Reference ....

TO:	cc	PS/Mr Hogg
		PS/Sir Peter Gregson
PS/SoS		PS/Sir Jeffrey Sterling
		Mr Williams
		Mr Nieduszynski
FROM:		Mr Moorey Inf
		Mr Lawrance Air 2a
DEREK MARSH		Mr Guise No 10 Policy Unit
Air 2		
Room 629		
Ashdown House		Sir Jeffrey Sterling
215 6199		(at 79 Pall Mall - by FAX)

27 Ocotber 1989

AIRBUS SECOND ASSMBLY LINE

1. We had a word Wednesday evening about my submission of 25 October attaching a copy of the final draft report from Sir Jeffrey Sterling and Sr Emilio Gonzales.

2. Sir Jeffrey decided that he wished to take the opportunity presented by Sr Gonzales being in London next Monday morning to have a final discussion with him about the report. They would then immediately after and together like to see SoS to present their report. This has been arranged for 11.45.

3. Although the report cannot now be sent to Dr Friderichs before the AI Supervisory Board meeting today, this timetable still enables SoS to put it to his German and French opposite numbers in advance of the meeting next Thursday of Presidents Kohl and Mitterand. To give German and French officials time to do this, it would be necesary to send the report to Airbus Ministers on Monday afternoon.

4. Sir Jeffrey and Sr Gonzales will bring the final report with them on Monday morning. The text is likely to be substantially the same as the attached revised final draft (which supercedes the one put forward on Wednesday). I think that it would be useful, therefore, for SoS to have seen this and draft letter to Airbus Ministers before the meeting on Monday morning.

5. I attach (for PS/SoS only) names, addresses and fax numbers of the Airbus Ministers and Dr Friderichs.

D R Marsh

D11ABG

CODE 18-77

Dr Hans Friderichs
Chairman of the Supervisory Board
Airbus Industrie GIE

M. Michel Delebarre
Ministre de l'Equipment du Logement,
des Transports et de la Mer

Dr Haussmann
Bundesminister fur Wirtschaft

Sr D Fernandez Panizo Arcos
Subsecretario de Industria y Energia
Ministerio de Industria y Energia

TEMPORARILY RETAINED

D11ABC

FINAL D R A F T (3)

REPORT ON THE QUESTION OF LOCATING A320/321 CUSTOMISATION AND FINAL ASSEMBLY LINE IN GERMANY

by Emilio Gonzales Garcia
Sir Jeffrey Sterling

CONCLUSIONS AND RECOMMENDATIONS

1. We have considered the MBB proposal for an A320/321 assembly line in Hamburg. The proposal is thought-provoking and we conclude that:

a. From estimates of possible cost savings, there is obviously a theoretical case for considering collocating customisation and the final assembly line (FAL) for A320 and A330/340 programmes, either at Toulouse or Hamburg, or elsewhere.

However, we also conclude that:

b. In the case of the A320 there are very real and considerable risks, difficult to evaluate accurately, in changing practical arrangements for customisation and final assembly now that aircraft are being delivered to airlines and a huge production increase is planned over the next two years.

c. If A320 customisation and assembly were disrupted and deliveries affected, Airbus Industrie's (AI) credibility on the A320 and, consequently, on the A330/340 programmes would be badly damaged; Governments' recovery of their financial support to the Airbus programme would be put at great risk and indeed further major support would be inevitable.

d. Given that the cost savings identified so far are by their very nature uncertain, and assuming that the AI management are totally satisfied that the assembly lines at Toulouse will meet the planned Airbus delivery timetable and costs, we do not believe that the risks are worth taking. This is of course a matter of judgement.

e. For the A330/340, which has not yet reached such an advanced stage, the risks could be less and the possible benefits and risks of rationalising A330/340 customisation and FAL are certainly worthy of an urgent and detailed study by AI.

f. Unquestionably, however, considerable savings can be made specifically in the area of customisation and final assembly and indeed in all areas of AI procurement from all their main contractors and sub-contractors as they are organised now. But this will only be achieved if the management of AI is allowed by the partners to manage AI effectively.

