

Prime Minister



PRIME MINISTER

BRITISH AEROSPACE FLOTATION

I hope we can
best on 1 Jan with
a view to flotation
Jan-1st. We shall
be dealing with the
Treasury
rather than
net

There is a dispute with the
Trang on this (see Flag A). I think
the best thing would be for E(DC)
to consider the Trang points - Sir Keith
is reminded is this; but I can
say that you want this done quickly.
Agree?

When I spoke to you on Tuesday, I explained the critical position
we have reached in our attempts to float British Aerospace. I am
now writing to set this out in more detail, and to indicate how
I believe we should proceed.

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30/12

2 We had planned to float British Aerospace in November, and
preparations for this date were far advanced. At a late stage,
however the Department was warned of the scale of the changes in
defence expenditure proposed by the Chief Secretary as part of the
public expenditure review. In addition to whatever measures are
necessary to compensate for the probable overspend by the Ministry
of Defence this year, the Chief Secretary in his initial, and not
necessarily final, proposal to Francis Pym has sought a reduction
in defence expenditure of £400 millions in each of the survey
years. Past experience shows that when substantial changes to
the defence budget are made they tend to result in the defence
equipment budget, which constitutes approximately 40 per cent of
the total, bearing a disproportionate share of the load. Any
agreement to proposals for defence expenditure of the scale
suggested by John Biffen would almost certainly therefore have a
significant effect on British Aerospace. We could not simultaneously
issue a prospectus based on the prospects for the business as now
known and be considering substantial changes to the defence budget
which would be likely to affect BAe severely. As promoter and
sole vendor of the company we are under the same legal requirements
to disclose our intentions towards the company we are selling
as any other vendor; the extent and importance of the Government's
/dealings ...



dealings with British Aerospace make these requirements particularly onerous and significant. The Attorney General has confirmed the previous legal advice we had received, requiring full disclosure to our advisers and appropriate disclosure thereafter to the prospectus.

3 I understand that as a Cabinet we shall not be taking decisions on public expenditure until the very end of this month at the earliest. Because of the uncertainty the Chief Secretary's proposals cause, we have been forced to abandon the prospects of a November flotation, and have therefore fallen back on the next opportunity, which arises in January/February. Our financial advisers on the flotation, Kleinwort Benson, have identified two ways of quantifying in the prospectus the effects of the possible cuts on British Aerospace. The first would be to ensure that they are minimal. In practice, the only means this could be guaranteed would be by largely exempting the defence budget from the effect of public expenditure cuts, which the Chancellor regards as - and I accept to be - impracticable. The second is to attempt to quantify or at least set an upper limit to the likely damage to BAE's business of any cuts in defence expenditure and to make this information public in the prospectus. Kleinworts believe this approach should be possible, provided:

- (i) Ministers had announced the general scope of their decisions on public expenditure including the general magnitude of any reduction in defence expenditure;

/(ii) ...



- (ii) the prospectus included an appropriate passage indicating the effect on British Aerospace of those spending reductions. This might be on the lines that the effect should not be more than an annual loss of profit of £X millions. [The figure could, for example, be £6-8 millions, roughly equivalent to loss of sales of £60-80 millions a year]; and
- (iii) the Government was prepared to accept the consequences for its net receipts, which will be reduced both by the reduction in the market capitalisation arising from the fall in profits and by the need to ensure that the new company starts off its life with adequate capital resources.

In order for this to be possible, the Ministry of Defence must set upper limits, in the light of any expenditure decisions taken by Cabinet, to the consequences for their business with British Aerospace; and must do this in time for British Aerospace and our financial advisers to assess the effects on the company in terms that enable an appropriate statement to be made in the prospectus. To meet the timetable of a January/February flotation, this will require work to start at once on this, and conclusions will be needed by the end of November. I do not pretend that any of this will be easy to achieve; if we are to succeed at all, it will require us to give high priority to bringing off the flotation, and demonstrating on a number of fronts our political will to do so.

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4 Time is very short. Both British Aerospace and Kleinworts have warned me in strong terms that early next year is almost certainly our last chance of bringing of a flotation within the life of this Parliament. If we delay further, political uncertainty and the risk of re-nationalisation without compensation will loom ever larger in investors' minds. Our chances of succeeding at all with British Aerospace will therefore be dealt a crippling blow unless we act now. We are already under attack for not being able to privatise shipbuilding; last week we announced the impossibility of early action on British Airways; unless we are resolute in our determination, we shall have at best to postpone, for some considerable time, the flotation of British Aerospace, which has been widely recognised as the front runner in our privatisation programme. If this were to occur, the political credibility of the Government would suffer acutely; and we should forego the benefits to the PSBR to which privatisation of British Aerospace will give rise (excluding the net receipts arising from the sale, these should be nearly £200 millions over 1980/81 and 1981/82).

5 I believe it of the utmost importance that we should not allow this to happen unless we are absolutely forced to accept defeat by uncontrollable circumstances, as could arise if British Aerospace's results deteriorated sharply. I therefore think we should attach high priority to dealing with the obstacles to a flotation caused by the present uncertainty over defence expenditure, on the basis set out in paragraph 3 above. There is, in addition, a particular decision that can and I believe should be taken now:

/before ...



before we can float the company, we must vest in it the present business of the statutory corporation. We should have to do this on 1 January 1981 for a flotation in January. I believe we should now decide to go ahead with the vesting on 1 January. A public decision to do so will be seen as a commitment to our privatisation target; it will help British Aerospace in a number of important preparations for the eventual flotation; and it will do much to revive British Aerospace's support for the flotation (they attach great weight to an early decision on this, and would not take our intention to float seriously unless we demonstrate this commitment). There are of course arguments about the exercise of control over the company while it remains wholly-owned by Government. But we have already faced these with the National Freight Corporation, where vesting occurred on 1 October against a flotation date that is some time off, and should do so again with British Aerospace. Geoffrey Howe, when I discussed British Aerospace with him, was content for us to take the step. This is just the sort of issue where we must show our determination to press ahead, if we are to succeed.

6 I am copying this to Geoffrey Howe, Francis Pym, Michael Havers, members of E(DL) and to Sir Robert Armstrong.

KJ

K J

23 October 1980

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