PREM 19/1162

The future and structure of British Airways and its subsidiaries.

The Price Waterhouse Report.

AEROSPACE.

March 1982.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~12.3.82~~		~~18.11.82~~					
~~8.4.82~~		~~24.11.82~~					
16.4.82.		~~18.7.83~~					
~~20.5.82~~		~~7.11.83~~					
~~21.5.82~~		~~17.11.83~~					
~~25.5.82~~		~~13.12.83~~					
~~3.6.82~~		~~7.2.84~~					
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~~14.10.82~~							
~~28.10.82~~							
~~23.11.82~~							
~~24.11.82~~							

PREM 19/1162

PART 1 ends:-

Lord King to PM 23/2/84.

PART Pt 2 begins:-

Transport to AT 5/3/84.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(NI)(82)20	21.7.82
E(NI)(82) 6th Meeting, Minute 3	26.7.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OWayland Date 23 July 2013

PREM Records Team

① M. Turnbull
② P.M.

British airways

Cleveland House, St. James's Square, London SW1Y 4LN
Telephone: 01-930 9766

Lord King of Wartnaby
Chairman

23rd February, 1984

The Rt. Hon. Mrs. Margaret Thatcher, MP,
The Prime Minister,
10 Downing Street,
London, S.W.1.

MT

Dear Prime Minister

A short note to say it was good of you to spare the time to see me yesterday, particularly in view of the very heavy programme that you had and, on top of everything, a bad cold, which I hope will soon be better.

I came away feeling much less depressed.

My thanks & best wishes

Yours ever John

cc MASTER

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file JR

cc TG Ledwood

10 DOWNING STREET

From the Private Secretary

22 February 1984

Dear Brian,

BRITISH AIRWAYS PRIVATISATION

Lord King came to see the Prime Minister today. He put very much the same case to her as he had done to your Secretary of State. In just over two years, BA had been turned from a loss-making airline into one of the most important and profitable in the world. The workforce had been reduced from 59,000 to 35,000. This had been achieved without industrial unrest because those remaining in the industry understood that they would eventually be working for a successful airline.

His worry was that, under pressure from the Conservative backbenchers and other UK airlines, the CAA would recommend a major re-allocation of routes. A foretaste of this was to be found in the terms in which the CAA had written to the Department of Transport about allocation of the Riyadh route to British Caledonian. Lord King did not object to this decision as such but to the suggestion in the CAA's letter that, in the interests of "competitive balance" between UK airlines, it was unlikely that further routes would be allocated to BA. This, in effect, denied BA any prospect of expansion. Lord King said that such a ruling, or worse a recommendation to take away some of BA's existing routes, would make it impossible to write an adequate prospectus. The privatisation exercise could be put in jeopardy.

Lord King denied the premise on which CAA and airlines like BCal appeared to be operating. He did not believe that competition was increased by re-allocation of routes. He was already in competition with all the other airlines flying the same routes as BA. In his view, BCal's argument was about the transfer of business and profits.

He could not agree to a reduction in the size of BA. This would undo the achievements of the past two years and would mean going back on his agreements with the BA workforce.

He was concerned that the CAA might be developing an independent policy which favoured a number of small airlines in the UK. The Secretary of State for Transport could be put in a difficult political position if their review came out with a recommendation for a major re-allocation of routes.

/The Prime Minister

KB

The Prime Minister took note of the points made by Lord King and agreed to consider them further.

The Prime Minister has asked for a report on the nature of the CAA's review and the kind of recommendations which might be expected to emerge. She has asked whether there is substance to Lord King's contention that if CAA recommended a major re-allocation of routes, the Secretary of State for Transport would either be in the difficult political position of rejecting the recommendations or accepting them and putting the privatisation timetable at risk. Finally, she has asked for your Secretary of State's views on the argument that a re-allocation of routes between BA and other UK carriers would not affect competition in the industry.

BF

Yours sincerely

Andrew Turnbull

(ANDREW TURNBULL)

Miss Dinah Nichols,
Department of Transport.

10 DOWNING STREET

Prime Minister

Attached is the DoT briefing for the meeting for Lord King. Also attached is a Policy Unit note which is distinctly less sympathetic to the B Cal case than Mr Ridley is urging you to be. I would take their line if the dominance of BA had been the result of its past commercial success - but it hasn't. It has been the result of past licensing decisions in favour of the state carrier. If we had always had two main private airlines, the distribution would not be as it is now.

AT
21/2

CONFIDENTIAL

21 February 1984
Policy Unit

PRIME MINISTER

LORD KING'S MEETING WITH THE PRIME MINISTER
WEDNESDAY, 22 FEBRUARY 1984

Lord King will want to argue that British Airways should not be restructured or reduced in size in the run up to privatisation. He will point to his undoubted success in turning round the Corporation from loss to profit, and in the better performance that is being recorded across the board.

We suggest that you should congratulate him on the substantial progress made, but should be impartial concerning the resolution of the British Airways debt problem and over the route licensing questions.

The Secretary of State for Transport is thinking of a deal which would entail British Airways surrendering some of its routes in return for payments which could correct the balance sheet deficit. It is a difficult hand to play, as the routes are not the property of British Airways but are the result of a grant of licence by the CAA. The Secretary of State cannot be seen to be meddling with BA's commercial decisions. However, it would be unfortunate if you said anything which made it more difficult for Nicholas Ridley to use the debt problem if necessary to persuade BA to sell some assets and make its own contribution to a better balance sheet.

The question of route licences is under review at the moment by the CAA. Until they report the matter is sub judice, and it would be dangerous to comment on the likely outcome of the CAA review. B.Cal. and some of the other independents have made submissions, as have British Airways.

An ideal political outcome in the end would be:

a. some modest reduction in the number of British Airways domestic routes and associated assets;

b. some cash from their sale which could offset part of the costs of repairing BA's damaged balance sheet (which their trading cash flow should also help);

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c. greater competition on the UK domestic routes. Experience to date has been encouraging in that where routes have been opened up to competition, the response of BA and the other airlines has been good, with fares coming down and services improving.

You could agree with Lord King if he pours doubt on Sir Adam Thompson's motives in wishing to reduce British Airways' dominance. It is not based on the principles of competitive free enterprise. B.Cal wishes to gain UK rights over certain international BA routes. B.Cal is in some difficulty with its South American and Nigerian routes, and is therefore looking for help rather than new competition.

There is no chance that the vexed question of airports can be resolved before the privatisation of BA. Nicholas Ridley is right to make the easy moves first and to consider airports policy more generally in connection with their privatisation.

Lord King was right to dismiss the B.Cal initiative some months ago as a smash and grab raid. However, he has a PR problem. BA have allowed B.Cal to play David against BA's Goliath. BA should now set to work on recapturing the lost initiative to help the Government on the presentation ready for privatisation.

Our own back-benchers and the press do not fully understand that BA's principal competitors are not the UK independent airlines, but the international airlines, many of which receive hefty state subsidy. The privatisation of BA is light years away from the substitution of a private for a public monopoly. Where anti-competitive practices exist, they are the result of route licensing activity by governments, not the result of the present aviation industry configuration.

It would be unwise for you to concede that privatisation necessitates the maintenance of all BA's current routes, or prevents more competition on domestic routes in due course.

JOHN REDWOOD

R.Y.

ROBERT YOUNG

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

21 February 1984

Private Secretary
10 Downing Street
LONDON SW1

Dear Private Secretary

Lord King is coming to see the Prime Minister tomorrow. I enclose a brief on aspects of the preparation for privatisation.

As you know, my Secretary of State saw Lord King and his Managing Director Colin Marshall yesterday evening. Mr Ridley impressed on Lord King, who appeared to take the point, that in the light of the figures now beginning to appear, he felt increasingly that there would be no case for the Government to authorise an approach to the court for a write-down of British Airways capital as a preliminary to privatisation. Such an approach would be bound to be criticised in Parliament. It is still premature to decide whether (and if so, how much) the flotation should be carried out in a way that would enable part of the proceeds of sale to improve the debt: equity ratio in British Airway's balance sheet, but Mr Ridley re-emphasised that he looked to the airline to do everything feasible to improve their balance sheet by their own efforts including revaluation of assets, and sale of profitable assets. It would be helpful if the Prime Minister could endorse this message.

On the pressure by BCal and other independent airlines for routes to be taken away from British Airways before privatisation, the Prime Minister will recall that Mr Ridley has asked the Civil Aviation Authority to assess the implications for competition and the sound development of the British airline industry of the privatisation of British Airways. Their report is not due until July, so

the issue is for the time being in suspense. Lord King may urge on the Prime Minister, as he did on Mr Ridley, that British Airways should not suffer any loss of routes. Mr Ridley took the line that the remaining issues over privatisation, including both the question of a financial reconstruction and of fair competition, had overall to be acceptable to Parliament. British Airways should not dig themselves into an entrenched position in advance of the CAA's report and recommendations. The Government would need to look at the position as a whole when these recommendations were received. The Prime Minister may like to endorse what Mr Ridley said, and certainly not to give any commitments on routes before the CAA report has been received.

Yours sincerely

Andrew Turnbull

for

MISS DINAH NICHOLS
Private Secretary

BRIEF FOR THE PRIME MINISTER'S MEETING WITH LORD KING, CHAIRMAN OF BRITISH AIRWAYS, 22 FEBRUARY 1984

1 A note on the main issues follows the "line to take".

Line to take

2 The Prime Minister might like to take the following line with Lord King:-

(a) Recent results

BA are to be congratulated on their dramatic return to profitability.

(b) Routes (paragraphs 5-8)

BA must recognise the political pressure on the Government to reduce BA's dominance before privatisation. The Government will have to give full weight to the Civil Aviation Authority's recommendations when they complete their review in July.

(if raised) (c) London-Riyadh service (paragraph 9)

This is a new route and does not prejudice the CAA's or the Government's decisions over route transfers. As there is likely to be an appeal the Riyadh decision must be treated as sub judice.

(d) Balance sheet (paragraphs 10 and 11)

BA must do all they can (including revaluation of assets, profitable disposals, maximising bottom line profit and repayment of borrowings) to restore their balance sheet to viability: they should not rely on a capital reconstruction facilitated by the Government.

(if raised) (e) Pay

BA were right to aim for a two-year pay deal, but their offer was on the high side. We are glad BA are determined not to increase the offer and to withstand current strike threats from engineers and cabin crew.

(if raised) (f) Pensions

BA are to be congratulated on their ingenious proposals for closing the present fully index-linked pension scheme to new entrants and for inducing its members to transfer to the new, less costly scheme.

Background

3 Following E(DL)'s decision on 24 November 1983, Mr Ridley told Parliament on 12 December that the Government would vest the British Airways Board's business in British Airways Plc on 1 April 1984 with a view to a flotation of the airline, based on results for the half-year to 30 September 1984, in early 1985, soon after BT. Preparations for vesting are now well advanced; and work is also proceeding, in co-operation with BA, on preparations for the flotation.

The main issues

4 There are two main areas of difficulty that may arise at the meeting:-

(a) BA's routes; and

(b) BA's balance sheet.

Routes

5 This is a difficult and controversial subject. The independent airlines, notably British Caledonian (B Cal), have argued that BA is too dominant and that more competition should be introduced into the airline industry before BA is privatised. B Cal have pressed publicly for the transfer of some of BA's routes together with the related assets (for which they have said they will pay). The independent airlines' case has attracted considerable support, not least among Government backbenchers.

6 In response to this pressure Mr Ridley announced during his statement in December on British Airways' privatisation that he was asking the CAA to advise him on the implications of BA privatisation for competition and the sound development of the British airline industry. The CAA decided the best way of responding was to initiate a review of its licensing policy and to that end has begun a process of consultation with the industry and other interests. The Authority is being asked to give advice and recommendations to the Secretary of State well before BA is privatised. He has been set a target date of 16 July. It is too early to forecast the outcome.

7 BA's counter-arguments - and they have recently put these to the CAA in their contribution to the review - are -

(a) that privatisation is irrelevant to the question of competition: the independent airlines' concern springs not from privatisation but from their recognition, in the new efficient and profitable BA, of a formidable competitor;

(b) that it would be very unfair to BA and their staff to penalise them for their turnaround by docking their routes;

(c) that giving up routes will damage the prospects for privatisation;

(d) that BA already faces sufficient competition, both on domestic services and, from foreign airlines, on international routes; and

(e) that to substitute B Cal for BA on various international routes, as B Cal wish, will not increase competition at all.

8 Mr Ridley discussed all this with Lord King on Monday evening 20 February, reiterating the political case for doing something to meet the criticism of BA's dominant position and urging Lord King again to consider offering some voluntary route transfers to B Cal.

9 Lord King is particularly incensed at the CAA's recent decision to license B Cal, rather than BA, to fly the new route between London and Riyadh in Saudi Arabia. The decision is subject to appeal to Mr Ridley, and BA are also believed to be considering taking the issue to the courts on the grounds that the CAA have exceeded their statutory powers.

Balance sheet

10 Hitherto it has seemed that BA's large negative reserves and massive debt will make it difficult to privatise them in the near future without some sort of capital reconstruction, if only by letting them retain some of the proceeds of sale in order to restore their debt:equity ratio to viability. Obviously, however, a capital reconstruction facilitated by the Government will only aggravate the independent airlines' criticisms of BA's unfair dominance of the market.

11 Lately BA have made good profits (estimated by them at some £280m before tax and interest for 1983/84) and have thereby begun to improve their balance sheet themselves. But if there is to be hope of avoiding the need for Government help completely, they will have to do a lot more - eg revaluation of assets, profitable disposals, avoiding unnecessary capital expenditure, maximising repayments of borrowings. As a first step, Mr Ridley has told Lord King that he considers that an approach to the Court by British Airways Plc for a write-down of capital (which E(DL) thought would be criticised in Parliament as a device) must and can now be avoided. Lord King appeared to accept this.

CAP1
Department of Transport

21 February 1984

Financial Times Thursday February 2 1984

Michael Donne looks at the main issues raised in submissions for the Civil Aviation Authority Policy Review.

BA opposes route-shedding to independents on privatisation

ANY TRANSFER of routes from British Airways to British Caledonian Airways and other independent airlines would seriously jeopardise the successful privatisation of BA, probably driving would-be investors away.

This point is made strongly by BA in its detailed submission to the Civil Aviation Authority's review of civil aviation policy, published yesterday. The review is being conducted urgently by the authority at the request of Mr Nicholas Ridley, Secretary for Transport.

BCal is asking for a substantial transfer of routes and aircraft from BA to the independents (in return for cash payment which would be in excess of £200m), so as to improve the independents' competitive position vis-a-vis the state airline.

BA, in reply, believes that this would be disastrous to potential investors on privatisation of the airline, and would in effect be useless, since it would dilute the overall UK air transport effort, which should be directed to meeting foreign airline competition.

The emphasis that both BA and BCal put in their submissions on the routes transfer issue mean that it now becomes one of the central issues, if not the dominant one, in the policy review, and is bound to influence the CAA's own attitudes in settling future route licensing policy.

Routes transfers are also bound to become a significant political issue over the coming months.

BCAL

Reorganisation of routes urged

"ONLY A substantial re-organisation of routes to strengthen the networks of Britain's private sector airlines will improve competition" in the UK civil aviation industry, according to the independent British Caledonian, Britain's second largest scheduled airline.

In its submission BCal claims that reorganisation would ensure that the independents, together with British Airways, could compete with foreign airlines as effectively and profitably as possible.

BCal believes that the opportunity for such changes offered by the impending privatisation of British Airways is unique. "Privatisation is a watershed, because it will result in important changes to the dominant organisation in the industry, and will affect all others."

BCal argues that the civil aviation structure in the UK is out of balance—in terms of airline strengths and airports.

Since 1971, 14 airlines have failed in Britain, BCal is the sole survivor of independents which sought to operate long-haul scheduled services.

The imbalance between the size of BA and the smaller independents cannot be altered by market forces alone, and it requires Government action to achieve a realignment.

The airports problem stems from the fact that Heathrow handles 27.1m scheduled passengers a year, while Gatwick handles only 5.1m (the rest of Gatwick's 12.5m annual traffic is mainly non-scheduled and charter traffic).

"There is a clear need to reinforce the Gatwick policy and enhance its development for scheduled services. The target should be to develop Gatwick to the point where there is indifference among foreign operators as to the London airport they serve," says BCal.

To achieve this, airline restructuring through route transfers from BA to BCal and the other independents should start soon. "It is clear that airline restructuring cannot be divorced from issues of airport policy and capacity."

BCal says the absence of competition is not in the interests of users or of sound development. In a thinly disguised attack on BA, BCal goes on: "Among the risks of over-concentration of international scheduled services in one large-scale enterprise is the likelihood, unless continuously challenged, of periods of management inertia, lack of innovation of new products, absence of vigour in development of new services and an ability to mask inefficiency.

"All this is compounded by a complacency implicit in the knowledge of being irreplaceable. However capable management is, it works better when effectively challenged."

BCal claims that it is the only airline able to compete with BA comprehensively. "If the object of policy is to enhance competition among UK airlines, there must be a reallocation of existing route opportunities from BA to BCal. Privatisation accentuates the long-standing need for a restructure."

It warns that privatisation will strengthen BA "because it will be born again on a very healthy financial base with regard to debt capacity, exchange rate guarantees and repayment of state investment."

BCal has also submitted a detailed assessment of BA routes that ought to be transferred to it, and an analysis of the likely effects on both airlines. Because of the highly sensitive nature of this information, BCal has requested secrecy.

BCal is believed to be suggesting that up to one-third of BA's routes, covering well over 3m passengers a year, ought to be transferred to BCal and other independent airlines and that most of the new traffic ought to be flown in and out of Gatwick rather than Heathrow.

This puts the transfer of routes onto a much higher level than a "smash and grab raid," as it was originally described by Lord King, chairman of BA, and makes it seem more like dismemberment of BA.

BRITISH AIRWAYS

Cuts in market share rejected

CUTS IN British Airways' route structure, with transfers of routes and aircraft to the independent airlines, would cast doubt on the airline's future among potential investors, and impede progress towards a successful privatisation of the state airline.

This is one of the key points in BA's counter-attack to the BCal bid for some of its routes, contained in BA's submission.

BA declares that it is convinced there is no case for reducing its present share of international or domestic air markets.

The truth, it claims, is that there is no international market of any significance in which BA has a dominant share.

Fares, capacity and service standards, says BA, are dictated by competition from other international airlines.

"There is a major fallacy in the argument that to transfer routes from one British airline to another would create more competition."

The competition, it stresses, comes from the foreign airlines, which the UK airline industry should be aimed at beating.

"A prime requirement for any airline is that the route network for which, having been designated and licensed, it plans its resources (aircraft, staff, ground equipment, buildings) is and remains, as far as possible, the route network it is allowed to fly.

"Without reasonable security of tenure, investment by an airline, and hence investment in an airline, would involve great risk.

"Investors, would, therefore, require a higher level of return, and the cost burden on the airline would be increased. This would have to be passed to passengers in the form of higher fares and/or in the case of international services, would put UK airlines in a very unfavourable position against foreign competitors, thus making profits impossible and continuing investment capital unavailable."

BA says there are "overwhelming economic and practical arguments against any transfer of British Airways international routes to another airline."

BA argues that:

- To transfer routes from Heathrow to Gatwick reduces the UK market share of the premier airport generally and thus the entire UK competitive position.
- Permitting foreign airlines to fly from Heathrow, while the UK airline flies from Gatwick or Stansted, would be of disadvantage to the UK and would reduce its market share.
- Even if the foreign airline could be persuaded to transfer its parallel service to Gatwick, the range of points served from Heathrow would be reduced and interline (connecting) traffic lost.
- Gatwick's single runway is saturated at peak commercial times on some days of the week.
- Resources would be wasted or not used to their optimum advantage.

BA claims that it would be ironic, "not to say unfair, if BA were now to be penalised for its increased efficiency."

"Why should a privatised British Airways be in a better position to act in an anti-competitive manner than a state-owned British Airways with the backing of the Treasury?

"The real reason why BA is now a greater force to be reckoned with, is that pressures of the market place have already forced it to achieve cost and performance efficiency that puts it very high in the international league.

"It would be a poor reward for BA and its staff if the consequence of its efforts were to be the arbitrary removal of a share of its business."

It is also BA's belief that there are no valid reasons for structural changes in the British air transport industry.

BRITISH ATLANTIC

'Competition absent'

BRITISH Atlantic Airways, the newly created airline which wants to operate a UK-New York service, argues in its submission that "effective competition is conspicuous by its absence on the UK's international air services."

It says the authority should stress to the Secretary of State the urgent need for a revision of the UK's international air services agreements with the U.S. and other countries.

Financial Times Wednesday February 1 1984

BCal seeks more of BA's routes

BY MICHAEL DONNE, AEROSPACE CORRESPONDENT

BRITISH CALEDONIAN, the independent airline, is believed to be suggesting to the Government that up to a third of British Airways' routes should be transferred to the independent sector on privatisation of the state airline.

This goes much further than the original £200m plan for a transfer of routes and equipment originally proposed by BCal months ago.

