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From the Private Secretary

24 May 1988

Dear Peter,

BRITISH AEROSPACE AND AIRBUS INDUSTRIE

The Prime Minister held a meeting earlier this afternoon to discuss the position set out in the Chancellor of the Duchy's minutes of 19 May and 27 April. Those present were the Chancellor of the Exchequer, Secretary of State for Defence, Secretary of State for Trade and Industry, Chancellor of the Duchy, Minister of State for Foreign and Commonwealth Affairs, Sir Robin Butler and Mr. Richard Wilson (Cabinet Office) and Mr. George Guise (Policy Unit).

I should be grateful if you and copy recipients would ensure that this record of the discussion is seen only by named recipients.

Opening the discussion the Chancellor of the Duchy said that the Chairman of British Aerospace had yesterday been to see the Secretary of State for Trade and Industry and himself to explain their concerns. The position was complex and a number of factors had to be taken into account:

(i) This was the latest episode in a whole series of difficulties that had arisen with Airbus, covering both the A320 and the A330/A340 development. Although reasonable market share had been achieved sales were only possible on terms involving large losses.

(ii) It was crucially important to improve the management of Airbus Industrie. There had been a surprising degree of progress, but there was a long way to go.

(iii) Although there were at present three major world aircraft producers, it was arguable that there was only room in the market for two. This pointed to the desirability of Airbus Industrie undertaking collaborative projects with McDonnell Douglas. There had been some talks between the two, and a number of options for co-operation could be conceived; for example AI concentrating on the A320 while at the same time looking carefully at the prospects for working together with McDonnell Douglas on the AM300.

(iv) The discussions between AI and McDonnell Douglas were helping to defuse the dangers of a trade war between the United States and Europe over aircraft sales. But this could erupt again at any time, particularly if the European governments supporting AI were to inject more financial assistance.

(v) The crucial factor that had undermined the financial projections for the A330/A340 was movements in the sterling/dollar exchange rate. The original proposal had been based on a rate of $1.30, but if the rate were to continue at around $1.85 BAe now projected a major cash flow crisis in the early 1990s.

The Chancellor of the Duchy said he had been pressing BAe to produce detailed figures of the prospects since Christmas, but the company was only now beginning to respond. He was taking the line with BAe that involvement in the A330/A340 reflected their own agreement, and it was for the company to take their own view on whether to continue with the development. It would then be for the Government and British Aerospace to work out together the costs involved, and then to discuss where those costs should fall.

In further discussion, it was noted there were three main options, though each could have variants depending on the degree of AI collaboration with McDonnell Douglas. First, BAe could pull out of the A330/A340, but with the other partners continuing with the development, perhaps with the wings then being built in Germany. Second, BAe could pull out and so precipitate AI pulling out of the A330/A340 altogether. The third option would be to press ahead with BAe involvement in A330/A340, but the company were then certain to press strongly for further heavy Government support, probably involving bearing the cost of exchange losses. Under any of the options it probalby made financial sense for BAe to continue its involvement in the A320.

The precise costs involved in any of the three options were highly uncertain at this stage. But the first option seemed likely to involve a minimum cost of perhaps £500 million, and the second option substantially more than that if the UK was liable for the costs involved in withdrawal by the other partners. The costs of the third option would depend critically on future movements in the exchange rate, but at a minimum would involve several hundred million pounds and would be open-ended.

In further discussion the following points were raised:

- It was noted that BAe must have been aware of the emerging position on Airbus at the time they signed the deal to purchase Rover - when the exchange rate was

$1.87, precisely as now. It would be important to avoid BAe seeking to link the terms of the Rover deal to the Airbus negotiations, particularly as the purchase of Rover on the basis agreed would substantially improve the cash and balance sheet position of BAe.

- There would be major political implications both externally and internally if BAe were to withdraw from the A330/A340. Externally, the major difficulty would be with the French. Internally, there would be strong constituency pressures as well as more general pressure from the aircraft lobby.

- It would be important to consider the implications of withdrawal for defence contracts and orders placed with BAe, such as for EFA.

Summing up the discussion the Prime Minister said it was now essential carefully to cost each of the options, and to assess their political consequences. The work needed to take into account sensitivities to exchange rate movements, and the implications for the position on defence orders. The Rover deal also had to be borne in mind. The further work should be carried forward jointly by the Department of Trade and Industry, Treasury, Ministry of Defence and the Policy Unit, with the Foreign and Commonwealth Office involved in the foreign policy aspects. Meantime, DTI Ministers should hold to the line they had been taking with BAe that it was for the company to reach its own view on the consequences of continuing with the A330/A340 development, while cooperating with the Government on assessment of the costs of the different options.

I am copying this letter to the Private Secretaries of Ministers present, and to the others who attended the meeting.

Yours,
Paul

PAUL GRAY

Peter Smith, Esq.,
Office of the Chancellor of the Duchy of Lancaster.