IT IS VITAL THAT MINISTERS AGREE THAT DECISIONS SUCH AS CUSTOMISATION AND FINAL ASSEMBLY SHOULD BE A MATTER SOLELY FOR THE AI SB TO DECIDE AND THAT THEY GIVE THE SB THEIR FULL SUPPORT IN TACKLING THESE PROBLEMS IN A FULLY COMMERCIAL AND INDEPENDENT MANNER. We are sure that M. Benichou and Dr Krackow agree with us in this conclusion.

2. The fundamental problem is the way in which AI is organised. The history of the second assembly line issue strongly suggests that AI still has a long way to go before it operates like a normal commercial enterprise. We fully understand the dilemma created for Governments as a result of the involvement of taxpayers' money. We recognise the difficulties that face the partners who wear two other hats as both management and main contractors. It may well be, therefore, that a fully commercial operation will only be possible when the activities of Airbus in the partner countries are "ring-fenced" and identify with and are accountable totally to AI. Dr Friderichs has already given his views on the evolution of AI from a GIE to a "joint-stock-company". We not only endorse his views but recommend that:

g. The SB formally commissions an in-depth study to examine how this objective can be achieved as sooon as possible.

3. In the meantime, we cannot emphasise too stongly the need for partner companies to refrain from involving Governments in the commercial decision making of AI. Our report in 1988 recommended a management structure that should have made this unnecesary, but it is clear that this has not been achieved. We recommend, therefore, that:

h. The SB should urgently examine whether AI has the full management strength necessary to deal with the challenge of making AI a full commercial operation.

4. The Chairman of the SB faces a particularly difficult and heavy workload over the next few years. There seems to us to be here a natural role for a Deputy Chairman working closely with the Chairman of the SB and the President of the Executive Board. We recommend, therefore, that:

i. the SB should appoint a Deputy Chairman to share this load and who would have the advantage of being totally objective and committed to the future of AI.

5. We are also concerned that the partners' conflict of interests, wearing, as they do, several hats, makes it very difficult for the President to run AI effectively. We also wish to point out that the terms of reference of the Director of Finance have been limited by the SB and his role is not as the 4 Wise Men recommended in 1988. He should report directly to the President as well as to the SB. We recommend, therefore, that:

j. THE SB should also urgently consider enlarging the terms of reference of the Director of Finance to embrace all the functions that a Director of Finance would have in a normal commercial company.

6. The sheer magnitude of the Airbus enterprise cannot be underestimated. In our view, AI is one of the most exciting companies in the EEC and all of us owe it to those who have brought it so far to give it the tools to succeed. If it is to achieve the commercial success it deserves, it is absolutely essential that the right management team and right management methods are in place as soon as possible. We have no doubt that both Dr Krackow and M. Benichou would totally agree with this conclusion.

<u>In particular,</u> we believe that they share our view that <u>it is urgent and vital that the two principles of: effective commercial management by AI, and the non-involvement of Governments, should be fully implemented as soon as possible.</u>

<u>BACKGROUND</u>

7. For a number of reasons, the AI management was not able, as it should have been, to resolve satisfactorily the question of collocating A320/321 customisation and FAL in Germany. As a result of the involvement of the French and German Governments, we were appointed by our Ministers in July 1989 to make recommendations to them on this question. Our starting point has been the reports submitted on 15 September by the German and French "Wise Men", Dr Krackow and M. Benichou, and we have had discussions with the senior management of Aerospatiale, Airbus

Industrie, BAe, CASA and Daimler-Benz, and with Dr Krackow and M. Benichou (see Annex for details.)

8. Facts relevant to the question have been covered in detail already by MBB and Aerospatiale, AI and Dr Krackow and M. Benichou. We have not felt it necessary or practicable in the time available to go over this ground again. Rather we have discussed the broad thrust of the facts with those most closely concerned and come to our own conclusions. Our report, therefore, has been kept short and concentrates on providing Ministers with a considered judgement of the main issues.