It is bound to generate a fight between the two airlines and effectively makes the BCal plan a political factor in the aviation policy review.

This is being conducted urgently by the Civil Aviation Authority at the request of Mr Nicholas Ridley, Transport Secretary. Submissions by more than a score of airlines and other bodies had been received by the authority by late last night, including those from BA and BCal.

Both BA and BCal have made route transfers a major item in their submissions. BCal has asked for details of the proposed route transfers to be kept secret at this stage but it is understood it has gone much further than originally thought likely.

Its overall objective would be to transfer up to about a third of BA's routes to the independents. Of these about a half in turn would go to BCal itself and a half to other independents.

The details remain confidential within the authority. The rest of the BCal submission, however, is likely to be published today with BA's own submission. Late yesterday neither side knew what the other was proposing.

BA, however, is expected to argue that though such transfers might strengthen BCal they would weaken BA and do nothing to improve the overall competitive capability of the UK air transport industry.

In BA's view the main task is to strengthen the entire UK airline industry to meet foreign competition and that any route licensing review should aim to achieve that. To carve bits and pieces out of one UK airline to favour another would be disastrously damaging and achieve nothing.

From the authority's point of view the fact that the two airlines have chosen the arena of the policy review to battle over route transfers does little to help a calm appraisal of overall civil aviation needs.

While many other ideas are advanced in the two airlines' submissions, including views on airports policy and route licensing, the entire review is bound to be clouded by the route transfers issue.

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Copy Mr Wood
Mr Mckie
Mr Turnbull
Mr. Gunner
Mr. Perry

Civil Aviation Authority
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Telex 883092

From the Group Director
Economic Regulation

Mr H M G Stevens
Department of Transport
1 Marsham Street
London SW1

13 February 1984

Dear Hawtrey.

LONDON - RIYADH ETC

The Authority has now concluded its hearing of the applications from British Airways to serve Riyadh and from British Caledonian to serve Riyadh and certain points in the Gulf. Both applicants stressed the importance of avoiding delay in the start of a Riyadh service by a British airline and I am therefore writing now in confidence to tell you and the parties to the case that the Authority has decided to grant British Caledonian's application, with one modification to which I shall return later, so that you can put in hand the necessary steps to secure access for British Caledonian to Riyadh at an adequate frequency.

It will be helpful to you if I give an outline of our reasoning. The full and definitive statement of our reasons will appear in our formal decision document in the usual way but since this letter may be held to constitute notification in writing of the Authority's decision of the case for purposes of Regulation 20(8)(a) of the Civil Aviation Authority Regulations 1982, it should specify the decision date. The formal decision document will be ready not later than 13 March 1984, and the decision date is hereby specified to be 16 March 1984.. It is of course clearly understood that, if British Caledonian starts its service while the matter remains under appeal, it will be at their own risk. This letter also sets out our advice on certain bilateral matters.

The Authority considered the applications within the framework of its duties under the Civil Aviation Act 1982 and its own 1981 Statement of Policies. It concluded that both applicants were able and likely to provide the public with a high standard of service both in the air and on the ground and that both would be well fitted to compete effectively against other airlines, noting in this connection that Section 68(1) of the Act relates to British airlines in the plural and is of a general character not restricted to any individual route.

The Authority found that the reasonable interests of users would be furthered if more than one British airline operated

/.....

services to Saudi Arabia. Although the fact that they would be serving different cities must limit the scope for direct competition between them, indirect competition was likely to be substantial and beneficial. In particular each airline will seek to maximise its traffic so as to justify the retention or expansion of frequencies, revenue and profit. Users will gain from the enhanced service and wider range of choice.

Users will benefit particularly from the introduction of non-stop services between Gatwick and Saudi Arabia; this will widen the choice of points of departure and interline connections, especially single airline services to oil-related gateways in the United States which are better served by British carriers from Gatwick than from Heathrow. From an airports policy point of view a service to Saudi Arabia will make a significant contribution to the standing and competitive attraction of Gatwick, going well beyond the simple benefit to Heathrow of a reduction in frequencies there, and there is no reason to suppose that the use of Gatwick will lead to a lower United Kingdom market share.

In considering the impact of its decision on British Airways' existing services the Authority had to consider under Section 68(2) the reduction in earnings that might result both from diversion of traffic and from an imposed reduction of frequencies on its routes to Jeddah and Dhahran; it did not have to consider in this context any loss of expectation with respect to Riyadh. The impact attributable to diversion will depend in some part on the competitive attraction of British Airways' services relative to British Caledonian's while any reduction in frequency will depend on the outcome of negotiations. Exact quantification is impossible while the underlying assumptions remain uncertain. One thing however is abundantly clear: whatever happens, British Airways' services will remain handsomely profitable in terms of both net operating revenue and operating ratio.

It is of course likely that the designation of British Caledonian to serve Riyadh will result in aggregate in higher costs and possibly in lower revenues than if all points in Saudi Arabia were served by one airline. Because of the uncertainties I refer to above, the actual cost to the United Kingdom of licensing a second carrier is difficult to estimate with precision but it is likely to be well within the limits that result from aggregating the separate projections of the two airlines. British Caledonian's projections of traffic, market share and profitability seem to be particularly conservative and we would expect them to do better. This "cost" however has to be seen as the price which the United Kingdom is willing to pay for the benefits of having more than one airline on international routes, with all that this implies in terms of a healthy and competitive industry and the maximisation of consumer benefit.

/.....

An important element in the Authority's reasoning did indeed relate to the competitive structure and sound development of the industry. In my consultative letter of 19 December 1983 I observed that the Edwards Committee had recommended, and all subsequent Governments have accepted, that the country and the public are better served by having a number of profitable and keenly competitive airlines than by depending on a single monopoly carrier, and this must be true whether or not the airlines can compete directly with each other on long-haul scheduled services. I went on to say that the Authority believes that the national interest continues to be best served by this policy, which implies the continuation and, if necessary, the expansion of opportunities for other airlines. The present case relates to a city not previously served by a British airline and therefore does not raise questions of substitution or of direct competition on the same sector: the decision does not therefore prejudge specific issues that have been raised in the current policy review. Where a profitable new point does become available however - and this is a relatively rare occurrence - considerations of competitive balance must come into play and these must generally operate in favour of the smaller airline if the present imbalance is not to be intensified. If one were to favour British Airways in such a case for the sort of reasons that British Airways itself advanced - competitive strength, world-wide sales network, Heathrow base, knowledge of the country and the likelihood of smoother bilateral arrangements - one would really be saying that airlines other than British Airways could have little or no hope of gaining access to major international opportunities in the ordinary course of events. This is a proposition that the Authority is not ready to accept. In our view, where other conditions are satisfied, the sound development of the industry requires the licensing of an airline other than British Airways on at least a high proportion of the new routes that become available if the industry's competitive balance is to become healthier than it has been hitherto.

Another important element in our reasoning relates to the number of frequencies that should be operated. In our view the level of frequency to be operated by British airlines to each of the three Saudi Arabian gateways should be such as to cater adequately for demand and the evidence suggests that demand on Riyadh is likely to amount to about 30% of the total. There is thus a strong case for seeking four frequencies to Riyadh, the number which both applicants applied for and which not only matches Saudia's non-stop frequencies but also in British Caledonian's case is the more justified by the smaller size of the aircraft it proposes to use (although we shall not restrict BCAL's ability to use larger aircraft in its fleet should the need and opportunity arise). The choice of British Airways to serve Riyadh would effectively have denied the United Kingdom any further opportunity to press for adequate opportunities for a British airline properly to serve the market demand.

CONFIDENTIAL

/....

CONFIDENTIAL

British Airways' high-handed action in agreeing with Saudia to limit its frequencies to two a week makes your task more difficult and is to be deplored.

A large part of British Airways' objections to British Caledonian turned on bilateral matters. British Airways sought to persuade us that there was little likelihood of the Saudi authorities' agreeing to accept British Caledonian's designation but we saw no reason to reach any different conclusion to that implicit in the Department's advice, viz that the outcome cannot be a foregone conclusion and we shall only find out what the Saudi authorities will agree to by asking them.

The one respect in which we have not granted the application in the terms applied for relates to the fifth frequency in year three. We wish to see first how the market evolves and how the bilateral arrangements go.

It seems to us that the addition of Riyadh to the route schedule suits the purposes of the Saudi authorities and is not something we should have to pay for but, insofar as we are asking them to suit us by accepting a second airline (although the agreement provides for it) and giving it combination rights beyond the new point to the Gulf, the opportunity will arise for a price to be asked. The United Kingdom should not be willing to pay through the nose or accept long delay. In the last analysis we should not settle for less than British Airways secured - two to Riyadh out of a total of twelve - and we should not trade away our place in the second tranche as originally described: but obviously we hope you will do better. If however the Saudi authorities say that in no circumstances whatever will they accept a second British airline or they demand too outrageous a price, the Authority would wish to be consulted as to the options that will then be available.

As to the Gulf points, the Authority has decided to grant British Caledonian's application in the terms applied for. The effect on British Airways' services to Rawalpindi and Australia is likely to be marginal so far as traffic diverison is concerned. Much will of course depend upon your obtaining the necessary rights from Saudi Arabia and we do not suggest that a substantial price should be paid for them. There is everything to be said for British Caledonian's continuing to deal directly with the Gulf authorities as hitherto. If it seemed that the entry of British Caledonian to these markets was going to lead to the reopening of existing arrangements in a significant way, this too would no doubt become a matter for further consultation.

/....

The Authority will announce its decision in a press statement tomorrow. The parts of this letter marked "confidential" will not of course be disclosed.

I am copying this letter to Colin Marshall and Alastair Pugh, whose attention I would draw to Section 18 of the Official Secrets Act 1982 so far as the information marked "confidential" in this letter is concerned; the wrongful communication of this information may result in prosecution under Section 2 of the Official Secrets Act 1911.

We wish you every success in any negotiations that may ensue. I am sure that your efforts will be assisted if, for the time being, our two airlines refrain from further dealings with Saudia or the Saudi authorities.

Yours sincerely

Ray Colegate

R Colegate

Colgate Power in our hands

Some very different motives

Transfer of Profit & wealth

from BA. without either

compensation.

Amersham

Foreign company

to CAL. go to market & not BA

NBPM AT 8/2

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Nicholas Ridley MP
Secretary of State for Transport
2 Marsham Street
LONDON
SW1P 3EB

7 February 1984

Dear Nicholas.

BRITISH AIRWAYS PRIVATISATION: MARKET FOR SHARES IN THE US

Thank you for your letter of 30 January to Nigel Lawson, to which he has asked me to reply.

I am quite content for you to proceed as you propose to arrange a competition of eligible US Houses, with a view to appointing one to help with advice both on the prospects of a flotation of BA in the US and on the international dimension of the BA sale more generally.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours
John

JOHN MOORE

MEMORANDUM
DA Future
3/82

BF with Treasury response

cc NO

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

30 January 1984

Dear Nigel

BRITISH AIRWAYS PRIVATISATION: MARKET FOR SHARES IN THE UNITED STATES

I have lately been considering whether we should follow the example of the Department of Trade and Industry in respect of British Telecom by examining the possibility, without commitment, of an issue of British Airways' shares on the New York stock exchange simultaneously with the UK flotation. BA and their advisers Lazards are strongly in favour of this - BA have indeed already retained the services of a US merchant bank adviser, Goldman Sachs, to this end. Our own advisers, Hill Samuel , agree that we should keep open the option of a New York issue and should investigate the pros and cons and the timetable further. There are of course other possibilities of raising money on the Eurobond market, and perhaps even Japan, which we may in due course wish to consider.

I accept Hill Samuel's view. As you know, we have now made it our target to dispose of 100% of the airline's equity and this may prove to be beyond the capacity of the London market at one offering. Capacity in New York is also limited; and we should probably not wish to market more than a modest proportion of BA's shares there. Nonetheless a New York flotation will help us both to keep the price and proceeds up and to dispose of all the shares we wish to sell.

We shall need to ensure that a New York flotation does not lead to substantial ownership or effective control of BA falling into foreign hands. However even if BA were floated only in London we would need safeguards (and we are already examining how to provide these). I certainly do not see the problem of foreign control as ruling out further consideration of the New York option. As you may be aware, KLM Royal Dutch Airlines recently made a successful issue on the New York stock exchange (although in that case I understand that the Dutch Government retains a majority shareholding).

In order to examine further the implications of a US flotation, I shall need to take expert advice from an American merchant bank (I do not feel that I can rely on advice from BA's appointee: BA's and my interests may not always coincide). Even if we decide eventually against a simultaneous New York issue, we shall in any case benefit from a US bank's advice on how best to arrange the London flotation to maximise secondary investors' interest in North America and leave the way clear for a later issue there should we fail to sell 100% the first time round.

I propose therefore to arrange a competition of eligible US banks with a view to making an appointment. This is bound to become public knowledge, and it will be damaging if it is interpreted as a sign that we are definitely proceeding with an issue of BA shares in New York and we then later decide against this. We shall therefore need to make it clear publicly that we have not decided in favour of a New York issue; but that we need advice on the pros and cons; and in any event, with an international business like BA, and with London's little experience of airline stocks, we shall benefit from US help with the marketing and pricing of the shares on the stock exchange here.

I understand that my officials have discussed all this fully with yours, and that there are no differences between them. I felt, however, that I should let you know personally how I propose to proceed.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours ever

Nicholas

NICHOLAS RIDLEY

3F

AEROSPACE
DIA future
3/82

10 DOWNING STREET

THE PRIME MINISTER

19 December 1983

PERSONAL

Dear Sir Adam.

Thank you for your letter of 29 November, and the documents you enclosed setting out your proposals for reducing the disparity in size between British Airways and other British airlines before the former is privatised.

You remember that when John Biffen was Trade Secretary he explained that a further transfer of routes (of the kind which was carried out in the 1970s) was no longer possible.

We cannot compel British Airways to do what you suggest and any redistribution now would only be possible by mutual agreement between the airlines concerned.

I understand that you have discussed your strategy document with Nicholas Ridley, and that he told you that he has discussed the matter with Lord King. I hope that when Lord King has responded you will have a further talk with Nicholas Ridley. Meanwhile you will have seen the statement that Nicholas Ridley made to Parliament on Monday, and his answers to supplementary questions. I enclose a copy of Hansard.

/It was kind

It was kind of you to invite me to visit you and see something of your operations at Gatwick, but I am afraid that my diary is so full in the coming weeks that I would find it very difficult to fit that in. As to a meeting, I do not think that I could tell you any more at this stage than I have done in this letter, and than you have already heard from Nicholas Ridley who, I am sure, will keep you informed.

Every good wish

Yours sincerely

Margaret Thatcher

Sir Adam Thomson, C.B.E.

10 DOWNING STREET

PRIME MINISTER

Sir Adam Thomson has asked for a meeting, but following Nicholas Ridley's statement there is not much you can add.

Mr. Ridley is seeking to persuade Lord King to yield routes and assets, and he has asked CAA to review the allocation of routes.

It should therefore be clear to Sir Adam that the Government is sympathetic to his case and has done all it can for the time being.

AT

15 December 1983

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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

MR Knigden
with papers
cc PS/MR Mitchell
MR Blanto
MR Stevens
MR Bootham
MR Clarke
MR Twyman
MR Baker
MRS Ramsay
PS/SofS
PSO/file

16 December 1983

John Dent Esq CBE
Chairman
Civil Aviation Authority
CAA House
45-59 Kingsway
LONDON WC2B 6TE

Dear Mr. Dent,

CIVIL AVIATION LICENSING POLICY REVIEW

Thank you for your helpful letter of 13 December in which you let me have your thoughts on how the Authority might proceed with a review of air transport policy. I am grateful to you and your colleagues for your ready response and for the thought you have already given to this matter.

In responding, may I first deal with the key issue of the timing. I would wish to have the results of your Review available well before the flotation of BA plc proceeds, so that the inevitable uncertainty created by it can be removed again in good time for the market and potential investors to assess the value of BA well in advance of flotation.

You indicate that you hope to be in a position to issue your conclusions by about September of next year; but I would very much hope that you can in fact complete it by July. If, for example, your Review poses some questions for Government decision, as it may well do, we could aim to resolve these questions and make public our

decisions before the Summer Recess, thus improving by perhaps 2½ months on what you have suggested. With this in mind, I hope that you and your colleagues would agree to aim for a target date of 16 July.

You refer to the possibility of a slow response from the industry. Given agreement between us on the date for completion of your Review, I have in mind that I could issue a formal Notice under section 69(2) of the Civil Aviation Act 1982 timed so that the six months statutory period ended at that date.

A review under section 69 is confined to questions of licensing policy within the terms of the Act, but of course the Authority is free to offer advice to me on other matters if it thinks it desirable. If you considered it useful I could, in parallel with a Notice under section 69(2), require you, under section 16(1) of the Civil Aviation Act, to provide your assistance and advice on my functions relating to civil aviation.

I am pleased to see from your letter that, as well as considering the impact of privatisation of British Airways, you propose to cover in your Review the central aspects of the possible liberalisation of domestic air transport licensing arrangements. This does indeed seem an appropriate time for the Authority to reconsider whether readier access should be given to these routes. I was also pleased to learn that you will review the extent to which it continues to be necessary to require the approval of fares on domestic routes.

I also understand your wish to consider the implications of the limit on air transport movements at Heathrow for domestic route licensing policy. As you know, my Department is currently considering as part of the Government's airport policy, how the limit is to be implemented, and we may wish to initiate a more formal consultation on this with interested parties in the coming months.

It will be important for your people and mine to keep in close touch on how you intend to handle this aspect of your consultation so that confusion among those consulted is avoided: for example, if your consultation were to make assumptions about the way in which the ATM limit will be administered when we had not reached a final view on that. I understand that there have already been preliminary discussions on this.

On the international aspects of your review, I need only say that I agree that the Government will continue to bear responsibility for our bilateral aviation relations with other countries and thus for making effective any international route opportunities for British airlines which may result from the Authority's licensing policy. I presume that in framing any policy changes or recommendations in this area you would, as usual, have regard to our advice with respect to the likely outcome of any negotiations with other countries that might be entailed. The effective constraint is, of course, what is negotiable at acceptable overall cost with other countries. We will continue to fight hard for additional competitive opportunities, both in terms of policy within Europe and generally.

May I conclude by expressing my thanks for the rapid response which you have made following our earlier discussion. The announcement of your review seems to have been generally well received.

Yours sincerely,

Dinah Nichols

pp NICHOLAS RIDLEY

(Approved by the Secretary of State & signed in his absence)

CONFIDENTIAL

file

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Barclay Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON SW1

13th December 1983

GR

Pse type draft for PM's sig.

D
15/12

Dear David,

GR's home aff on this?

You asked for advice on Sir Adam Thomson's letter of 29 November to the Prime Minister about the consequences of privatising British Airways. He argues that the dominant position of British Airways in the British airline market, coupled with the financial strength of their balance sheet which he expects will result after privatisation, will put BA in too strong a position, so that they will pose a threat to the survival of the remainder of the independent airlines like his own. He proposes that the Government should reduce this disparity by transferring routes currently operated by British Airways to British Caledonian and other independent airlines, together with the aircraft and crews who operate them, in return for a cash payment.

The Prime Minister will recall that Sir Adam Thomson has asked the Government several times during the last Parliament for a further transfer of routes (in addition to those which he had in 1971 and 1976). The last time this was raised with the Prime Minister in 1982, she encouraged Sir Adam to agree to a voluntary transfer with

CONFIDENTIAL

British Airways if he could but commented that for the Government to initiate such action would be contrary to the Civil Aviation Act 1980, which made the Civil Aviation Authority, rather than the Government, responsible for policy on route licensing. In recent consideration of the privatisation of British Airways, compulsory route transfers have again been ruled out. As the Prime Minister knows, the possibility of a voluntary sale by BA of assets related to scheduled service routes, so as to contribute to improving BA's balance sheet, has been raised with Lord King.

Given the policy of successive Governments to aim for more than one airline rather than a single flag carrier, it is, of course, also desirable that policy should encourage a regime in which such airlines can flourish without anti-competitive dominance by any one airline. Civil aviation competition policy is also a matter on which the Civil Aviation Authority have statutory responsibilities and the Prime Minister will wish to know that my Secretary of State has been discussing this aspect with its Chairman. As a result, the Authority will shortly initiate a review of their policies for regulating competition in the civil aviation industry, in the light of prospective privatisation of British Airways. He would not expect such a review to result directly in immediate route transfers. Rather it would be looked to for some response to those who argue that British Airways' market power is too entrenched, and may be abused. My Secretary of State announced this review during his statement on British Airways on Monday. The aim is for this review to be completed well before BA is privatised.

Against this background, and because he has kept Sir Adam Thomson informed, my Secretary of State does not recommend the Prime Minister to see Sir Adam.

/ I enclose a draft reply for the Prime Minister's signature.

I am copying this to John Kerr (HM Treasury), Callum McCarthy (Department of Trade and Industry) and Richard Hatfield (Cabinet Office).

