have been boasting about since March, that they will not allow it to collapse.

   By standing firm on launch aid, <u>we</u> take the initiative and push BAe to an early resolution of the Rover acquisition. Only after that becomes unconditional following a successful EGM, would we be prepared to enter discussions about amended launch aid. At that point the high cards would be in our hands. Depending upon the seriousness of BAE's position, as demonstrated by a properly worked financial analysis with sensitivities, we might consider some help. That is very different from being blackmailed into it now.

4. If the Commission does cut back the Rover aid by a substantial amount, such as £100m or more, and the political pressures are extremely powerful, the most we should concede is to make good any reduction by the Commission. The net transfer from taxpayers to BAe will then remain at £650m. However, the detailed analysis and negotiation of this sum should wait.

GEORGE GUISE