9. We addressed three main issues: risk, management and finance.

RISK

10. Both Dr Krackow and M. Benichou drew attention to the question of the risk involved in changing arrangements at this stage of the A320 programme. Dr Krackow referred to the "transitional problems, which are certainly not trivial". In the section of his Report headed "Industrial Risks" Dr Krackow referred to four main areas: production increase, the start of an A320 line in Hamburg with the tranfer of the existing line from Toulouse, A321 production start, development and subsequent production start of the A330/340. Dr Krackow proposed that the partners produce a plan, with the aid of independent consultants, as a basis for decisions before the end of the year "in order to limit these risks". M. Benichou identified similar areas of risk but reckoned that "from an industrial point of view", the necessity for MBB to master new skills (and Aerospatiale too if the A330/340 were included) "in a short and difficult period of time could induce serious maufacturing disruptions".

11. We agree with Dr Krackow and M. Benichou that there are several main areas of risk. First A320 deliveries to customers have taken place; the order book for A320 stands at over 500 firm plus 224 options and for the A321 at over 100 firm and 74 options with no more delivery slots available until the late 1990s; production is steadily increasing from a current rate of about 6 to 10 or even 12 per month, and there is a need for the A321 to be integrated into the assmbley process. The working capital required when production is at its highest rate will be very demanding on the partners' resources.

12. Without question, all the civil aircraft manufacturers, Boeing, MDD and AI, are having to meet unprecedented levels of orders. To bring about a FAL in Germany both AI and the partner companies would have to

make significant investments of money and senior management effort at a time when they are already stretched. The equipment companies which are themselves stretched by booming demand from AI, Boeing and MDD would also have to make significant adjustment. All these factors impose a very significant strain on the management of AI and on the management and workforce of the partner companies.

13. The Airbus system, like that of Boeing and MBB, is under "stress". The changes proposed would greatly increase this stress at a time when AI has at last gained significant market share, is about to prove its ability to deliver considerable numbers of aircraft to a large number of airlines, and the partner companies see more clearly than they have done before the likelihood of profitability in a few years time.

14. If these risks came to pass it would be very damaging for all participants, including Governments, in the Airbus system. It would risk the success of the A330/340 as well as the A320 programme and the participants' profitability. The set-back could well allow Boeing and MDD to recover their previously dominating competitive position and AI might never recover its current position.

15. The newer A330/340 programme is several years less advanced than the A320. The first A330/340 deliveries will take place in 3 to 4 years time and the order book has grown rapidly to somewhat over one-third of that of the A320/321. The risks could, therefore, be less than with the A320/321. The costs and benefits of rationalisation of A330/340 customisation and FAL deserve detailed study by AI as soon as possible.

MANAGEMENT

16. Both Dr Krackow and M. Benichou said that ultimately the decision must lie with AI and the four partner companies. Matters such as the arrangements for assembly and customisation must be decided by the management of AI and not by Governments (or Wise Men). The management must make, and indeed be allowed to make, commercial decisions for which they will be fully accountable.

FINANCE

17. There is a clear difference of opinion between MBB on the one hand, and Aerospatiale on the other as to the possible investments required to collocate the customisation and final assembly and the savings which might arise. This difference is shared to some extent by Dr Krackow and M. Benichou.

18. We have noted the figures quoted and have not investigated in detail either how they were arrived at or their validity. Both sets of figures are theoretical and it is sufficient for this purpose to suggest that the true figures could lie between the two. We take at face value, therefore, that there is a theoretical possibility that despite the substantial investments required to collocate there could be considerable annual savings from the proposed arrangements.

30 OCTOBER 1989

D11AAU

ANNEX

PERSONS CONSULTED

Aerospatiale	M. Martre M. Plenier M. Michot
Airbus Industrie	Dr Friderichs M. Pierson
BAe	Professor Smith Mr Gillibrand Mr Haddow
CASA	Sr Alvarez Vara
Daimler-Benz	Dr Reuter Dr Schrempp Dr Mehdorn
Others	M. Benichou Dr Krackow

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