Yours,

Dinah

MISS D A NICHOLS
Private Secretary

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PERSONAL AND CONFIDENTIAL

DRAFT LETTER FOR THE PRIME MINISTER TO SEND TO
SIR ADAM THOMSON CBE, CHAIRMAN, BRITISH CALEDONIAN AIRWAYS LTD
CALEDONIAN HOUSE, CRAWLEY, WEST SUSSEX RH10 2XA

Thank you for your letter of 29 November, and the documents you enclosed setting out your proposals for reducing the disparity in size between British Airways and other British airlines before the former is privatised.

You have written to me making similar suggestions before, when John Biffen explained to you that a further transfer of routes (of the kind which was carried out in the 1970s) was no longer possible; any redistribution of that kind now would only be possible by mutual agreement between the airlines concerned.

I understand that you have discussed your strategy document with Nicholas Ridley. He has told me of his discussion with you. He has also told you that he has discussed the matter with Lord King. I hope when Lord King has had time to think about it, that you will have a further talk with Nicholas Ridley. We cannot of course compel British Airways to do what you suggest. That would require further legislation, which in turn would delay the privatisation which has already had to be postponed because of BA's losses, and you will understand that that is a course which I should be most reluctant to pursue. Meanwhile you will have seen the statement that Nicholas Ridley made to Parliament on Monday, and his answers to supplementary questions.

It was kind of you to invite me to visit you and see something of your operations at Gatwick, but I am afraid that my diary is so full in the coming weeks that I would find it very difficult to fit that in. As to a meeting, I do not think that I could tell you any more at this stage than I have done in this letter, and then you have already heard from Nicholas Ridley.

We could keep the question of a meeting under review, and meanwhile I am sure Nicholas Ridley will keep you informed.

British Caledonian

Caledonian House
Crawley West Sussex
RH10 2XA England

Telephone: Gatwick (0293) 27890
Cables: Scotair Gatwick Telex: 87161

Sir Adam Thomson, C.B.E.
Chairman

29th November, 1983.

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
London SW1.

Dear Prime Minister,

The Government's privatisation plans for British Airways will bring about the greatest change to the British Airline Industry since the end of the Second World War.

If consideration is given to the effect of this change on the private sector of the industry and to the Airports policy and if appropriate action is taken, then the results could be beneficial to the consumer and to the industry as a whole. Should the privatisation plans proceed without any regard for the effect this will have on the existing private sector or on the Airports policy, then damage will be done to both. British Airways has 83% of the output of British scheduled air transport.

We in British Caledonian have been discussing this with Ministers and officials since the privatisation proposal was first raised and earlier this year we decided that we should prepare and submit a document to the appropriate Department. This was sent in confidence to the Secretary of State for Transport on the 8th September. The title of our document is "A Strategy for British Civil Air Transport in Private Ownership". We then produced a summary suitable for public circulation and the title of this is "Airlines and Airports". I enclose a copy of both documents. Naturally I would not expect you to have time to read these but I believe that a glance at the main document will show that our case has been prepared in depth and, where appropriate, is backed up by factual information.

I believe that this matter is of sufficient importance to our industry and to British Caledonian for me to request a meeting with you at your earliest convenience. Ideally I would like to fly you in a British Caledonian Helicopter from the centre of London to our base at Gatwick to give you the opportunity of seeing something of our organisation and the spirit of all of our people. If this visit is not possible I will, of course, understand. If it is, I would be delighted.

Yours sincerely,

Adam Thomson

Sir Adam Thomson 14/12
British Caledonian —
request for meeting

→ file

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10 DOWNING STREET

From the Private Secretary

30 November 1983

I enclose a copy of a letter to the Prime Minister from Sir Adam Thomson. I should be grateful for a draft reply for the Prime Minister's signature, to reach this office by 14 December.

Could you please include in your advice your Secretary of State's view on whether it would be appropriate for the Prime Minister to accept Sir Adam's invitation to a meeting, and if so, what the form and timing of such a meeting might be?

I am sending copies of this correspondence for information to John Kerr (HM Treasury), Callum McCarthy (Department of Trade and Industry) and Richard Hatfield (Cabinet Office).

(David Barclay)

Miss Dinah Nichols,
Department of Transport

ecretary of State to see BA file. (10)

Advice please (ASAP)
Mr Twyman.
for Mr Ridley

Civil Aviation Authority
CAA House
45–59 Kingsway
London WC2B 6TE
Telephone: 01-379 7311

John Dent CBE
Chairman

13 December 1983

cc PS/Mr Mitchell
PS/Mr Lazarus
Mr Clarke.
Mr Yass
Mrs Ramsay
Mr Knighton
Mr Blanks
Mr Stevens
Mr Baker

The Right Hon. Nicholas Ridley MP
Secretary of State
Department of Transport
2 Marsham Street
LONDON SW1P 3EB

Dear Secretary of State

When we met on 28 November 1983 you asked whether the Authority would be ready itself to take the initiative in reviewing the policy issues that arise in the context of the proposed privatisation of British Airways.

As we see it, privatisation in itself is a neutral action in terms of regulatory policy. If in the process of privatising British Airways there were to be, one way or another, a substantial writing off of debt, this would intensify an already existing situation of competitive imbalance within the industry. It would not however be the writing off of the debt as such which would give rise to the basic difficulty but rather that it would aggravate the fact that British Airways is now becoming a keener and more efficient competitor so that the imbalances which have always existed become far more significant for the future development of the industry.

The basic policy question goes back to the Edwards Report and even before. The Edwards Committee recommended and all subsequent Governments have accepted that the country is better served by having a number of profitable and keenly competitive airlines than by depending on a single flag carrier. The fundamental question is whether the national interest continues to be best served by this policy, which envisages the maintenance of opportunities for airlines other than British Airways to enter its markets, either in direct competition where the institutional framework permits or in substitution for it where direct competition is ruled out. If it is in the national interest to maintain this policy, then it is important to ensure that the alternative carriers are not squeezed out through the extensive use of dominant market power by British Airways.

Continued.....

In the Authority's view these issues are of sufficient moment and immediacy to warrant a substantial policy review and the Authority would be willing to initiate and conduct this. A first question to be asked would be whether the situation does indeed warrant the taking of corrective action and a further question is what the action should be. British Caledonian has offered its own solutions, although it has to be asked whether and in what ways these would lead to greater competition among British airlines or a strengthening of the ability of the British industry to compete with foreign airlines. If the present independent sector is unfairly disadvantaged and if the industry is structurally unbalanced, it is primarily because the independent airlines have only very limited access to international routes generally and to Heathrow's traffic potential in particular. If corrective action is needed, it should be focused mainly upon the resolution of these two problem areas. It is unfortunate of course that the possible solutions to the problem tend towards a greater degree of regulatory intervention in the industry rather than the reverse, at least when viewed in classical terms. For this reason it would be desirable that a policy review should also encompass the possibility of adopting more innovatory techniques.

If the Authority is to consult the industry about these fundamental issues, the process will subsume some of the main elements of the proposed review of policies on domestic routes that we have had in mind. One such issue is the question of access to Heathrow for operators of domestic services. It would not be our intention to review the policy and machinery for allocating Heathrow capacity among different classes of airline but a relevant question would be whether, within any given entitlement for domestic services, other airlines should have some opportunity to displace British Airways in whole or in part on some of its present routes. Another issue which might be subsumed concerns the machinery that would be needed for regulating domestic fares so as to enable the Authority to deal with anti-competitive behaviour while giving airlines the greatest possible managerial freedom to determine their own prices. A third issue which might be subsumed is the possibility of introducing a freer regime for small scale services. In order however to avoid unduly complicating the task and delaying the conclusions it will be necessary to defer certain other aspects of the domestic policy review that are not immediately relevant.

I would not wish to predict at this stage what the likely outcome of such a consultation might be. Depending on whether a case is made for substantial changes of policy and depending also on what measures would be best and also practicable, one might envisage a range of possible outcomes. To the extent that it was concluded that greater opportunities should be provided for airlines other than British Airways to compete, we would not envisage any undue problems of accommodating revised policies within the Authority's present statutory powers since these are already biased in favour of competitive solutions; insofar as greater opportunities for competition brought in

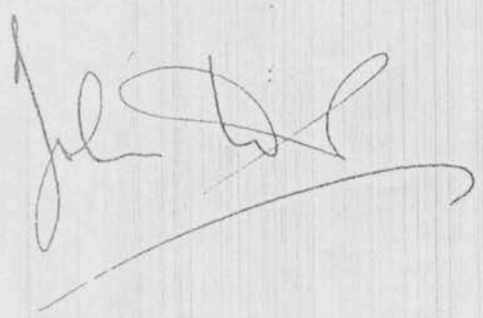
Continued ....

questions of our bilateral relationships with other countries, the outcome would of course be dependent at least in large part on the readiness of your own Department to go along with them. However, if for example it were to be concluded that substantial transfers of routes should take place without the agreement of those concerned, going beyond what might be achieved by some sharpening of the Authority's present policies on substitution, our restatement of policies might need to be accompanied by recommendations to you to take legislative or other action.

More important perhaps is the question of timing. The issues are weighty and, if the parties are to be given ample time to express their views and the Authority a full opportunity to consider its conclusions, the six month limit that is entailed by invoking Section 69(2) of the Act may well prove insufficient. If the Authority initiates the review itself it is not bound by this limit and can take a little time longer. It is in any case desirable to initiate the consultation at the earliest possible moment and we have in mind a relatively brief initial statement that will be a signal to the industry to start preparing its submissions. Given an early start we would hope to be in a position to issue our conclusions by about September 1984. We believe it is important to allow this length of time in order to arrive at sound and robust conclusions. If by the early Spring it seemed that progress was falling behind due to a slow response from the industry, the option of using Section 69(2) would still be open.

You have told me that, subject to further discussion about timing, you are content that we should proceed on this basis and you have already made it clear in your statement yesterday that the review has your approval. We do of course look forward to your continuing support in ensuring that these important issues are given serious attention by all concerned.

Yours sincerely



10 DOWNING STREET

PRIME MINISTER

I attach a brief for your meeting with Mr. Ridley. You may also wish to note David Wolfson's comments, in the course of his note at Flag A, about the possibility of Walter Goldsmith heading the new NHS management team.

DAVID BARCLAY

17 November 1983

PRIME MINISTER

cc Econ Pol: Privatisation

MEETING WITH SECRETARY OF STATE FOR TRANSPORT

Mr. Ridley is likely to raise the following topics at his meeting with you.

1. British Airways/British Caledonian
See David Wolfson's note about this, attached at Flag A, and Policy Unit advice at Flag B.*

* others in Policy Unit see more in B Cal case. AT.

2. British Airways Privatisation
Mr. Ridley is considering the possibility of proceeding without legislation. It might be possible to apply to the Companies Court for a write down of capital. This would mean that the timetable could be speeded up, but there is a significant risk of accusations of privatisation by the back door.

3. National Bus Company Privatisation
Mr. Ridley is inclined to go slow. There is no prospect of legislation this session so he would prefer to take time to get the competitive framework and the subsidy regime right.

4. London Transport
Mr. Ridley is worried about concessionary fares. The Boroughs are supposed to be taking over responsibility when the GLC is abolished. They are using this as a lever to oppose abolition, and Mr. Ridley is some way from a satisfactory solution.

/ 5. Non-rail transport

5. Non-rail Transport Subsidies

The Secretary of State believes that transport subsidies other than rail subsidies (which he regards as inevitable) provide at best indeterminate value for money. He may propose a measure of transfer of resources from revenue subsidies to highway construction.

6. Ministerial Responsibilities

Finally, Mr. Ridley may wish to raise with you the possibility of some reinforcement of his Ministerial team at the Department of Transport.

DMB

DAVID BARCLAY

17 November, 1983

cc Econ Pol: Privatisation

10 DOWNING STREET

Prime Minister. Nov.15, 1983.

1. You are seeing Nick Ridley and will no doubt discuss British Caledonian's offer for British Airways routes.
The Policy Unit have advised you to ignore Adam Thompson's bid. Ivan Fallon would advise you differently. I draw to your attention that there are, in my opinion, two sides to the case. A Privatised British Airways, with over 80% of the market, making £150 Million per annum, would be able to destroy British Caledonian whenever it chose. The threat implied by a near-monopolist would be enough to inhibit competition.

There is a real dilemma: speed of privatisation, and simplicity, may speak in favour of leaving British Airways as it is, but the creation of a properly competitive market for British Scheduled passengers favors a partial break-up sale before privatisation.

2. I feel sure that we are going to face continuing attack on the Health Service over the next two years, during which time hopefully better management will be introduced to help the service provide more for less. While Walter Goldsmith has all the talents to head the management team, his political vibrations would be of the "axeman" variety. On reflection, I doubt that he would get a real chance to do the job. The fears of privatisation of the NHS would run riot, and a less publicly right wing choice seems more likely to succeed.

DW.
David Wolfson.

Not such a King-sized BA

COMMENT by Ivan Fallon

FOR the past two years the aviation world, the Government and a large chunk of the public has watched Lord King's progress through British Airways with considerable astonishment.

There have been redundancies, massive losses (£540 million in a single year when everything including the kitchen sink was written down or written off), management changes, dissent and jubilation from opponents and supporters—and towards the end of the day the growing belief that King can actually achieve what he set out to do which is take the airline out of the State sector and privatise it.

Watching even more closely than the rest of us were Sir Adam Thomson and his men at the independent, fully-privatised British Caledonian, who have viewed it all with mixed feelings. Competing with an overblown inefficient, uncaring and unprofitable State-owned airline is one thing. Flying against a slim, motivated, private—and most important of all — decently financed airline, which is what BA could become by this time next year, is another.

So Sir Adam and his managing director Alastair Pugh concocted a plan of their own, one which Lord King does not like at all, but which the Government, in the guise of new Transport Secretary Nicholas Ridley (for starters) will have to take seriously, even if it does potentially endanger the BA privatisation timetable.

The British Caledonian scheme is an ingenious and intellectually attractive one.

> British Airways at present is seven times the size of Caledonian, and if nothing is done to change that on privatisation, four-fifths of Britain's scheduled air transport business will be controlled by one operator.

If BA had its debt wiped off and came to the stock market with a cleaned up balance sheet, which is about the only way it *could* attract outside investors, then the competition would become more unequal still.

The imbalance between the two airlines is paralleled by the imbalance between London's two airports, Heathrow and Gatwick. Again Heathrow is seven times larger on scheduled services. BCal represents the heart of Gatwick's scheduled business.

Operating out of Gatwick puts it at quite a disadvantage—and if the more formidable King-sized BA moved into the private sector, BCal might even move to Heathrow with all the implications that would have for both airports.

Such is the scene, viewed from Caledonian House, at Gatwick. So what to do about it?

If BA is to be sold, BCal wants to buy at least a part of it. It has put itself first in the queue, before the City institutions, private investors or even BA's management.

It has picked out a series of routes which it reckons would boost both its own operations and Gatwick Airport, and offered £200 million for the assets that go with them.

These routes are still on the secret list, but are listed in BCal's blue book — and apparently include routes to the Caribbean, the Middle East, and Japan. BCal insists they are by no means BA's most profitable routes, but obviously they are not loss-makers either.

But the independent airlines and Sir Adam Thomson have gone a stage further. They also suggest that BA be relieved of regional operations as well. BCal itself does not want them. But it suggests that operations based on the "mini-hubs" of Glasgow and Manchester, and possibly even the German internal routes, should be sold for cash to other specialist independents who could create strong locally-based concerns and run the routes more effectively than BA.

Now the effect of all this would be considerable. BCal itself would increase in size by perhaps two-thirds — a quantum leap which otherwise would take it 10 to 15 years of hard slog. Its share of scheduled services would grow from 17 to 29 per cent, while other independents such as British Midland and Dan-Air would rise from 2 per cent to 5 per cent.

And British Airways? Instead of having four-fifths of British Scheduled passengers, it would drop to a healthy enough two-thirds. At that level it would still be the giant, but no longer quite so dominant. And if he could get his extra routes, Sir Adam and his friends would no longer kick up a fuss about write-offs of BA debt and cleaned up balance sheets.

In the past 10 years 14 independent British airlines have gone out of business, including of course Laker, Invicta, Skyways, Channel, IAS and so on. It is difficult enough just to survive. To make headway in an industry dominated by State concerns is exceptionally difficult, which makes BCal's achievement all the more laudable.

What then is the argument against Sir Adam's plan? The sale of £200 million of assets would make BA a smaller airline, and, therefore, more easy to sell — and of course, there would be £200 million of cash up front before the operation got under way.

But whatever argument Sir Adam presents, the plan would tear a hole in BA's profitable operations, result in major redundancy payments all over again (BCal would not necessarily take all the people that went with its routes) and set back the privatisation timetable.

King himself might get so disillusioned that he would seek other pastures, and without him the privatisation momentum would run down, and so too would the drive for efficiency.

> But maybe there is room for a delicate compromise. It does not have to be £200 million of assets — even a £100 million shift from BA to BCal, and of routes from Heathrow to Gatwick, would make a great deal of difference.

> BCal is willing and able to offer the Government hard cash for assets independently valued in what is a genuine attempt to introduce greater long-term competition into the British airline business.

SPOTLIGHT

1983 High	Low	Comment
77	56	Brokers' visit
95	69	Interim due
5	90	Consumer sales
5	345	Takeover tussle
4	23	A'Court buying
8	177	US bid hopes

cf For meeting with S of S for Transport on Thursday please.

cc. Econs Pol Privatisation

DMB 11/11

MR. TURNBULL

c Mr Alison

Meeting with the S/S for Transport

Since I dictated the attached note to you about the Prime Minister's meeting next week with Mr. Ridley, Dinah Nichols has suggested two further topics.

They are:

i. NBC privatisation - Mr. Ridley is inclined to go slow on this. There is no prospect of legislation in the current session, so he would prefer to take his time in getting the competition and subsidy framework right.

ii. Non-rail transport subsidies - Mr. Ridley may express a general view that transport subsidies (other than rail subsidies, which he regards as inevitable) provide indeterminate value for money. He may say that he is aiming to transfer resources from revenue subsidies to highway construction.

DMB

11 November 1983

cc: Mr. Alison

cc Econ Pol Privatisation

MR. TURNBULL

MEETING WITH THE SECRETARY OF STATE FOR TRANSPORT

The Prime Minister has agreed to see the Secretary of State for Transport next week.

I understand from Dinah Nichols that he is likely to raise three topics:-

(i) British Airways Privatisation - He is considering the possibility of proceeding with BA privatisation without legislation. Apparently it would be possible to apply to the Companies' Court for a write down of capital. This would mean that the timetable could be considerably speeded up, so that flotation could proceed at a decent interval after British Telecom, or at the time currently scheduled for British Telecom if this slips. On the other hand, there must be a considerable risk that such a procedure would be criticised as unfair circumvention of Parliament.

(ii) London Transport - Mr. Ridley will wish to discuss particularly concessionary fares. As you know, the current proposal is that when the GLC is abolished the London Boroughs should take over full responsibility for concessionary fares. This is a sensitive political issue, which the London local authorities are exploiting in their opposition to local government reform, and Mr. Ridley is apparently by no means confident that a satisfactory solution is at hand.

/(iii)

(iii) Ministerial Responsibilities - I understand that Mr. Ridley may also ask the Prime Minister for some reinforcement of his Ministerial team at the Department of Transport, to reflect his enlarged responsibilities.

DMB

DAVID BARCLAY

11 November 1983

cc DW

Prime Minister ② cc R. Young
You may be interested to see
a Policy Unit view

CONFIDENTIAL

cc Mr. Mount

MR. TURNBULL

BRITISH CALEDONIAN - A BITE OUT OF BRITISH AIRWAYS?

The BCal "offer" made public last Friday (to purchase some of British Airways aircraft and to take on some of their routes) is one-tenth substance and nine-tenths an enterprising piece of public relations for BCal.

The substance of BCal's statement is that, throughout the many years over which British Airways have received huge subsidy from the taxpayer, BCal have had to survive without support. Related to that is their fear that, in order to privatise BA, Government will write off accumulated debts of over £1 billion and launch it into the private sector with an unfair advantage of routes, aircraft and balance sheet.

The BCal case is vulnerable at several points:

1. The restructuring of BA's balance sheet is not yet worked out, but it is very unlikely to be debt free at the date of flotation. In any event, it is difficult to see why the removal of BA's subsidy prop in the future will put BA in a stronger position or BCal in a weaker one. It is equally difficult to see why the taxpayer's past involuntary contribution should be turned exclusively to BCal's advantage.

2. Route allocation is determined by the Civil Aviation Authority in a quasi-judicial way. If BCal is unhappy with its present route structure centred on Gatwick, Government cannot act directly to satisfy the airline, unless it wishes to pass new primary legislation.

BCal must know that the Government's policy, oft repeated, is greater liberalisation of product markets. In air transport, Shuttle has already been opened up to competition against representations from BA.

BCal's "threat" to leave Gatwick is not something on which Government should act. (In fact, the moral here is not to privatise Gatwick and Heathrow together: they must compete).

3. BCal submitted their case to the Department of Transport in a sizeable document some three weeks ago. It is curious that they should make their proposal public while it is still under consideration. Certainly BCal lay themselves open to suspicion of a public relations stunt.

If Government nevertheless wish to consider making some gesture towards BCal, they must recognise that:

- the other private sector UK airlines would hold out their hands too

- even a voluntary agreement by BA to hand something over would require CAA approval

- the disruption to BA's operations would inevitably delay privatisation.

Policy and tactics dictate that Mr. Ridley should turn down Sir Adam Thomson's offer.

RJ

ROBERT YOUNG
7 November 1983

10 DOWNING STREET

(2)

Prime Minister

You asked if the Trade and Industry Committee has been set up yet. The answer is no. It won't be until after the recess when the Labour party have sorted themselves out.

MCS 18/7

MT

Prime Minister (2)

MCS 15/7

ACK 15/7

LORD McFADZEAN OF KELVINSIDE

TELEPHONE:
01-934 5115

SHELL CENTRE
LONDON
SE1 7NA

MCS
to see

12th July 1983

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
LONDON SW1.

Has it been set up yet? MT

Dear Margaret,

As a courtesy I am sending you a copy of a submission being made to the House of Commons Committee on Industry and Trade. You will see that it is not quite in accord with the post prandial speech you made in Tokyo!

The senior management now being dismissed, or side tracked, in such large numbers by Sir John King are the people who pulled the airline out of the slump. Credit is due in particular to Roy Watts and Peter Herman; the latter was one of the ablest Management Services Directors that I have met in private or public enterprise.

Please do not trouble to acknowledge.

I have acknowledged on your behalf

Best wishes for the new session,

Yours ever,

Frank

Encl:

B R I T I S H A I R W A Y S

British Airways has recently been the subject of critical comment, much of it couched in extravagant and emotive language. Being nebulous, these attacks are sometimes difficult to rebut. "Quagmire of privilege", "overmanning on a prodigious scale", "Conducted.... as though money grew on trees", and "recipe for disaster" are but a few of the phrases used to denigrate the airline. This, coupled with a Price Waterhouse report, which apparently ignores readily available evidence, has given the widespread impression that until the arrival of Sir John King, British Airways was an incompetently administered airline which had done nothing to improve its efficiency. This does such a grave injustice to many of my former colleagues - some of whom are now being forced to seek posts outside British Airways - that a few facts should be introduced to give a more balanced view of the airline's history.

British Airways was originally formed under the 1971 Civil Aviation Act to take over the activities of British Overseas Airways Corporation (BOAC), British European Airways (BEA) and various subsidiaries of these two corporations. The super-imposition of the British Airways Board was intended to co-ordinate activity, achieve economies of scale and create a common trading identity. Although in the early days of the merger there was some erosion of divisional operational integrity by the creation of single departments for engineering, sales and industrial relations for example, the mainstream airline business remained divided into three units - Overseas Division, European Division and Regional Division. All were relatively self-contained, the three divisions had their separate "boards", were situated at geographically different points and were inclined to become inward looking and defensive. The staff built up at Headquarters largely mirrored the three divisions and problems were often resolved in committees of equals. These tended to proliferate thus slowing down the decision-making process. The centralised industrial relations department of the personnel function filled a substantial part of the management vacuum which a structure of this type creates. Little took place in the way of inter-divisional standardisation of equipment, while planning tended to be a summation of divisional plans. This organisational structure also made it difficult to present a single face to the outside world. For example, no one person was in charge at Heathrow Airport, while the negotiation of a mail contract with the G.P.O. required the presence of three or four individuals not necessarily with an identity of interest.

.../...

The senior staff of British Airways were well aware of the defects of the organisation as it had evolved and two of them - Messrs. Herman and Wood - were deputed to seek the views of their colleagues as to the best way forward. Various alternatives were considered, including the liquidation of British Airways and the re-establishment of BOAC and BEA; maintaining the status quo with rationalisation of the U.K. services; breaking the airline down to mini groups with their own routes and dedicated aircraft; and a wholly functional organisation. There were arguments for and against each of the different proposals but the eventual recommendation, agreed by the Board and accepted by the Government, was the elimination of the three divisions and the substitution of a unified structure with three operating units:

Flight Operations
Engineering
Commercial Operations

and seven service departments:

Finance
Planning
Management Services
Personnel
Subsidiaries
Legal
Public Relations

The main feature of commercial operations was a structure of route groups, each responsible for British Airways in its territories and for the development of the markets. The new organisation came into effect in April 1977. In 1982 a three divisional structure was created but this in turn was liquidated in mid-1983 when British Airways underwent yet another re-organisation which bore some similarities to the one introduced in 1977 but downgraded certain activities such as Flight Operations and Planning. Anyone who has ever administered a large operation appreciates that there is no single structure that is perfect. Indeed if the will to make an enterprise succeed is present the objective can usually be achieved by several different forms of organisation. However, constant chopping and changing are destabilising.

It was appreciated that the 1977 organisation would not obtain its objectives in terms of efficiency and profitability overnight. The airline had to continue operating during the period of reorganisation and elimination of duplication and overlap. A contribution audit was started with the aim of determining the personnel establishment necessary to operate the airline under its new organisation.

British Airways had already carried out several studies on its productivity relative to its main competitors. Comparisons of this type, particularly across national frontiers, are notoriously difficult to make with any degree of accuracy. Published information is rarely

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adequate; airlines vary widely in equipment, the nature and density of their route structures, complexity of operations and the extent to which services are purchased from outside, or work performed for others. In an endeavour to eliminate these differences British Airways participated with ten other scheduled airlines in providing sufficient information to a firm of management consultants - McKinsey and Company - to enable them to make meaningful comparisons both of overall productivity and the relative performance of specific functions. The total airline operation was broken down into more than one hundred personnel categories. A detailed study, copies of which can no doubt be obtained from British Airways, was produced in 1977. It showed that, compared with its major competitors, British Airways was overmanned by 15,000, or approximately 25% of total personnel. In functional terms engineering and maintenance, ground handling and stations, and flight operations, accounted for about 80% of the total. The study also showed that approximately 60% of the overmanning was in direct personnel, while overhead categories were just below 30%. One of the most noticeable productivity gaps was in the supervisory category where overmanning amounted to 2,300 staff, or 35% of total supervisory personnel.

An interesting feature of the report was that in spite of the productivity difference of 15,000 personnel the lower British wages and salaries resulted in personnel costs per available ton mile of 12.6 U.S. cents for British Airways which put it marginally below the 12.9 cents for the North American carriers and substantially below the 18.4 cents of the European airlines in the survey. In other words, British Airways was a low productivity and low wage airline and in this respect was not markedly different from many other businesses in the U.K. in both the private and public sectors. It was, however, different from several other British industries insofar as the low wages and salaries offset the low productivity and left the airline competitive at the rates of exchange then prevailing.

The fact that British Airways, in spite of its overmanning, was competitive with other major airlines was reflected in the financial results of the Company. In the 1978-79 financial year, Mr. (now Sir) Ross Stainton was able to report a profit (before tax and cost of capital borrowings) of £110m., which showed a £13m. improvement on the previous year. After interest, taxation and a dividend payment to the British Government, as shareholders, the Company was able to plough back £62 million. The return on net assets was 14.7% against 12.4% in the previous year which had suffered serious disruptions as a result of strikes by ground engineers and air traffic control assistants and the need to repair the cracks which had been discovered on the wings of the Trident 3s. In the ten years to 1978-79 British Airways achieved a return on net assets of 9.1% and an overall self-financing ratio of 71.5%, or 81.4% if Concorde is excluded. In common

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with other members of the industry, the airline was looking to a continuing expansion of business although at a slower rate than the historical trend.

Against this background there was no case for wholesale dismissal of personnel. Indeed any attempt to have done so would have been unacceptable to the Labour government and the Unions and would almost certainly have grounded the airline. The general industrial relations atmosphere of the late seventies seems too easily forgotten. Official strikes were the least of British Airways' problems; it was the almost interminable unofficial strikes, normally in breach of agreed procedures, that delayed aeroplanes, disrupted the planning of schedules, earned the Company the ill-will of its travellers and put an almost intolerable burden on the staff who formed the inter face between the airline and the travelling public. In addition, British Airways suffered from a "blacking syndrome". The practice of blacking union members who worked during disputes was extended to "blacking" aeroplanes, specific engines and equipment and, in one case, part of a hanger. The constant guerilla warfare, sometimes pursued with almost total contempt for the interests of passengers, was sharply diminished when travel privileges were withdrawn from unofficial strikers and individuals were directed to work on "blacked" equipment or face suspension without pay.

Moreover, while the McKinsey study represented a considerable advance on those made previously, the authors were the first to emphasise that it would be "imprudent and naive" to use the 15,000 figure as a precise measure of productivity improvement. They recognised, for example, that, compared with other airlines, British Airways probably had greater problems of "peaking" in arrivals and departures and also had specific problems such as the need to staff three terminals at Heathrow. As a follow-up to the McKinsey exercise an analysis was made by British Airways' staff of how personnel numbers were likely to develop over the following five years, taking account of expected wastage, known retirements and the growth estimates then assumed in the forward plan, with the aim of reaching the McKinsey productivity levels by the end of the five-year period. Although the occupational distribution would change, the broad objective was not to reduce numbers dramatically but to increase productivity in terms of Available Ton Kilometres per man from 145,400 to 200,500. This represented an increase of 8½% per annum or 55% over the period. To implement this scheme the broad McKinsey conclusions were translated into detailed plans of action and personnel establishments for every aspect of the airline's operations. The most difficult and time consuming task was convincing employees that it was in their interests to give up a massive range of restrictive practices in order to move from a low productivity, low wage, operation to a high productivity, high wage venture. This involved trying to change what were often deep rooted social attitudes and the renegotiation with Unions of a multitude of agreements.

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To give but a few examples, the then current rosters did not match the operational requirements nor produce what the airline was paying for under national agreements on working hours; supervisory staff would not permit qualified tradesmen to sign out aircraft because it would have resulted in substantial reductions in supervisory numbers which was one area of over-manning highlighted by the McKinsey study; in ground services, cargo, ramp and catering, high overtime earnings had reached epidemic proportions and was protected by restrictive practices, overtime built into shift rosters and guaranteed overtime, whether worked or not, and the high level of payments became a major course of unrest among skilled tradesmen who found their differentials virtually eliminated.

Given the industrial relations atmosphere prevailing in the late seventies, this mass of complex problems could not have been solved by any "stroke of the pen" approach. As a shrewd observer of the British industrial scene perceived: "Institutions and habits of mind, once firmly rooted, are not easy to displace in the absence of calamity or upheaval".* It required patient discussion, negotiation, persuasion and management firmness in the face of an over-elaborate consultative and negotiating machinery which only too easily resulted in the passive sabotage of time. At this particular juncture British Airways had 17 Trade Unions each with its own shop steward structure; there were approximately 700 shop stewards in the Engineering Department, 350 in the Ground Services Department, 125 in the Flight Operations Department and 150 representing clerical and administrative staff. There were 11 national sectional panels and over 150 local panels - involving more than 800 people - under the National Joint Council. It was not until August 1979 that the massive effort involved started to produce the reductions in numbers. By March 1980 numbers were down by 1,000 from the peak reached in 1978/79 and a year later the total was reduced by a further 4,288. Both Sir John King and Price Waterhouse choose to ignore the work which was done by British Airways career staff to achieve a solution of this complicated issue.

Another major problem for British Airways was the structure of its aircraft fleet. For a variety of reasons - some of the most important ones imposed on the airline - British Airways found itself in the latter half of the seventies with a more complex fleet than any of its major competitors. Leaving aside helicopters it had, in a fleet of under 200 aircraft, 12 basic types against 3 for Panam and 5 for T.W.A. It had 8 types of engines against 3 for Panam and 5 for T.W.A. In the McKinsey study British Airways had a fleet diversity, measured by the weighted number of types of aircraft and engines, of just under 16 compared with under 11 for Air France and under 6 for Eastern Airlines and Qantas. This, plus some

*G.C. Allen "The British Disease": I.E.A.

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of the sub-divisions of the basic types, resulted in greater inflexibility in crewing, higher training expenses, a higher number of employees and a higher value of spares, all of which put the airline at a competitive disadvantage. Moreover, the fleet had 80 aircraft (31 Tridents 1 and 2; 25 Trident 3s; 9 Boeing 707s and 15 V.C.10s) that would be unable to meet the 1986 noise regulations set out by the Government in its White Paper on airport policy. In addition, a further 25 aircraft (Viscounts and Merchantmen) had to be withdrawn for technical reasons before 1986.

In effecting the replacement programme, one of the basic objectives of British Airways was to rationalise its fleet. On the long haul side the decision had been taken in the late sixties and early seventies to built up the Boeing 747 fleet for the dense routes and use the Lockheed Tri-Star 200/500 for the less dense routes. As these aeroplanes came into the fleet, the V.C.10s would be phased out and the number of 707s would be reduced before being completely withdrawn in the latter part of the eighties.

In the short haul operation, the main strategic decisions were made in the late seventies. At the thinner end of the range the Boeing 737 was assessed as the best aeroplane available and the decision was taken to introduce it in 1980 and progressively replace the Tridents 1 and 2. In the plus/minus 180-seater range, the Board of British Airways opted in favour of the Rolls-Royce engined Boeing 757, while on the densest short haul routes the decision was made to employ either the Tri-Star 1 or, a later member of the Tri-Star family, the 200, which could be employed in either short haul or long haul according to the demand.

All of these decisions were reached on the basis of operational cost assessments made in considerable detail by the career staff of British Airways. The reasoning was accepted by the Government and during the course of 1978 orders were placed for 19 757s and 28 737s, with 9 of the latter being for British Airtours. Since the orders fell short of the number of aeroplanes that had to be replaced by the mid-eighties concern was expressed that British Airways was putting its main effort behind the long haul operation. This was not so. One of the many advantages of rationalising the fleet in the manner proposed was the flexibility it afforded the airline. Forward estimates of route densities and profitabilities had been made but in the changing market circumstances these estimates were subject to a considerable margin of error. If the market proved more buoyant than current estimates showed the additional aircraft requirements would be in the 757/Tri-Star category. If, on the other hand, the passenger and cargo potential had been over-estimated, the emphasis would be more on the 737. It was the desire to retain flexibility as long as possible between different types of aircraft, and not any change in direction, that was responsible for the number of new aircraft ordered falling short of the number which required replacement. Giving an impression of financial laxity, the Price Waterhouse Report apparently

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refers to a British Airways' commitment of £2 billion for future aircraft purchases. No such commitment was made, nor, given the budgetary controls in force, could it have been made without the approval of H.M.G.

During the negotiations that resulted in the steps to rationalise the fleet, Mr. Callaghan, the then Prime Minister, accepted the principle that the Board of British Airways should be permitted to buy the aeroplanes which, in its judgement, were regarded as the most suitable for the airline's current and projected route structure. He realised that this was an essential ingredient in clarifying accountability, although it was equally accepted that it would take many years for the full results of the policy to be achieved.

As a corrollary to this return to business sanity it was accepted that British Airways should be free of extraneous costs in its operations. It was not at all clear to the management why the return on capital, or the wages and salaries it could afford to pay, or the amount it could plough back into the business, should be reduced by carrying the high costs of Concorde, an aeroplane which could not be expected to show a profit on any normal accounting basis. The Government accepted the reasoning and Concorde was written down to nil in 1978-79 with an associated reduction of £160m. in public dividend capital.

The turn of the decade saw an abrupt change in the outlook for British Airways. The sharp downturn in the world economy coincided with a greater degree of deregulation and freedom of entry into the airline business, while the appreciation of sterling made companies based in the United Kingdom that less competitive in the international market. These factors were compounded by the prolonged Air Traffic Control strike in the U.K. and subsequently the U.S.A. Although the detailed work done on manning levels post McKinsey was an essential ingredient in the accelerated staff reductions, the target of partially growing into American cost levels over a five-year period was no longer appropriate in the changed market circumstances. For British Airways the traffic decline started at the beginning of the fiscal year 1980-81. Surplus capacity became common in the industry, competition increased and the discounting of fares by various devices became endemic. In that financial year revenue fell short of budget by £400m. and the loss before cost of capital borrowings and taxation was £70m. After interest and taxation the loss became £145m.

As the recession deepened and the much heralded economic turnaround receded into the future, more drastic measures were required. In September 1981 Mr. Roy Watts announced the details of a "survival plan" drawn up by himself and his Executive Board of Management.* It involved reductions in routes, stations, bases, staff and air-

*British Airways Bulletin of 10th September 1981.

.../...

craft. It was sufficiently dramatic, both in content and presentation, to provide "the calamity and upheaval" which, as the late Professor Allen observed, are often necessary to displace firmly rooted attitudes and habits of mind. The measures taken resulted in an improved operating performance in the financial year 1981-82. Profit before cost of capital borrowings and taxation was £11m. (against a loss of £70m. in the previous year, while the loss before taxation was £114m. (against £145m.). However, after taxation and extraordinary charges of £426m., the loss was £544m. against a loss of £145m.

The main ingredients in the extraordinary charges were £199m. for redundancy payments and £208m. special write down of certain aircraft and related specialised buildings. The redundancy provision included £98m. of expenditure anticipated to be incurred in the following year. The fleet write down included, inter alia, reducing the book value of the Trident fleet to zero at 31st March 1982, although the 2s and 3s are still flying fare paying passengers and are likely to do so for a few years more. Only a State-owned industry could afford the luxury of such a performance and survive with the distorted Balance Sheet it produced. There are many private airlines, as well as shipping, refining, chemical and engineering companies, which wish it were possible to behave with such cavalier opulence. From now on it will be extremely difficult to make any very meaningful comparisons about the performance of British Airways over a reasonable time span, or how its efficiency measures up to the competition.

Various other accusations have been levelled at British Airways and its career staff. Thus Messrs. Dunlop and Dibbs gave great publicity to an alleged deficiency of £600m. in the Airways Pension Scheme; yet as the Accounts for 1981-82 recorded, the last actuarial valuation showed a deficit of only £20m. on estimated current, deferred and prospective liabilities of £1,980m., while the 1982-83 Accounts record that British Airways could reduce its pension contributions without impairing the solvency of the Scheme. Again security of airline tickets is a major problem. Accusations of widespread theft and the supposed calling in of Scotland Yard received considerable publicity but this too has gone silent. Overmanning in British Airways has been highlighted as if it alone suffered from the British disease, whereas historically it was a better performer than many other industries in both the private and public sectors*. There has been a tendency to attribute as particular to British Airways problems which are in fact common to the airline industry as a whole. British Airways was far from being the only airline company which had its forward estimates wrong and airlines were not alone in failing to foresee the depths of the slump - there are currently around 100 million dead weight tons of shipping laid up, primary distillation in refineries is averaging about 60% of capacity and ethylene plants are heavily underloaded.

*Graham Hutton "Whatever Happened to Productivity?": I.E.A.

.../...

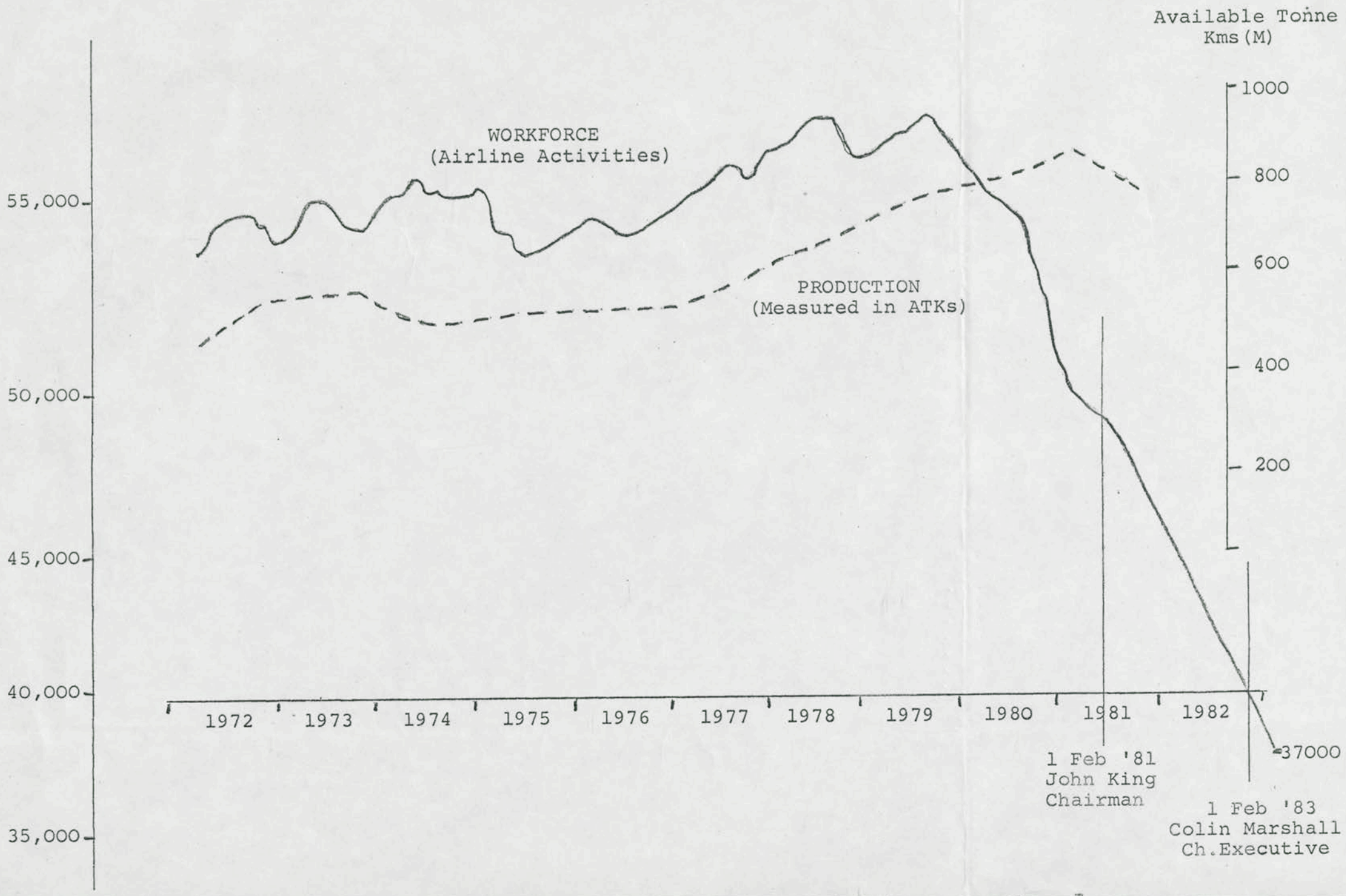
The Government must carry a certain amount of responsibility for the generally hostile atmosphere against British Airways' staff. When he was a junior minister, Mr. Ian Sproat was almost hysterical on the subject but it runs much deeper. Distaste of nationalisation as an institution has too readily slopped over to scarcely veiled distaste of individuals who have sought their careers in the industries concerned. Too ready an ear is given to criticisms and too little to ascertaining whether they are soundly based or not. The Price Waterhouse Report on British Airways apparently went to the Prime Minister, raw and unprocessed by anyone with a knowledge of the airline industry or the history of the Company. I have spoken to two people who have read the report - one who used to be inside the airline and one from outside. Both were highly critical. Apart from the points made above, the document seems to contain the usual statements that can be made about any organisation - the need to improve management information, make better use of assets, provide greater clarity on management relationships, sharpen up financial procedures and so forth - and does not acknowledge how many of the apparently over thirty proposals originated from inside the airline. There is a case for publishing the Report, particularly as the secrecy surrounding it has fuelled rumours about its contents.

Many criticisms can fairly be levelled at British Airways as, indeed, they can at much of British industry. However, the extraordinary provisions in the 1981-82 Accounts apart, there can be no doubt that the airline in the last few years has tackled its problems with vigour. A study of the dates shows that the main strategic decisions were taken and personnel numbers were being reduced before the arrival of Sir John King.* The survival plan was constructed and implemented by Mr. Roy Watts and other career employees of British Airways, several of whom now find themselves out of the airline or shunted into a siding. No doubt Sir John King ratified some of the major parts of the programme; he cannot claim, as is common belief, to have originated them.

*See Appendix

APPENDIX

BRITISH AIRWAYS MANPOWER AND PRODUCTION



Aerospace

BRITISH AIRWAYS

1. Sir John King came to see the Prime Minister at 10.30 a.m. on Tuesday, 23rd November.

2. Although Sir John said that he was very anxious to proceed with privatisation at the earliest possiblt date, and that the Government had no business to be owning an airline, he accepted that it would not be possible to proceed with privatisation as fast as he would wish.

3. The Prime Minister said that it would be very difficult to justify the Government writing off inherited debt, and that it would be unfair to British Airways' competitors to do this.

4. The Prime Minister said that the objective of privatisation remained, and that the only issue was one of timing and method.

5. Sir John said that he had in mind to reduce still further the number of employees of British Airways, below the figure of 35,000 which would be achieved by 31st March 1983.

6. Sir John raised with the Prime Minister the question of Tristar and the Ministry of Defence. The Prime Minister asked Mr Gow to have a word with the Secretary of State about this, WHICH HE HAS DONE.

24th November 1982

10 DOWNING STREET

Prime Minister

Sir John King

You might wish to refresh your memory of the 3 main points which led you to decide that BA privatisation should be postponed — see para 3 of my record.

MCS 22/11

cc Mr. Gow

Aerospace

1. MR. SCHOLAR
2. MR. BUTLER
3. PRIME MINISTER

Sir John King of British Airways would like to come and see you privately and fairly urgently to bring you up-to-date on matters concerning British Airways which have a political context.

Shall I give him 20 minutes next week?

CS.

P.M. agreed to see him. Sir John coming in at 10.30 on Tuesday.

CS 19/11

18 November 1982

Reference M

SECRETARY OF STATE FOR TRADE OFFICE MINUTE NO: 1295/82

CONFIDENTIAL

Mr Clarke CAP

PS/PUSS
PS/Secretary
Mr Knighton
Mr Beckett
Mr Blanks CAP
Mr Roberts IAT
Mr Instone CAP1
Mr Garrod Inf

BRITISH AIRWAYS

The Secretary of State saw Sir John King this morning to tell him the outcome of the Prime Minister's meeting to discuss British Airways. The Secretary was also present.

The Secretary of State told Sir John King that it had been decided that legislation to provide for the restructuring of BA's finances could not be introduced before a General Election. A capital reconstruction could not therefore go ahead in the timetable we had originally envisaged. The Secretary of State regretted this but there was nothing to be done.

Sir John King said that it was important to keep up the momentum. As far as he was concerned, British Airways "remained on course". The Secretary of State agreed that the momentum should be sustained. In response to enquiries we should say that we had no immediate plans for legislation. It remained our intention to privatise BA when practicable. The essential framework had already been established in the 1980 Act. Whether further legislation were needed, and if so what it might contain, we were not now in a position to say. British Airways had got themselves into profit, but had yet to establish a track record. We could only take decisions on privatisation and a capital reconstruction on the basis of a more acceptable level of profit. When the figures came through, we would look at the question of a reconstruction. If pressed on how long a track record would be required before we would look at the issue again we should have to say that this depended on market conditions and views of our financial advisers in the circumstances then applying. Sir John King agreed that this was the line to take.

The Secretary of State took the opportunity to raise one or two other matters with Sir John King. On the question of a Chief Executive Sir John said Mr Basil Collins had been "looking into" Mr Marshall. Both Mr Dibbs and Sir John thought Mr Marshall would do very well; though Mr Henderson thought that Mr Marshall might not be tough enough. Notwithstanding this, Sir John hoped to ask Mr Marshall shortly if he would be prepared to take the job of Chief Operations Officer on, were it offered him. He hoped for a favourable response and that it might be possible to get Mr Marshall installed by the beginning of January or February 1983. The Secretary of State said that it was essential to appoint someone with drive to the job.

Sir John also mentioned that British Airways had completed one half of the audit of £100m worth of tickets which had been undertaken to establish the extent of losses through discounting. The audit showed a revenue short-fall of £5m, not as bad as he had feared.

Finally the Secretary of State asked Sir John whether he planned any further pruning of BA's route network. Sir John said 60 odd routes and 64 aircraft had gone already and he had no further specific plans at this stage. He alluded

briefly to BA's discussions about routes with B.Cal and emphasised that any deal would have to show advantages for both parties. It was not clear at the moment what Mr Thomson could offer BA.

John Whitlock

JOHN WHITLOCK
PS/SOS/TRADE
807 V/S
215 5422
10 November 1982

CONFIDENTIAL

SUBJECT

cc Charles

Prefer to make a real gesture. Don't draft it - when you and I will

(PA)

DTI Power of Reference looking at - will be consulted

BA has offered Tinker to be consulted i.e. U.K. Leaseback call consult.

TALK TO JOHN NOTT.

10 DOWNING STREET

9 November 1982

From the Private Secretary

P.M. Can we talk M.
Do not allow
This you behalf too - too in off the interest.

CITY. Stockholm

MANSER - GOOD
FARNHAM SOUND
HISCOX NOT YOUR
WALTER MONSTRUM
N.M.C.

Dear John,

BRITISH AIRWAYS: PRIVATISATION

The Prime Minister held a discussion this afternoon about the matters raised in your Secretary of State's minute to the Prime Minister of 4 November, together with the attached paper. The Chancellor of the Exchequer, the Lord President of the Council, the Chief Secretary, Treasury, Sir Robert Armstrong and Mr. Sparrow were also present.

It was argued that there was a strong case for putting a receiver into British Airways immediately. He would deal with BA's indebtedness, would call the Treasury guarantees, and would sell the business as a going concern. But this course was ruled out by the fact that it could not be followed without legislation. An alternative would be to push ahead as quickly as possible, aiming for privatisation in late 1983 or early 1984, as recommended in paragraph 22 of the paper. This would require legislation, and a cash injection into British Airways in the region of £600 - £750 million. BA were now making an operating profit, and were forecasting a profit next year after payment of interest. The timetable for privatisation in 1983/84 was having, and would continue to have, a very desirable effect in galvanising the Corporation. Postponement of privatisation would all too easily cause BA to slip back into the morass.

Against this, it was argued that such a timetable would cause considerable political difficulties, both with the Opposition, who would criticise the arrangements as being a very poor deal for the taxpayer; and also with BA's private sector competitors, who might reasonably feel (although they were not in fact in direct competition with BA route by route) considerable resentment about BA's debts being forgiven. It was not clear where the balance of advantage lay as between reconstructing BA's balance sheet as soon as possible, so as to give them the possibility of showing reasonable financial results, and postponing any reconstruction, so as to set them the task of repaying some of their indebtedness through their profits. Certainly, to give them no cash injection and to

/ require

require them to repay their debt wholly from profits would entail their remaining in the public sector for many years. Equally, to make an immediate reconstruction, with a very large cash injection, would give entirely the wrong signal. A middle course would be to envisage a cash injection at some stage, after BA had made some progress in themselves reducing their indebtedness; and to limit a cash injection to a sum well below that envisaged in paragraphs 12 to 15 of your Secretary of State's paper - say to £200 million or to such sum as would be compatible with a 3:1 debt/equity ratio. BA would thereafter aim to improve their financial position steadily, so as to enable them to go to the market with a good track record before too long.

The Prime Minister said that it was agreed that we should not contemplate introducing legislation providing authority to restructure BA's accounts this side of the General Election. Both political and economic considerations argued for the adoption of the middle course which had been identified in the discussion, and if legislation could be brought forward very soon after the General Election privatisation should not be put back as far as 1986/87. Much would depend on BA's progress, and on the quality of its management.

I am sending a copy of this letter to the Private Secretaries to those present at this afternoon's meeting. I would be grateful if you and they would ensure that it is seen only by those specifically authorised to do so by your Secretary of State.

Yours sincerely,

Michael Scholar

John Rhodes, Esq.,
Department of Trade.

Ref. A082/0034

PRIME MINISTER

British Airways

BACKGROUND

When the Ministerial Sub-Committee on the Nationalised Industries considered British Airways (BA) in July, they expressed some doubt whether it would be possible to privatise BA as soon as late 1983, but agreed to continue to plan on that basis. They recognised that it would require legislation to permit the reconstruction of BA's capital (E(NI)(82) 6th Meeting, Item 3).

FLAG A

2. The minute of 4 November from the Secretary of State for Trade and the paper attached to it are in accordance with that decision. The Secretary of State favours early privatisation, in late 1983 or early 1984; in order to keep open the option of such a course he recommends the introduction of legislation early in the current Session. He suggests that this might take the form of either a short separate Bill, or an addition to the 1983 Finance Bill or to a Miscellaneous Financial Provisions Bill. When it had been enacted, BA's capital would be reconstructed: between £600 million and £750 million of BA's debts, which are mainly owed to overseas banks, would be discharged by the Government. Directly after the reconstruction BA's business would be vested in a Companies Act Company under the Civil Aviation Act 1980.

3. The Secretary of State also says that it is possible that a condition for privatisation might be that the Government should in some way underwrite the liabilities of BA's existing index-linked pensions scheme. Legislation would be required for such a guarantee. However, the need for a guarantee will not be clear for some months. Immediate legislation would therefore have to be prepared on the assumption that it will not be needed. The Secretary of State implies that this assumption is likely to be correct.

4. The paper is to be discussed by yourself and a small group of Ministers at 5.00 pm on Tuesday 9 November.

MAIN ISSUES

5. The essential issues before Ministers are:

(i) Should legislation as proposed by the Secretary of State for Trade be introduced early in the current Session of Parliament?

(ii) If so, what should it provide?

The answer to the first of these questions will depend largely on the answers to the following:

(iii) What are the prospects for privatisation in late 1983 or early 1984?

(iv) Even if privatisation on such a timescale is feasible, is it prudent?

Prospects for Early Privatisation

6. BA operates in an industry which is currently very badly depressed; it has a record of serious inefficiency and commercial misjudgment; and in 1981-82 it recorded a loss of some £550 million. Investors are bound to look for hard evidence of an improvement before they will buy shares in such a business. It is true that the figures for 1981-82 were heavily influenced by exceptional items (mainly severance payments and a change in depreciation policies). But that is not necessarily a helpful point: on the contrary, commentators in the financial Press have suggested that so much was loaded on to the 1981-82 figures that profit forecasts for the following years will be distorted and give no reliable indication of long-term prospects.

7. Hill Samuel have advised (Annex A to the Secretary of State for Trade's paper) that privatisation in late 1983 by means of a conventional offer for sale is 'highly unlikely'. They suggest that there is a better chance of privatisation in early 1984. But, as the Secretary of State points out, there is the potential complication of the date of the next General Election.

8. A point which you will wish to investigate further is the Secretary of State's suggestion that if privatisation is not achieved by early 1984 it will probably have to be put off until 'much later'. Why should this be so? One would have thought that privatisation in, say, early 1985 should be feasible: the effects of the losses in 1981-82 should be less; and the benefits of the drive to improve efficiency should be more clearly evident.

Prudence

9. Legislation in the 1982-83 Session followed by privatisation in early 1984 would be certain to attract criticism on the following lines:

(a) As the Secretary of State admits, if BA's recovery proves well-founded, the proceeds of sale in late 1984 would probably be substantially higher. If the recovery does not prove well-founded, then either early privatisation will be impossible, or it will be followed by a campaign of complaints from disappointed investors.

(b) The Government will have paid out between £600 million and £750 million of the taxpayers' money in exchange for sale proceeds of £200 to £250 million, plus a half-share in the business, worth the same amount: it will be hard to present that as anything other than a loss of at best £100 million and at worst £350 million. It will be hard to justify paying any premium, let alone such a large one, in order to dispose of a business forecast to make operating profits of £200 million a year.

(c) There will be strong objections from the private airlines, such as British Caledonian. These airlines cannot legitimately complain if there is a capital reconstruction. This is inevitable if privatisation is to take place; and it is really no more than a recogniton of past losses. But they will have a legitimate complaint if the reconstruction is over-generous, since that will leave BA with surplus cash which could be used to subsidise competition against other airlines. The earlier the sale, the more generous the reconstruction will have to be in order to induce private investors to buy shares in a business with a poor track record.

10. The counter-argument advanced by the Secretary of State for Trade is that BA will be an embarrassment to the Government as long as it is in the public sector. It is not entirely clear what this means. If it means that the business of BA will continue to be in difficulties, the Government, as 50 per cent owner and recent seller of shares, would hardly be able to stand aside.

Pensions

11. The Secretary of State for Trade suggests that it is unlikely that the Government would be called upon to underwrite the liabilities of BA's existing pension scheme; and that legislation should proceed on the assumption that it will not be so called. But if the assumption proved to be wrong, the Government would be in great difficulty. If it refused to give some form of comfort or guarantee it might be unable to proceed with privatisation; but to give a guarantee would:

(a) require fresh legislation; and

(b) create difficulties elsewhere: the Government does not, in general, underwrite the pension liabilities of the nationalised industries, still less of private sector organisations.

These are arguments for waiting until the pension situation is clearer next year.

Case for Legislation in the Current Session

12. The matters discussed in paragraphs 6 to 11 above have an obvious bearing on the case for early legislation. The legislation, though short, would certainly be contentious. It would almost certainly have to be the subject of a separate Bill: the Miscellaneous Financial Provisions Bill is to be taken through procedures suitable only for uncontentious matters; and I understand that Parliamentary Counsel has advised that the Finance Bill could not be used. The Lord President will no doubt argue that a Bill should not be added to the existing programme unless it is judged to be of such priority as to displace some other Bill already there. Colleagues will be unwilling to agree that it has such priority unless they are convinced that there is a genuine chance of privatisation by early 1984.

13. A rather different line of argument in the Secretary of State for Trade's paper is that a capital reconstruction would improve morale in BA. It is often suggested that it is undesirable for the management of a nationalised industry to face a prospect of permanent deficit, on the grounds that they will not be sufficiently motivated by the aim of marginally reducing the deficit. But that appears not

to be the situation here: BA are forecasting operating profits of about £200 million a year in real terms, substantially more than interest charges with the present debt structure (£111 million in 1981-82). Again, although legislation to improve motivation may well be desirable, the question is whether it commands sufficient priority to be put into the 1982-83 programme.

Content of Legislation

14. If it is decided that the case for early legislation is not made out, it will not be necessary to discuss the content. If the meeting favours early legislation it will be necessary to consider, in particular, the size of the proposed capital reconstruction. The Secretary of State for Trade seeks discretion, in agreement with the Chief Secretary, Treasury, to decide on a sum between £600 million (to achieve a debt/equity ratio of 50/50, which Hill Samuel advise is the minimum necessary for early privatisation) and £750 million (requested by BA - this would give a ration of 30/70). The transaction does not affect the PSBR, since it replaces debts owed by BA to the banks by debt owed by the Government to holders of gilt-edged stock. But it does transfer to the taxpayer and away from BA's customers the cost of servicing the debt. As noted earlier, write-off of this size would be criticised as being significantly more than the prospective total of sale proceeds and the value of the Government's remaining share in BA's business.

15. Treasury Ministers are likely to argue strongly for much smaller figures, to give a debt/equity ratio of between 85/15 (which would be sufficient to extinguish the existing negative reserve on BA's balance sheet) and 70/30 (which would be in line with the gearing ratio of British Caledonian and some other leading private airlines). Such an approach would almost certainly rule out early privatisation: investors will look for either a much more favourable debt/equity ratio or a longer and better track record. But it could form the basis of a package involving capital reconstruction, and vesting of BA's business in a Companies Act Company in preparation for privatisation at a more appropriate time. This could have political attractions, since it would demonstrate that the Government intended to press ahead with privatisation, but without offering the same scope for criticism of lack of financial prudence. The Treasury consider

that the Government could set up arrangements giving it adequate control of 'British Airways PLC' while it was wholly-owned by the Government. But again, it would be necessary to assess whether the desirability of the package outweighed the difficulties of early legislation.

Machinery for Any Further Consideration

16. Depending on the course of discussion, it may be necessary to involve other Ministers, at least on some aspects. For example, there may be European Community implications, which would need to be discussed with the Foreign and Commonwealth Secretary. If there are serious differences of view at the meeting, the issues may have to be put to E or E(NI).

HANDLING

17. You will wish to ask the Secretary of State for Trade to introduce his paper. The Chancellor of the Exchequer and Chief Secretary, Treasury are both likely to have extensive comments. The Lord President of the Council will advise on the implications for the legislative programme.

CONCLUSIONS

18. You will wish the meeting to reach conclusions on the following:

(i) Should there be legislation in the 1982-83 Session of Parliament as proposed by the Secretary of State for Trade?

(ii) If so, what should it provide regarding:

(a) The size of the proposed capital reconstruction.

(b) The liabilities of BA's existing index-linked pension scheme?

(iii) Should it take the form of a separate Bill, or is there any other vehicle (apart from those suggested by the Secretary of State for Trade, which do not seem suitable) which could be used?

(iv) (Depending on the course of discussion) whether other Ministers need to be consulted.

Approved by
ROBERT ARMSTRONG
and signed in his absence.

8 November 1982

(2)

Prime Minister

Please also see Lord Cockfield's minute and paper (attached) for Tuesday's meeting.

MCS 5/11

CONFIDENTIAL

Qa 06129

To: PRIME MINISTER

From: JOHN SPARROW

5 November 1982

British Airways

1. Lord Cockfield sent me a copy of his letter of 4 November, which we will be discussing on Tuesday. In his letter he proposes an early capital reconstruction of the balance sheet of British Airways (BA) and the vesting of BA in a successor company for flotation at the earliest feasible date.

2. I agree that a capital reconstruction of BA is necessary, simply because its losses have left it under-capitalised. Even without the prospect of privatisation, it would be necessary to correct the present position, as would happen in any comparable private sector company whose owners did not wish to liquidate it. An injection of funds to restore past losses should not therefore lead to serious presentational problems.

3. Restoring the amounts written off in 1981/82 alone would involve about £550m., giving a debt:equity ratio of 55:45, whilst additionally funding the 1980/81 loss would increase the amount to about £700m., giving a debt:equity ratio of 37:63. Just to get back to a going-concern basis, I believe that the former figure would be sufficient, but Lord Cockfield is understandably concerned about the prospect of things then going amiss again before flotation. In considering the higher figure, however, we should remember that the circumstances in which further funding would be necessary (namely, profits below forecast) are precisely those which would lead to the postponement of privatisation until BA was fully fit for sale.

4. Lord Cockfield's paper says, and I agree, that a flotation will be well-nigh impossible if a General Election is still in prospect, and that the proceeds could well be substantially higher in late 1984 than a year earlier.

5. Despite the considerable progress made under Sir John King, BA still has a long way to go before it becomes a commercially sound business; many doubts remain about its ability to achieve enduring profitability. I believe that BA will fetch a reasonable price only after it has achieved an audited record of healthy past profits, perhaps for two years or more; in the absence of such a record the financial market will have little faith in forecasts of future profits, particularly in the current parlous state of the international airline business where forecasting is inherently difficult and particularly in the case of BA which (under previous management) has an unenviable reputation for over-optimistic forecasts. Thus the flotation of BA is unlikely to be a sound business proposition before late-1984.

6. Even that timing must be doubtful. BA forecasts profits for 1983/84, before interest and supplementary depreciation, of around £265m. This figure, which appears to be about 13 per cent of forecast revenue, is an ambitious and perhaps optimistic target; by comparison Delta, one of the most successful US airlines, earned a margin of only 10 per cent in its most successful recent years, when the market was more buoyant than now.

7. Despite the doubts about the timing of privatisation, however, the case for reconstruction before April makes it highly desirable to legislate this Session. BA will then be able to report its financial results for 1982/83 on the basis of a respectable, commercial-looking, balance sheet; and, when we come to a prospectus, will not need to make retrospective adjustments to the figures.

8. There are two other points raised by Lord Cockfield. First, I agree with Hill Samuel's advice that BA's pension liabilities should be clarified and limited as soon as possible. Ministers will need a clear understanding of the burdens that the Airways Pension Scheme may place either on a future privatised company or, possibly, as residual obligation on Government after privatisation, including any effect that these may have on the amount of capital reconstruction required.

9. Finally, BA is not yet in a state when Ministers can afford to release it from the control proper for a nationalised industry in difficulty; it will probably not have reached such a state by next April. I note that

Lord Cockfield intends to retain a measure of control during the period between vesting and privatisation through the successor company's Memorandum and Articles of Association and his power as sole shareholder, but this will need to be sufficient to cover the points listed on the attachment to this minute.

10. I am sending a copy of this to Lord Cockfield and to the other recipients of his letter.

B.

Att

Some BA matters needing Government attention between vesting and privatisation

---

1. Management team: The composition of the Board and the senior executive team needs to be determined soon, so as to give them time to establish a convincing track record in the period leading up to privatisation; ideally this matter should be settled before next April.

2. Financial performance: Ministers will need to set BA demanding but attainable targets and to monitor carefully BA's progress towards them.

3. Size of the business: Even after the reductions announced in BA's latest Financial Plan it is still not evident, at least outside BA, that they will have established a route structure that will generate a stream of future profits that is sufficiently robust to the uncertainties of the airline business. BA's profits appear to be vulnerable to adverse events on a relatively small number of their routes. The Board could be asked to examine whether changes to the route structure, either by cutting back or by exchanges with British Caledonian, might lead to a more secure profit position.

4. Investment: Ministers should retain some measures of control over new investment, particularly in view of BA's previous tendency to over-invest on the basis of optimistic forecasts. Ministers will need to be reassured that the cash surplus that BA will be able to earn after reconstruction does not encourage over-ambitious investment.

5. Pay and Redundancy Agreements: For as long as BA's financial performance remains insecure it would be a sound general principle for the Chairman to consult the Secretary of State before entering into any major new agreements.

6. Corporate Plan: Privatisation should be preceded by the submission of a Corporate Plan to the Secretary of State. Given the scale of the changes being wrought at BA there will, in any event, be a continuing need for the Board to reassess the medium term prospects for the business, taking account of the new split into three operating divisions. This will involve them in assumptions on the key parameters of the business especially those identified in the Price Waterhouse report as needing attention, such as fleet utilisation and labour productivity. A Corporate Plan would also cover in more detail the issues raised in the recent Financial Plan, such as tighter commercial policies and the generation of additional business.

A

PRIME MINISTER

BRITISH AIRWAYS

I understand that you have asked to discuss British Airways in a restricted group rather than in E(NI) as was originally planned.

As a basis for discussion I attach the paper which I was on the point of circulating to E(NI). The paper deals in turn with a number of complex and difficult issues. But it leaves us with a simple choice. Do we keep open the option of privatising BA in late 1983 or early 1984 - if so we must legislate now for a capital reconstruction? Or do we hold back from immediate legislation and thus postpone privatisation until the summer of 1984 at the earliest and probably much later even than that?

Neither course will be popular with our supporters. They will not welcome a further deferment of privatisation. But nor will they relish another "hand-out" to a nationalised industry even if it is to pay for past inefficiencies: in particular, it will be argued that what appears to be generosity to BA is unfair to British Caledonian and other private sector airlines.

The "unfairness" lies simply in the fact that BA will be given £x million to pay off its debts while British Caledonian will receive no such generosity but will have to carry the burden of its debts until it can pay them off itself. This frankly is no more than another aspect of the general problem that nationalised industries have access to an apparently bottomless public purse while private sector companies have to sink or swim by reference to their own efforts.

What British Caledonian really want is to pick up some (no doubt the more profitable) of BA's routes (as for example Adam Thomson proposed in his letter to you of 26 August). This would of course be a simple matter if BA were liquidated, and looked at in this way the "unfairness" of bailing out British Airways is that British Caledonian is being denied this opportunity. But I understand in any case that John King and Adam Thomson have been having confidential discussions about their respective route structures, and as you recognised in your reply of 10 September to Adam Thomson this is clearly the most constructive way to proceed.

[Copies of the correspondence are attached].

BA will continue to embarrass us for as long as it remains in the public sector. That is why, despite the immediate political difficulties, I believe we must legislate quickly for a capital reconstruction. Early reconstruction is the only route to early privatisation. Moreover it is the only way of ensuring that our hands are free to move whenever an opportunity presents itself.

Quite apart from the question of privatisation I believe an early reconstruction is the only way we can consolidate the progress we have made and ensure that henceforth BA is really run as a commercial enterprise.

I hope therefore that you can agree the conclusions at para 22 of the attached paper.

I am copying this minute to Geoffrey Howe, Leon Brittan, John Sparrow and Sir Robert Armstrong.

Arthur Cockfield

LORD COCKFIELD

Department of Trade
4 November 1982

Aerospace: Future & Structure
of British Airways
March '82

BRITISH AIRWAYS: PRIVATISATION AND CAPITAL RECONSTRUCTION

INTRODUCTION

1 At a meeting of E(NI) on 26 July (E(NI)(82)6th meeting), the Sub-Committee endorsed the general strategy proposed by British Airways' (BA) Corporate Plan (subject to certain qualifications). The meeting also agreed that we should continue to plan for the privatisation of BA in late 1983 (though this would be difficult), recognising that before privatisation could take place legislation would be needed for a capital reconstruction.

2 In this note I report on:-

(a) BA's current financial position and immediate prospects;

(b) BA's latest financial plan;

(c) the current prospects for privatisation; and

(d) the need for a capital reconstruction, and for legislation to achieve it.

BRITISH AIRWAYS' FINANCIAL POSITION

3 BA's 1981/82 accounts, which have just been published, show a Group loss of £550m. But the bulk of this (£426m) reflects non-recurring items - the cost of severance payments and more prudent depreciation policies. If they were not charged in the 1981/82 accounts, then future years' results would only look worse. Interest charges amounted to £111m and there was in fact a small operating profit (after normal depreciation) of £13m.

4 The underlying trading position, however, continues to improve. The 1981/82 operating profit of £13m before interest compares with an operating loss in 1980/81 of nearly £100m. For the present financial year BA are forecasting an operating profit of about £170m (which they are on track for achieving), a very considerable improvement.

BA'S NEW FINANCIAL PLAN

5 I have now received from BA a new financial plan for the next five years, which reflects improvements on the Corporate Plan which the Sub-Committee considered in July. At that meeting, I commented on the desirability of BA securing further reductions in manpower levels, in unprofitable routes, and in uncommitted investment in the later years of the Plan. The plan now reflects BA's new manpower target of achieving a reduction to 35,000 by next March. This compares with a figure of 58,000 in 1979, a reduction of nearly 40%. It reflects BA's recent decision to withdraw from a further nineteen unprofitable routes. BA argue that further reductions in manpower or routes are impracticable immediately, but they will be keeping the situation under review. Capital investment at the end of the planning period, too, now shows a substantial reduction.

6 The key feature of the plan is a target of profits before deducting interest of around £200m per year from 1983 onwards. This figure is struck after charging £85m supplementary depreciation based on replacement costs. If these profits can be achieved they would represent a remarkable improvement. Annex B shows BA's forecasts as given in their Plan.

7 If we privatised BA in late 1983, it would therefore be on the basis - according to present estimates - of the following profits before interest and after historic (but not supplementary) depreciation:-

(a) for 1982/83, profits of about £170m (these results would be available in June 1983);

(b) for the first four months of 1983/84 profits of perhaps about £100m (this is an unduly short period but it is specified by Hill Samuel as a minimum);

(c) for 1983/84 as a whole, forecast profits of around £265m.

PROSPECTS FOR PRIVATISATION

8 I have obtained advice from Hill Samuel on whether BA's present position - and these forecasts - provide an adequate basis for privatisation within the timescale we have in mind. At Annex A I attach a copy of their conclusions, the most important of which are as follows:

(a) A flotation in late 1983 is unlikely to succeed, though it cannot absolutely be ruled out. A flotation in the first part of 1984 stands a somewhat greater chance of success, though even this depends on everything going well. However, a flotation will be well nigh impossible, if a General Election is still in prospect, because of the effect this would have on the market.

(b) A capital reconstruction is essential before privatisation and should take place by the end of March 1983 if possible. (Hill Samuel assume its cost at around £500-£700m.) Hill Samuel strongly favour this on grounds of propriety, commercial discipline and morale, even if the prospects for privatisation remain uncertain.

(c) Hill Samuel strongly favour the conversion of BA into a Government-owned limited company at the same time. This would clear the way for privatisation as soon as BA was ready.

(d) Hill Samuel regard it as impossible to forecast the proceeds of privatisation with any certainty, but they estimate a market capitalisation of around £450m (so that in theory the sale of about 50% of BA - the proportion we have envisaged - would bring in about £200-£250m). They suggest that, if BA's recovery

proves well-founded, the proceeds could well be substantially higher in late 1984 than a year earlier.

(e) BA's pension liabilities should be clarified and limited as soon as possible.

9 I see no reason to disagree with this advice. It means that we are now most unlikely to achieve a flotation before the next Election; but, if the Election were out of the way, we might still just be able to privatise BA in late 1983 or, more plausibly, early 1984. However, since we should probably get a better price by delaying privatisation for a further year or so after that, privatisation in late 1983 is unlikely to be justifiable on purely economic grounds: it would be a political decision.

CAPITAL RECONSTRUCTION

10 The situation which now exists is largely a product of the decision taken many years ago that BA should be financed largely by loans from commercial banks, guaranteed by Government, instead of by direct advances from Government itself.

11 As the Sub-Committee has already noted at its July meeting, we cannot privatise BA without a capital reconstruction. There is also a strong case - recognised by Hill Samuel - for a capital reconstruction quite irrespective of the case for privatisation. BA's debt:equity ratio has deteriorated so far that their liabilities now substantially exceed their assets. No company in the private sector could continue trading with such a capital structure; and BA's interest burden is now so heavy that it threatens to damage the management's motivation further to improve operating efficiency. Moreover, an early capital reconstruction could improve the prospects of privatisation whenever privatisation occurs as it will enable BA to demonstrate better profits in their published accounts over a longer period.

12 The best way of achieving a reconstruction is to provide a cash injection into BA, which BA would then use to pay off its debts to private banks; the cash would be provided by a combination of direct grant (to wipe out the negative reserves) and an injection of public dividend capital (pdc) (as an element of new "equity" investment by the Government). As part of the package, BA's relatively small borrowings from the National Loans Fund (NLF) could be written off. Although such a capital reconstruction would involve a significant cash outlay by the Government, the effect on the public sector borrowing requirement (PSBR) would be neutral, since the cash injection would be offset by an equal reduction in BA's indebtedness. But it could be said to involve a substantial subsidy because the taxpayer would be relieving BA of much of its debt servicing obligations.

AMOUNT OF RECONSTRUCTION

13 BA are seeking a capital reconstruction costing £750m. This would give them a debt:equity ratio at the end of March 1983 (on the basis of BA's current profit forecasts) of 30:70. Hill Samuel advise that BA could not be privatised with a debt:equity ratio less favourable than 50:50. To achieve this on 31 March 1983 would - again on the basis of BA's forecasts - cost

about £600m. But it is possible that, between now and privatisation, BA will achieve profits which, though adequate for a flotation, are below forecast levels. In that event, £600m may not be enough to achieve and maintain a 50:50 debt:equity ratio, and a larger sum might be needed. I therefore think it essential that in proposing to Parliament soon a figure for a reconstruction we go for a figure above £600m (but not more than the £750m BA have asked for).

14 It is clearly essential we should be able to justify the reconstruction, to the independent airlines and others, as not over-generous. But it is obviously also essential that the reconstruction should be big enough to give a good prospect of a successful flotation. It would be disastrous to have to reconstruct a second time through being too hesitant now. I suggest therefore that the figure for which we seek Parliament's approval should be expressed as a maximum, the actual amount to depend on BA's position when the reconstruction is effected, with a reasonable safety margin.

15 If colleagues accept the principle, I would aim to agree separately with the Chief Secretary within the next two or three weeks the maximum figure (within the range of £600m-£750m) for which we should go to Parliament (this without prejudice to the amount we eventually decide to inject). I am also prepared to discuss with the Chief Secretary and Hill Samuel other ways of guarding against accusations of over-generosity (eg a mechanism for reconverting some of BA's equity into Government loans immediately before privatisation, should events by then have shown the reconstruction to be too large; and a cancellation of BA's tax losses commensurate with the size of the reconstruction).

THE NEED FOR LEGISLATION

16 Legally the required payment to British Airways could be made without new specific legislation. However the Treasury takes the view that Parliamentary propriety requires specific legislative backing for such a large payment and for such a purpose.

17 It would take us a further step towards privatisation and help attitudes within the airline if, once a capital reconstruction had been effected, we were to vest BA into a limited company. My powers in the British Airways Board Act 1977 automatically lapse on vesting, and I shall need to be sure I retain adequate control over BA plc while it remains wholly Government-owned. Having taken legal advice I am satisfied that I can exercise sufficient control between vesting and privatisation through the successor company's memorandum and articles of association and my power as sole shareholder.

18 One other item might require legislation. The British Airways Pension Scheme (APS) is index-linked; and it is conceivable that BA would not be saleable unless it were completely discontinued. BA have just announced they are considering its closure to new entrants, but it remains to be seen if this will go far enough. BA are proposing to seek a declaratory judgement on the extent of their liability to the APS in the event of complete discontinuance. If (contrary to expectations) the judgement were to make BA liable for very large

sums in the event of complete discontinuance Hill Samuel might advise that privatisation could not proceed unless the Government were to give BA some comfort or guarantee in respect of the pensions liabilities. If such a guarantee were to be necessary I should need a statutory power; but I shall not know till sometime next year whether such a provision would be necessary. If we decide to go ahead immediately with legislation, we must therefore do so on the assumption that this special provision will not be necessary.

19 We need, then, legislation providing authority to pay to BA sums up to a specified maximum amount in public dividend capital or grant, together with authority to write off BA's NLF loans within this maximum. I realise that this puts us in a difficult position, because of the problem of securing Parliamentary time for the passage, desirably by the end of next March, of what will be a short but controversial Bill. But unless we can secure the necessary legislation for a capital reconstruction, there is no hope of privatising BA before the second half of 1984 and probably much later.

20 If colleagues see no room for a separate Bill this Session, then we should consider using the 1983 Finance Bill or a suitable piece of general legislation (eg the miscellaneous financial provisions Bill that I understand the Treasury are hoping to introduce in the new Session). I appreciate the difficulty of encumbering Treasury legislation with additional controversial clauses and I well understand Treasury objections to this course. Nevertheless this appears the only other way of keeping our options open for privatisation this Parliament.

EUROPEAN COMMUNITY IMPLICATIONS

21 We should need to clear the proposals with the European Community,though they are unlikely to object.

CONCLUSIONS

22 If we are to keep open the option of privatising British Airways in late 1983 or early 1984, we must reconstruct BA's balance sheet, and for that we need legislation. Even if we do not consider privatisation likely within this timescale, there are still persuasive grounds, supported by Hill Samuel, for an early reconstruction of BA's capital. I therefore invite my colleagues to agree:-

(i) to a capital reconstruction of BA, as proposed in paragraphs 12-15 above;

(ii) to the vesting of BA in the successor company under the Civil Aviation Act 1980 directly after the reconstruction (paragraph 17);

(iii) to the introduction of legislation in the new Session to this end containing the provisions described in paragraph 19, either:-

(a) in a separate Bill for introduction as early as possible in the Session; or

(b) failing that, in the 1983 Finance Bill or a suitable miscellaneous financial provisions Bill; and

(iv) to the employment of Parliamentary Counsel for the urgent drafting of clauses for (iii)(a) or (b) above.

CONCLUSIONS OF HILL SAMUEL'S MEMORANDUM OF 13 OCTOBER 1982 ON PROSPECTS FOR PRIVATISATION OF BRITISH AIRWAYS IN LATE 1983

ANNEX A

CONCLUSIONS

1. The possibility of privatisation by the end of 1983

(a) We believe it is highly unlikely that privatisation of BA will be achievable in late 1983 in the form of a conventional and successful offer for sale to the public of a controlling interest. The current management has undoubtedly taken positive and vigorous action to restore BA's immediate profitability and to re-establish it as a viable business in the longer term. However, the effects of this action are only now beginning to be felt. We think it most improbable that those involved (HMG, BA and their advisers) will by the end of 1983 believe that BA's recovery is sufficiently well established to consider it responsible to issue a prospectus to the public. On an important point of detail, we doubt whether those involved would feel able to put their names to the necessary forecast of profits for the financial year to 31st March, 1984.

(b) However, on the latter point of forecasting, we believe it far more likely that a proper public forecast of profits for the year to 31st March, 1984 could be made in early 1984. By this time interim results for the six months to September, 1983 would be available, and there would be some experience of the traditionally weaker winter months.

(c) We believe it possible but not likely, if circumstances are particularly favourable, to achieve privatisation by the end of 1983 in an unconventional form, involving the sale of shares mainly to investment institutions, who would be

sufficiently sophisticated to make their own assessment of the potential and the risks involved in BA's business, and with perhaps some limited offer to the public.

The circumstances we are envisaging are those in which there was a "good story" to tell the investors about BA's recovery and prospects, albeit with a degree of confidence falling short of that needed to make a conventional offer for sale to the public.

2. Action required between now and the end of 1983

In order to keep open the possibility, however slight, of privatisation by the end of 1983, and, in any event, to optimise the prospects for successful privatisation as soon as practicable the following action is required:-

(a) For the reasons given in our letter of 13th September, 1983, legislation should be brought forward to reconstruct the balance sheet of BA and vest its business in the successor company by the earliest practicable date, namely 1st April, 1983. We believe that the commercial and financial arguments for the capital reconstruction are overwhelming. New capital is, in reality, needed to replace losses already incurred. It is clearly unsatisfactory for a major nationalised industry to continue in a state of quasi-insolvency. Finally, a decision to delay the reconstruction implies an indefinite deferment of privatisation, and the effect of this on the internal morale at BA would, in our view, be very damaging to the airline's prospects for continued recovery.

(b) We have already raised a number of important commercial, managerial and financial matters. An action plan requires to be formulated to address these matters. All of the areas identified will need to be substantially resolved if privatisation is to take place.

(c) We have, in this report, dealt separately with BA's pension arrangements, in view of their importance and the specific reference to them in your letter of instruction.

3. The proceeds of privatisation in late 1983

It will be clear from what we have already said that we would at this time regard such a calculation as an artificial exercise in view of the enormous uncertainties involved. As a matter of investment arithmetic, the valuation placed on BA in an issue in late 1983 would be based on its profit forecast for the year to 31st March, 1984 and this is a figure that has not yet been estimated by BA. In the circumstances we can only give a theoretical indication of the market capitalisation of BA if its shares were already listed and held by the public.

Assuming BA achieves its forecast for the current year to 31st March, 1983 of profits before tax of £160 million (ignoring supplementary depreciation, and after adjusting for notional interest savings arising from the £750 million capital reconstruction proposed by BA), we would expect a theoretical market capitalisation of around £450 million. This would represent, on the above assumptions, a fully taxed historical price earnings multiple of around 6, and a fully taxed prospective multiple of BA's "annualised" projection for 1983/84 of 3.4. This market capitalisation would compare with net tangible assets at 31st March, 1983, on the same assumptions, of £567 million.

4. Next General Election

In our view (and ignoring election considerations, as you have asked us initially to do) privatisation by the end of 1983 is highly unlikely; if the envisaged highly favourable combination of circumstances existed, the decision to proceed would, necessarily, still be very finely balanced, in terms of the then state of BA and the airline industry generally. This would be readily apparent to potential investors. Any additional external uncertainty, such as the imminence of a general election would almost certainly prove fatal. General adverse comment on possible political reasons for premature flotation, coupled with the direct attacks from opponents of privatisation (witness the Britoil affair) would draw attention to the past problems of BA and the short lived nature of its turn around. The opposition, or factions within it, would no doubt pledge immediate re-nationalisation. All in all, against the background of an imminent election the investment climate would almost certainly be poisoned against participating in any conventional issue, if it were otherwise possible.

In our view the impending election is another reason to delay privatisation beyond 1983. If BA's recovery proves to be well-founded, the potential proceeds from privatisation, if delayed by a further year, (i.e. after the general election) could be substantially higher.

5. Amount of Capital Reconstruction

In our memorandum dated 14th July, 1982 our estimate of the required capital reconstruction was in the range of £500 million to £700 million.

This estimate was, of course, based on the then available information. We have had insufficient time to discuss with BA or the Department the implications of the draft

1981/82 Accounts of BA, or the "BAB Financial Plan 1983/87" dated 30th September, 1982. In the circumstances, we have no evidence which would lead us to alter our earlier estimate. We have noted BA's own proposal that its borrowings should be reduced by £750 million, and that its forecasts are based on this assumption. In the circumstances, we have in this report used (but not accepted) BA's projections, although the sum proposed by BA is slightly above the upper end of the range indicated by us.

As we have previously indicated, there may be methods to structure the capital reconstruction so as to improve the potential return to HMG from the funds committed to reconstruct BA's balance sheet. These would take the form of (i) ensuring some flexibility in the initial arrangements so that any surplus over the requirement at the time of privatisation can be returned to HMG and (ii) devising a capital structure at the time of privatisation which permitted the sale of voting control but maximised the prospects for HMG to obtain a return from its initial capital injection. We should be pleased to examine these possibilities in detail in due course in conjunction with the detailed discussions which will be necessary in connection with the capital reconstruction/vesting process.

6. Airways Pension Scheme ("APS")

There is at present conflicting actuarial and legal advice as to the precise nature of BA's financial commitment to the APS. The September 1982 triennial valuation of the APS will not be available until March 1983. In addition, we understand that BA is proposing to (i) introduce a new pension scheme for new employees with lower contributions than the existing Scheme and reduced (but acceptable by private sector standards) benefits, in

particular in relation to limited indexation, (ii) close the existing Scheme to new entrants, and (iii) offer members of the existing Scheme the opportunity to transfer to the new scheme.

In the circumstances, it is clearly impossible to express any precise view over the degree of comfort, if any, which would be required from the Government in respect of BA's pension obligations at the time of privatisation.

We think it unlikely, however, that any cash injection would be required; some form of long-stop guarantee in relation to BA's obligations towards the APS cannot be ruled out.

In order to advance matters we recommend, as a matter of urgency, that:-

(i) An authoritative view of BA's obligations towards the APS in the event of discontinuance be sought. Counsel have indicated that a declaratory judgement from the Courts might be obtainable.

(ii) The new pension scheme should be developed and introduced as soon as is, in the view of the Board of BA, practicable.

(iii) The September 1982 actuarial valuation of the APS should be progressed with all speed.

ANNEX B

CASH PROJECTIONS

Plan A		83/4 £m	84/5 £m	85/6 £m	86/7 £m	Total £m
1)	Operating result	180	230	230	230	870
2)	Interest on capital borrowings	(30)	(30)	(28)	(25)	(113)
3)		150	200	202	205	757
4)	Interest on new cash	–	18	30	34	82
5)	Result before tax	150	218	232	239	839
6)	Corporation and overseas tax	(75)	(109)	(116)	(120)	(420)
7)	Available for dividend	75	109	116	119	419
8)	Dividend payable	(50)	(50)	(50)	(50)	(200)
9)	Transfer to revenue reserves	25	59	66	69	219
10)	HC + supp. depreciation	200	200	200	200	800
11)	Book value of disposals	15	–	14	–	29
12)	Timing of dividend & tax payments	125	34	7	4	170
13)	Internal funds available	365	293	287	273	1,218
14)	Loan repayments	(35)	(40)	(40)	(40)	(155)
15)	Capital expenditure	(185)	(160)	(213)	(250)	(808)
16)		145	93	34	(17)	255
17)	Eximbank loans drawn down	40	18	12	–	70
18)	New cash generated (required)	185	111	46	(17)	325

Plan B						
1)	Operating result	180	230	230	230	870
2)	Interest on capital borrowings	(30)	(30)	(28)	(25)	(113)
3)		150	200	202	205	757
4)	Interest on new cash	–	20	24	22	66
5)	Result before tax	150	220	226	227	823
6)	Corporation and overseas tax	(75)	(110)	(113)	(114)	(412)
7)	Available for dividend	75	110	113	113	411
8)	Dividend payable	(50)	(50)	(50)	(50)	(200)
9)	Transfer to revenue reserves	25	60	63	63	211
10)	HC + supp. depreciation	200	200	200	200	800
11)	Book value of disposals	40	–	–	–	40
12)	Timing of dividend & tax payments	125	35	3	1	164
13)	Internal funds available	390	295	266	264	1,215
14)	Loan repayments	(35)	(40)	(40)	(40)	(155)
15)	Capital expenditure	(199)	(234)	(258)	(126)	(817)
16)		156	21	(32)	98	243
17)	Eximbank loans drawn down	40	18	12	–	70
18).	New cash generated (required)	196	39	(20)	98	313

Note: This and the following page show BA's current (October 1982) profit and balance sheet projections. The figures are in constant prices and assume unchanged operating profits in real terms, once BA's current measures to improve profitability are complete. The difference between PlanA and Plan B reflects different assumptions about whether BA will obtain exemption from noise regulations due to come into force in 1986 and over the timing of certain aircraft disposals. The figures also reflect BA's proposal for a capital reconstruction to give them a 30:70 debt:equity ratio by 31 March 1983.

BALANCE SHEET PROJECTIONS

Plan A

	At 31 March	1983 £m	1984 £m	1985 £m	1986 £m	1987 £m
	Net Assets					
1)	Fixed assets & investments	964	1,019	1,064	1,148	1,283
2)	Cash at bank		185	296	342	325
3)	Dividends & tax payable		(125)	(159)	(166)	(170)
4)	Net current liabilities	(144)	(144)	(144)	(144)	(144)
5)		820	935	1,057	1,180	1,294
	Financed by					
6)	Share capital & reserves	482	507	566	632	701
7)	Replacement reserves	85	170	255	340	425
8)	Capital borrowings	250	255	233	205	165
9)	Minorities	3	3	3	3	3
10)		820	935	1,057	1,180	1,294
11)	Debt:Equity ratio	30:70	27:73	22:78	17:83	13:87

Plan B

	Net Assets					
1)	Fixed assets & investments	964	1,008	1,127	1,270	1,281
2)	Cash at bank	-	196	235	215	313
3)	Dividends & tax payable	-	(125)	(160)	(163)	(164)
4)	Net current liabilities	(144)	(144)	(144)	(144)	(144)
5)		820	935	1,058	1,178	1,286
	Financed by					
6)	Share capital & reserves	482	507	567	630	693
7)	Replacement reserves	85	170	255	340	425
8)	Capital borrowings	250	255	233	205	165
9)	Minorities	3	3	3	3	3
10)		820	935	1,058	1,178	1,286
11)	Debt:Equity ratio	30:70	27:73	22:78	17:83	13:87

CONFIDENTIAL

SLO,

bcc J Vereker

Aerospace

10 DOWNING STREET

From the Private Secretary

3 November, 1982

British Airways: Privatisation

As I mentioned to you earlier today, the Prime Minister has decided that the consideration of British Airways' privatisation should take place not in E(NI) but in a smaller group which she will chair. Arrangements have been made today to set up such a meeting.

The Prime Minister is concerned about the proposal for a capital restructuring of British Airways. She has commented that there will be serious implications for British Caledonian and that she hopes that your Secretary of State's paper for the meeting will take full account of this.

I am sending a copy of this letter to Margaret O'Mara (H.M. Treasury), John Gieve (Chief Secretary's Office), Richard Hatfield (Cabinet Office) and Gerry Spence (Central Policy Review Staff).

M. C. SCHOLAR

John Whitlock, Esq.,
Department of Trade

CONFIDENTIAL

HL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

c/c IV

010

Prime Minister (2)

MCS 1/11

CONFIDENTIAL

From the Secretary of State

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

November 1982

Dear Geoffrey,

PRIVATISATION

My colleagues and I have carried out a thorough review of my Department's activities to see what can be transferred to the private sector. I have also reviewed the possibility of abandoning some activities altogether.

I see scope for substantial advance in three areas: British Airways; airports; and export credit insurance.

We have already agreed to privatise British Airways and announced our decision. Enabling legislation - the Civil Aviation Act 1980 - has been passed; I shall shortly put proposals to E(NI) on the necessary capital restructuring, which would require a short Bill; we shall then have to take decisions on the timing of flotation.

I am very concerned about this and its effect on B. Col

MT

On airports, our objective is clear: to minimise Government involvement in their ownership and operation.

I aim to dispose of some or all of the Civil Aviation Authority's aerodromes in the Highlands and Islands of Scotland (with a continuing Scottish Office grant) to the airlines who use them. One or two disposals of this kind may be possible before the Election.

CONFIDENTIAL

From the Secretary of State

We have agreed that we cannot privatise the British Airports Authority's airports in the short-term because of the uncertainties arising from the current litigation by airlines and, to a lesser extent, the public inquiries into the expansion of the South East airports. But we are actively investigating the scope for introducing private sector finance into the Authority's investment programme, starting in this Parliament.

The Authority's airports are, however, clear candidates for privatisation in the next Parliament. This will raise a series of problems, which we have already started to work our way through. We are also looking at the future ownership of local authority airports in connection with Michael Heseltine's exercise on the metropolitan authorities, and considering whether local government should be in the airport business at all.

ECGD provides, in the field of export credits, an insurance and financing service. Although the latter is now largely privatised in the sense of the banks serving exporters with all the funds needed (other than interest rate subsidy) under simple ECGD guarantees, the private sector has developed very little in the way of competitive or supplementary export insurance facilities. Governments cannot escape involvement in the political risks of such insurance; but there should be scope for devolving some of ECGD's operations on the United Kingdom private sector. Also, in contrast to independent enquiries in the mid-50s and early-70s, an E & AD Departmental "efficiency audit" favours ECGD changing from Departmental to public corporation status. These findings are due to come before the PAC shortly. A recently-published CBI report has made similar recommendations.

We shall therefore be undertaking a fundamental review of ECGD's future organisation and functions, which will cover the scope for privatisation. But if substantive changes appeared possible legislation would be needed and implementation would then have to be left to the next Parliament.

From the Secretary of State

In addition to these three major areas, our review has identified several other functions which might be discontinued or substantially devolved to the private sector. Individually they are minor - even very minor - variants on the privatisation theme, whether judged in terms of staff or of expenditure, but collectively they offer promise of a useful slimming down of the scope of the Department's activities. The areas where I am looking for progress, in most cases starting in this Parliament, are:-

- discontinuing film industry controls as rapidly as political considerations allow;

- further reducing our involvement in seamen's conditions of service;

- further devolvement of ship surveys and marine equipment approval to classification societies;

- further devolvement of the actual setting and conduct of seafarers' examinations;

- devolving from the Companies Registration Office the issue of copies of company documents after they have been registered;

- devolving from the Patent Office the publication and distribution of patent specifications;

- devolving to private sector bodies (eg Chambers of Commerce) the administration of the British Overseas Trade Board's Outward Mission Scheme, which organises overseas visits for groups of businessmen to seek export opportunities; and

From the Secretary of State

- an expansion of the revenue earning activities of the Simplification of Trade Procedures Board (SITPRO) leading, perhaps three years hence, to its conversion to a private sector body operating on an essentially commercial basis.

I would take this opportunity to mention one other possible candidate for privatisation, namely the Meteorological Office. This falls within John Nott's responsibility but the industries for which I am responsible pay a substantial part of the cost. The industry's principal representative body, the British Civil Aviation Standing Conference (BCASC), has suggested that some or all of the Met Office's activities could be transferred to the private sector. BCASC believe that market pressures would increase the Met Office's cost-effectiveness and accountability to its customers. I have written to John Nott expressing the hope that as the Minister responsible he will take the same view.

I am sending a copy of this letter to the Prime Minister, to the other members of E(DL), to John Nott and George Younger, and to Sir Robert Armstrong.

Yours,

Arthur.

LORD COCKFIELD

Aerospace

file

PERSONAL

da

10 DOWNING STREET

From the Private Secretary

28 October 1982

Dear John,

I enclose a copy of an exchange of personal correspondence between the Prime Minister and Lord McFadzean of Kelvinside about British Airways.

I would be grateful if you would ensure that this is not circulated outside your Private Office.

Yours ever,

Michael

John Rhodes, Esq.,
Department of Trade.

PERSONAL

da

file

JR

10 DOWNING STREET

THE PRIME MINISTER

28 October 1982

PERSONAL

Dear Frank,

I found the paper attached to your letter very illuminating, and I am grateful to you for the work which you put into it.

It is, I am afraid, inevitable when things have gone as wrong as they have at British Airways that there are accusations and counter-accusations about where the blame lies. Our efforts must go into putting matters right at BA: with a loss last year of £545 million and liabilities currently exceeding assets that will be a huge task.

Yours ever

Margaret

Lord McFadzean of Kelvinside

da

10 DOWNING STREET

CP/PM send

Prime Minister

Should a copy of this go to Lord Lockfield — marked personal?

MCS 27/10

Yes — thank you and.

LORD MCFADZEAN OF KELVINSIDE

65 BUCKINGHAM GATE
LONDON SWIE 6AT
01-222 9020

PERSONAL

R23

Yes - we shall need to handle it carefully - but he has made considerable allowances for what he will be publicly put

22nd October 1982.

#2

Prime Minister

Shall I draft a reply saying you take his point, but the fact remains that BA lost £54 5m last year and their liabilities exceed their assets?

MCS 26/10

Dear Margaret,

I do not want to enter into public controversy over British Airways but if the indiscriminate, counter productive, mud slinging against the career staff continues, someone will have to redress the balance. The attached note brings out just a few of the points.

Too many people are behaving as if they had been pre-conditioned by some naive economic Pavlov. Government owned - bloated, incompetent, mismanaged, stupid, shortsighted; private sector - lean, well managed, entrepreneurial, thoughtful, far seeing. The division hardly accords with the facts.

Yours ever,

Frank.

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
LONDON SW1.

Encl:

B R I T I S H A I R W A Y S

Fleet

British Airways entered the second half of the seventies with the most complex fleet of any major airline. It had 12 basic types of aircraft against 3 for Pan American and 5 for T.W.A.; it had 8 engine types against 3 for Pan American and 5 for T.W.A. Result for British Airways was more inflexibility in the use of crews, higher training expense, more working capital tied up in spares, and so forth. Because of an unstable inter face between Government and British Airways over the years it was not possible to pin-point responsibility for the state of affairs. Aware of this, the Prime Minister - Mr. Callaghan - agreed in 1978 that the Board should be permitted to order the aircraft which, in its judgment, were the best suited to its route structure. It was decided to rationalise the fleet on four main types - the 747, the Tri-star, the 757 and the 737. This of course takes time - the first 757 is not due for delivery until 1982/83.

Manning Levels

Since airlines conduct their operations in widely different fashions calculations of relative efficiency are difficult. To achieve a comparable basis British Airways and a selection of American and Continental airlines submitted data to a leading management consultant. The final report showed that per 10m. available ton miles British Airways employed 142 people, the European airlines 115 and the North American carriers 71. However, when wage and salary differentials were taken into account, British Airways personnel costs per available ton mile were the lowest at 12.6 cents against 12.9 for the Americans and 18.4 for the Europeans. In other words, the overmanning of British Airways was more than offset by the low wages. In this respect British Airways was little different from the rest of the economy, including the private sector.

The overmanned areas were identified - approximately 80% of the problem was in flight operations, engineering and ground handling - and detailed targets were worked out by British Airways management services personnel, with all the divisional heads involved. At that particular stage return on net assets was 12.4%. In common with the rest of the industry, the forward projections were quite optimistic with British Airways expecting to double traffic in eight years. The staff were informed that the Company objective "of achieving levels "of staff productivity at least equal to the average of other "leading European and North American Carriers can, in general,

.../...

"be realised over a reasonable period of time through natural
"wastage and retirement on two main provisos:

" (i) Revenue and output targets are achieved which,
" in turn, are heavily dependant on providing a
" reliable high performance service; and

"(ii) The Unions and men cooperate with management
" in the introduction of new working methods.
" This will involve re-negotiation of agreements
" and a more flexible approach to restrictive
" practices, rostering and automation.

"There may nevertheless be a few areas where these measures
"will not of themselves suffice to raise productivity to the
"required levels. Plans are being drawn up for re-training,
"re-deployment and voluntary retirement schemes."

Three years, one oil crisis, two major swings in the exchange value of sterling, and an economic depression later, British Airways has had to adjust its sights. It would be fair to criticise the management for not foreseeing these events (who did?) but to give the impression that the long-serving employees of British Airways were unaware of the overmanning problems is not correct.

Finance and Accounts

British Airways had an accounting system which produced monthly management figures against budget and previous year, quarterly accounts and annual accounts all in the time span normal for a well run company. Since broadly the same people were responsible post-1978, it is difficult to see how the performance could have deteriorated to the extent that various public pronouncements would lead one to believe.

20th October 1982.

CONFIDENTIAL

FILE SW

10 DOWNING STREET

From the Private Secretary

14 October, 1982

British Airways' Financial Position

Thank you for your minute of 12 October.

The Prime Minister found this helpful in reaching her decision, recorded in my letter to John Whitlock of today's date, about the comfort letter to British Airways.

M. C. SCHOLAR

John Sparrow, Esq.

CONFIDENTIAL

CONFIDENTIAL

FILE JW

10 DOWNING STREET

From the Private Secretary

14 October, 1982

British Airways

Many thanks for your letter of 12 October.

As I told you on the telephone this afternoon, the Prime Minister now agrees, in the light of the Chief Secretary's letter of 13 October to your Secretary of State, to the issuance of the letter of comfort on the lines suggested in your Secretary of State's earlier minute, and on the conditions which have now been agreed.

I am sending a copy of this letter to John Gieve (Chief Secretary's Office) and Richard Hatfield (Cabinet Office).

M. C. SCHOLAR

John Whitlock, Esq.,
Department of Trade

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

Prime Minister (2)

MCS 14/10

CONFIDENTIAL

From the Secretary of State

Rt Hon Leon Brittan
Chief Secretary
H M Treasury
Treasury Chambers
Parliament Street
London SWI 3AG

14 October 1982

Dear Leon,

BRITISH AIRWAYS: 1981/82 ACCOUNTS

Thank you for your letter of 13 October. – TPM

You will be pleased to know that I have now prevailed upon Sir John King to leave out of the accounts the special provision of £50m for the effect of the redundancies on the pension scheme. I have accordingly now sent Sir John a letter of comfort on the lines agreed. British Airways will now proceed with publication of the accounts on the planned date, 19 (not 18) October.

As you say, we shall now have to decide in E(NI) which way we are to go over British Airways – and, in particular, whether we should keep open the option of privatising the airline in late 1983 or soon thereafter. I shall circulate a paper shortly.

I note what you say about our public line over the accounts and about British Airways' future borrowings.

I am sending a copy of this letter to the Prime Minister and Sir Robert Armstrong.

Yours,
Arthur

LORD COCKFIELD

cc JV

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon The Lord Cockfield
Secretary of State
Department of Trade
1 Victoria Street
London SW1H OET

13 October 1982

Dear Secretary of State

BRITISH AIRWAYS

Thank you for your letter of 6 October responding to mine of 10 September and that from the Prime Minister's office of 6 September. I have now also seen the Prime Minister's further comments of 11 October.

The publication of BA's accounts has now become very urgent. One American lender has already given notice of default (expiring 27 October) and other lenders have acquiesced in the delay in publishing the accounts following written advice from BA that they would be published in early October. Advising of further delay would cause concern amongst BA's creditors and if publication if not attained by mid-October it would be open to any lender to give notice of immediate default which taken with the various cross default clauses in the loan agreements could require the Treasury to make immediate repayment of a large proportion of BA's foreign debt.

It could be argued that given the existence of the Treasury guarantee on all these loans such precipitous action is unlikely. However, the consequences should it occur are so serious that neither the Treasury nor the Bank of England would wish to take the risk. The accounts should therefore be published no later than 18 October and the rest of this letter is written on that assumption.

I will not dwell on the remarks in your second paragraph except to note that I am quoted out of context. You may also be interested to know that since March 1979 BSC have cut numbers by 44% and will have cut them substantially more by the end of this financial year.

Of course I accept that Sir John King cannot be held responsible for the appalling inheritance he took over in 1981. But I must make two points. First, any business must be expected to recoup

its losses. The request for a massive capital reconstruction is an admission of failure and is much more than a mere reflection of past methods of finance. Second, we need to be satisfied that giving BA a fresh start is justified both in relation to its competitors and in relation to the likely proceeds of sale. These two considerations will have to be borne in mind when we come to consider whether any special assistance is called for, and if so how much.

Turning to the questions of pay, cost of redundancies and pensions, I agree with the Prime Minister's comments on these. The case for making a special provision of £50 million in the accounts for the possible adverse effect on the pension of redundancies is particularly questionable. I think this should be removed from BA's accounts altogether. In any event it should be made clear to Sir John King that the Government is looking to him to make reductions in both the pensions and the other exceptional costs.

One important issue is whether the measures BA are now taking will give a real prospect of early privatisation. We are due to discuss this, together with BA's revised plan, when you have received merchant bank advice. We should consider at the same time whether it would be right to press BA to do more to bring home to their staff and employees the reality of the airline's situation.

Meanwhile the accounts must be published. I agree therefore that a letter of comfort should be sent to Sir John King on the lines suggested in your paragraph 18. The conditions which you intend to stipulate on this are right and I am grateful to you for agreeing to them.

I generally agree with the line you intend to take in public when the accounts are published. However I would make one point. It would not in my view be right for us to get trapped into defending all aspects of the existing management and blaming everything on past mistakes or misfortunes. It is quite correct to observe that action is being taken to reduce manpower and that underlying profitability was better in 1981-82 than 1980-81. But there are too many question marks still standing to be fully satisfied. We would do best to indicate that we are still looking for very considerable improvements.

I should also take this opportunity to remind you that before any further finance for BA can be provided from the National Loans Fund (or from other sources subject to Treasury guarantee) it will be necessary to advise Parliament that this is to be done whilst the Government pursues measures to restore the viability of the Corporation. My officials are already in touch with yours about the terms of a suitable statement.

I am sending a copy of this letter to the Prime Minister and Sir Robert Armstrong.

Yours sincerely

J.S. Grier

LEON BRITTAN
[Approved by the Chief Secretary
and signed in his absence]

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

CONFIDENTIAL

From the Secretary of State

Michael Scholar Esq
10 Downing Street
London SWI

12 October 1982

Prime Minister

I have commissioned the work you wanted on public sector pension schemes, separately from this.

Please also see John Sparrow's note on this subject (Flag A).

Are you prepared now, in the light of the Chief Secretary's letter (Flag B) to agree to the letter of comfort?

MCS 13/10

Dear Michael

BRITISH AIRWAYS

Thank you for your letter of 11 October.

The Prime Minister asks if the Trust Deed governing the Airways Pension Scheme can be changed. Changes to the Trust Deed and to the Scheme's rules are a matter for the Management Trustees of the Scheme and require the approval of at least two-thirds of the twelve Management Trustees, half of whom are nominated by British Airways as employer and half elected by members of the scheme. Any change requires the agreement, therefore, of all the trustees nominated by British Airways and in addition of at least two of the members' representatives. My Secretary of State considers it inconceivable in these circumstances that the Management Trustees could be prevailed upon to change the Trust Deed so as to remove the clause preventing diminution of members' rights that he quoted in paragraph 14 of his letter of 6 October or to materially worsen the position of members in any other way.

The Trust Deed could only therefore be amended in that sense by legislation. Specific legislation to reduce the rights of members of the Airways Pension Scheme would, of course, run into problems of hybridity.

My Secretary of State agrees that the Airways' Pension Scheme is too costly for British Airways; but it has been so for some years. The BA Board have decided to close the scheme to new entrants but that cannot alter the contents of their 1981/82 accounts, nor can it change the vested rights of existing members.

I am copying this letter to John Gieve (HM Treasury) and Richard Hatfield (Cabinet Office).

Yours sincerely

John Whitlock

JOHN WHITLOCK
Private Secretary

cc J.V.

APPOINTMENTS-IN-CONFIDENCE

Qa 06081

Prime Minister

To: MR SCHOLAR

From: JOHN SPARROW

12 October 1982

BRITISH AIRWAYS' FINANCIAL POSITION

1. I have seen the correspondence leading up to the Secretary of State for Trade's letter of 6 October.

Pay Settlement and Redundancy Schemes

2. I agree with the Secretary of State that whether or not the Board might have been able to negotiate less generous agreements originally they should not now renege on the agreements they have made. I think we must accept Sir John King's judgement that to do so would probably precipitate a damaging strike that would cost much more than the settlements agreed. As the Secretary of State says the severance scheme represents a good investment for BA, with a payback period of less than $1\frac{1}{4}$ years. A less generous scheme (perhaps with a different response) might or might not have been an even better investment, but that water is under the bridge.

3. One could speculate on an alternative, high-risk strategy which would have been to hold out for a pay freeze, or even pay cuts, and for compulsory redundancies at the statutory minimum cost, accepting the various expensive consequences that might have followed. These might have included a long and bitter strike and the possible destruction of the business as a going concern, leaving the Government to pick up some major costs including BA's guaranteed debts. On the credit side, a very much smaller but profitable business might have emerged. This would have been a very risky course - which incidentally might well have been unacceptable to Sir John King

and have precipitated his resignation and replacement. Given the risks I cannot myself recommend that the Government should pursue this type of strategy now. The Government's policy, firmly held so far, has been to try to return BA to profit and to privatise it at the earliest opportunity in roughly its present form. I see no reason to alter this policy now.

4. Given the present dreadful financial situation in BA it is unfortunate that Sir John King did not consult the Secretary of State before committing the Board (and ultimately the Exchequer) to the pay and severance agreements. It would be a sound general principle for Chairmen of loss-making Nationalised Industries to consult their sponsor Ministers about such matters, particularly where the agreement appears likely to cause a breach of a previously agreed EFL.

Recovery Plan

5. The Secretary of State has now obtained from Sir John King a financial plan, endorsed by the Board, for the next 5 years. I understand that the plan outlines a strategy involving large manpower reductions (by means of the severance scheme refered to above) and withdrawal from a small proportion of routes; on the basis of this strategy the Board expects to be able to achieve a sufficient level of profitability to enable BA to be privatised at an early date, thereby meeting the Government's main objective for BA. Hill Samuel has been asked to assess the prospects for privatisation, both for next year and for later, on the basis of the plan. The Secretary of State will doubtless report Hill Samuel's assessment when he brings

his proposals for privatising BA to E(NI), probably in about one month's time. Ministers will then have an opportunity to judge the adequacy of the plan.

6. But even if we conclude that the plan is adequate BA could yet be blown off the course charted by the plan. International airlines generally are in difficulties at present, with far too much capacity and continuing uncertainty about future demand. As we know from the Price Waterhouse report BA's profits are particularly vulnerable to adverse events on a small number of routes. BA's performance should therefore be monitored carefully. If events should start to turn against them we might need to ask Sir John King to re-examine the assumptions in his present plan about the size of the airline; a more drastic pruning of loss-making routes might then be required in order to transform BA into a secure and profitable business in the longer term.

Management Team

7. The Secretary of State suggests that, as one of the conditions attached to a letter of comfort, Sir John King should be pressed to complete his reorganisation of the senior management team quickly. I support this suggestion. But the reorganisation may include new Board appointments, for which the Secretary of State himself is formally responsible; the position of Mr Watts, presently Chief Executive and Deputy Chairman, is likely to be a key factor. The Prime Minister may therefore wish to invite the Secretary of State to discuss the reorganisation, including Board appointments, with Sir John King, and to report back with a firm plan for making the

I understand that this happened, yesterday.
MCS 12/10

necessary changes as soon as possible. The earlier the new management team can be completed the greater the opportunity for it to display a convincing track record in the period leading up to privatisation and, thereby, to gain the confidence of potential investors.

8. I am not entirely convinced by the Secretary of State's argument that BA needs a full-time Chairman. Sometimes a part-time Chairman can be more effective in a Nationalised Industry because of his independence and detachment, as perhaps Sir John King has been. But you do need a good full-time Chief Executive if you have a part-time Chairman; hence the particular importance of resolving the uncertainty about Mr Watts' position.

The 1981/2 Loss

9. I agree with the Secretary of State that BA are within their rights to make the proposed large provisions for extraordinary items (for accelerated depreciation and redundancies) and for pension liabilities. I accept that the Government cannot overrule them. However there seem to be grounds for believing that at least some of these provisions could have been spread out over later years. BA's decision may be prudent and proper but it makes the 1981/2 loss look worse than it need have done and should make the profit for future years look better. This presentation may facilitate an early flotation and to that extent it may serve the Government's interests. Notwithstanding the size of the loss there is no need for the Government to promise now to supply a large injection of capital when restructuring.

Any pressure for this should be resisted. The amount of capital injection required can be calculated at the appropriate time in the light of all the relevant information then available.

Letter of Comfort

10. A letter of comfort is needed urgently for BA to continue trading. I agree with the Secretary of State that it should be issued with the three conditions he suggests. I also agree that the letter should imply no Government commitment to any particular level of capital reconstruction; in my view this could best be achieved if the letter made no mention whatsoever of reconstruction.

JB.

Copy to: Sir Robert Armstrong

Aerospace:
Entire of B.A.
3/82

File

Aerospace

cc: Econ Pol
Inflation
Proofed Pensions,
Pt 4

CONFIDENTIAL

8/11

Sus

bc. J. Vereker

10 DOWNING STREET

From the Private Secretary 11 October 1982

PUBLIC SECTOR PENSION SCHEMES

You will have seen from a copy of my letter of today's date to John Whitlock that the Prime Minister continues to be concerned about the burden imposed on British Airways finances by their Pension Fund.

The Prime Minister has commented "we are top heavy on pensions everywhere"; and has asked for a note on all the public sector pension funds: on the burden they are imposing on their industries in terms of write-offs, subsidies, and employers' contributions. The Prime Minister has commented that this material will be required in any event for the debate on the Scott Report later this month.

I am copying this letter to John Whitlock (Department of Trade) and Richard Hatfield (Cabinet Office).

M. C. SCHOLAR

John Gieve, Esq.,
HM Treasury.

CONFIDENTIAL

c/c: Econ Pol.
Inflation Proofed Pensions.
Pt 4

CONFIDENTIAL

File

AEROSPACE.

10 DOWNING STREET

From the Private Secretary

11 October 1982

BRITISH AIRWAYS

The Prime Minister has seen a copy of your Secretary of State's letter of 6 October to the Chief Secretary.

The Prime Minister feels that Ministers have been bounced by the action which British Airways have taken. She remains of the view that British Airways should have imposed a pay freeze, given the extent of their losses; and that the redundancy terms are too generous and the pensions scheme too costly. The Prime Minister enquires whether it would be possible to change the Trust Deed governing the British Airways' pensions scheme. If legislation would be required, the Prime Minister asks what other public sector pension funds would be involved.

B/F

I would be grateful if you would let me have this information as soon as possible, so that the Prime Minister can consider whether she can now agree to your Secretary of State's proposals. You will see from my letter of today's date to John Gieve in parallel, that the Prime Minister has asked the Treasury to let her have a note on the position of public sector pension schemes across the board.

I am sending a copy of this letter to John Gieve (HM Treasury) and Richard Hatfield (Cabinet Office).

M.C. SCHOLAR

John Whitlock, Esq.,
Department of Trade.

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

CONFIDENTIAL

From the Secretary of State

The Rt Hon Leon Brittan MP
Chief Secretary to the Treasury
Treasury Chambers
London SWI

6 October 1982

Dear Leon,

1 Thank you for your letter of 10 September about how we handle BA's accounts for 1981/82. This letter also takes up the Prime Minister's request in the letter from her office of 6 September for more information about British Airways' redundancy payments and pension liabilities.

2 I have made no secret of the fact that I regard BA's past performance as appalling. But it does not help to make statements, as your letter of 10 September does, which are patently wrong: nor to denigrate what Sir John King has in fact achieved. You say that Sir John King should take "early and radical measures" and you claim that "overmanning [is] not now going to be forcibly attacked." The truth of the matter is that it has been. The staff has been reduced from 58,000 in August 1979 to 42,000: and Sir John King plans a further reduction to 35,000 by the year end. This is a total reduction of 40% in a very brief period of time. If you can quote me examples of similar cuts undertaken over a similar period of time by other organisations in the public sector, including the Civil Service, I should be interested to hear of them.

3 Your references to a "capital reconstruction (at the expense of the taxpayer)" and "fresh injections of capital" show a considerable misunderstanding of the position. Much of the money in question was effectively lost years ago (although the events of 1981/82 also brought heavy losses): what we are now facing is the moment of truth when the books have to agree with the facts. That this apparently requires a large injection of capital is due to the way that BA, no doubt with Treasury approval, as well as that of my Department, borrowed money from third parties with a Government guarantee. Much of this

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From the Secretary of State

money has now effectively been lost. Had the Government followed the straight-forward course of enabling BA to meet the losses as and when they were incurred no injection of capital on the present scale would have been required. That it is needed on this scale is not a reflection of current losses or future needs but simply of the method of finance adopted in the past.

4 So far as John King's stewardship is concerned, in 1980/81, BA made an operating loss of £95m. In what was effectively his first year this was translated into an operating profit of £13m: and he is on course this year to achieving his target of £180m. There are few if any nationalised industries which have achieved a turnaround of this magnitude in so short a period of time.

5 The whole of the present trouble arises from interest payments and exceptional provisions. The interest payments are essentially on loans in respect of losses - either revenue losses or losses of capital. A loss is not an asset and it does not earn an income. You cannot therefore judge the current performance of a business on whether it can service the cost of debt representing past losses whatever the nature of those losses might be.

But it should not have owned

6 Nor can you judge present performance by exceptional write offs rectifying past errors and also external factors, such as Lockheed's withdrawal from civil aircraft manufacture. This is no more than recognition of what has happened. I have doubts about the treatment of some of the items - for example the method adopted for depreciating the fleet. However the treatment adopted by BA's accountants and accepted by their auditors is in accordance with standard accounting practice - or at least one interpretation of it - and we are in no position to demand that BA should be less "prudent" in their accounting than their auditors have agreed. The same is true of the massive redundancy payments - I refer later to the calculation of the amounts - as these represent the cost of putting right excessive overmanning inherited from the past. Again I personally think it is wrong to charge the whole amount in the 1981/82 accounts although many of the redundancies do not occur until 1982/83. But once again - and for the same reasons - it is difficult to be more royalist than the auditors.

CONFIDENTIAL

From the Secretary of State

7 What BA needed - right from the beginning - was a full time executive Chairman. However good John King is, a part time nominally non-executive Chairman was not what BA needed. Most of the present management difficulties spring just from that. The right answer was for John King to go full time as executive Chairman abandoning his other commitments. I asked him; he refused. He has however already taken steps to strengthen the senior management by the appointment of a new Chief Finance Officer and I expect him to discuss with me before long certain other senior management appointments.

8 There are three specific points I need to deal with. First the pay settlement. I have no interest in defending this. I did not agree: I was not asked. I was not even told. The way it was done was a psychological error. It was dressed up to look like a 11% pay rise. In fact it is less than 5½% on an annual basis. It is considerably less than has been given on a two year basis to other loss making industries such as the miners and the railwaymen. It is comparable to the increases given to the Civil Service. The Health Service workers are now also being offered a very similar figure also over 2 years. Of course it is all wrong. But we cannot pick out BA to impose a pay freeze which we are not prepared to impose elsewhere. The offer has in any case already been made to nearly all employees in BA and has been accepted by nearly all of them. The only group where the offer has not yet been made formally is to the pilots; but there is a clear expectation that they will receive a similar offer. John King's judgement is that to try to go back on the offer would lead to an immediate and across the board strike. The cost would rapidly exceed any hoped-for savings. If this happened the only sensible course would be to close the airline down completely and finally. This would require legislation. And British Airways accounts for some 60-65% of British airline operations. It is no good threatening to do this unless we are prepared to carry out the threat. You need to ask yourself whether you are.

why not? when they are losing we have lost so much?

9 Second, the redundancy payments. Again, I was not asked. Of course the easiest way to eliminate these is not to make the redundancies. But if you want

From the Secretary of State

to proceed with the redundancies you have to ask yourself what are the minimum terms which will be acceptable - that is without provoking a major strike. The terms of the special redundancy scheme, introduced in September 1981 with the object of reducing staff numbers to 43,000 by March 1982 were as follows:-

> for those with less than 3 years service, a lump sum payment of 6 months salary;
>
> for those with 3-10 years service, a lump sum payment of a year's salary;
>
> for those with 10 years service and over, a lump sum on a sliding scale up to a maximum of 18 months salary for those with 15 years service and over.

5,000 staff left under this scheme between September 1981 and March 1982. The same terms are being offered for the latest tranche of redundancies which aim to bring numbers down to 35,000 by March 1983. If this target is achieved some 13,000 staff will have left under the special scheme at a total estimated cost of some £200 million: an average cost per head of some £15,500. (A further £25m was spent on redundancies under the old severance scheme in the early part of 1981.) This average of course disguises large variations in payments to individuals. Low-paid staff with only a short period of service - who were among the first to go under the scheme - will actually have received comparatively little. The key point in all of this to my mind is that it is a very good investment: the payback period for this latest scheme is estimated at less than 1¼ years.

10 My own view is that these terms are nonetheless too generous (though some other public sector bodies - especially dockworkers and the civil service - appear to have schemes which are just as generous, and less generous payments could well make it harder to reduce BA's manpower numbers within the ambitious timescale BA have set themselves). But whether what has been done was

right or wrong is not in issue. The question is whether we can do something different now. We have discussed this with John King. His assessment of the situation is that we could not - at least not without provoking serious industrial action which itself would frustrate the attempt to bring the airline back into profit.

11 The third point relates to pensions. Pensions for British Airways' staff are provided predominantly through the Airways Pension Scheme (APS), which began in 1948 but which dates in its present form from 1973. This is financed (in the usual way) by employer's and employees' contributions and through the scheme's investments. BA's employer contributions in 1981/82 amounted to about £70m.

12 Actuarial valuations of the scheme are carried out at intervals of not more than three years. Any deficiency revealed by these valuations is financed either through setting contributions - in practice this means employer's contributions, as the maximum rate of employees' contributions is fixed by the Trust Deed - at a level higher than would otherwise be necessary or through special deficiency payments. As a result of the 1979 valuation BA are at present paying deficiency payments of an extra £2.16m a year over twenty years. BA are proposing in addition to charge to their 1981/82 accounts a sum of about £50m for the adverse effect on the fund that they expect the next valuation of the scheme to show as a result of their large staff reductions last year and this year. The next triennial valuation is about to commence and its results should be known early next year.

13 So much for the cost to BA of the APS while it continues in being. The Trust Deed governing the scheme provides, however, that if it is discontinued BA must pay over immediately any sums necessary "to restore the solvency of the Fund ....." The interpretation of this "solvency guarantee" is uncertain, and BA are considering whether to seek a declaratory judgement on it.

14 We understand that the BA Board have recently concluded that the present (fully indexed) pension scheme is too costly for the airline. The freedom to take corrective action is, however, circumscribed by a clause of the Trust Deed that precludes any change that "would operate in any way to diminish or prejudicially

From the Secretary of State

affect the present or future rights of any then existing Member or pensioner". The Board are therefore proposing to leave the present scheme in force for existing employees, to close it to new entrants, and to open for staff joining the airline in future a new scheme offering less generous benefits. BA hope that some members of the present scheme might be induced by the prospect of lower contributions to transfer voluntarily to the new scheme. This change will require careful presentation to BA's employees, and the Board will not be announcing it until they have worked out the full details in the next few months.

15 Meanwhile we need take no quick decisions here. BA have now accepted a rewording of their report and accounts that omits controversial or embarrassing references to previous liabilities; the new text has been agreed between your officials and mine. We shall need to revert to the subject before privatisation, and then we shall have to ensure that anything BA ask us to agree to is compatible with the decisions we have yet to take on civil service pensions: we shall therefore need to make clear to BA that the civil service solution, when it emerges, should limit our liability so far as BA is concerned.

16 On the subject of BA's corporate plan there is no disagreement between us that we need something more rigorous than GP10. John King has now just sent us a new financial plan covering the next five years, which reflects BA's latest decisions on route withdrawals and on manpower reductions. We have sent the plan over to your officials. We have also sent the plan to Hill Samuel to assist them in their assessment of BA's prospects for privatisation, which we have asked them to undertake urgently.

17 To sum up we face an inevitable dilemma. In the private sector British Airways would have gone bankrupt as did Rolls Royce and Laker. The problems of insolvency would then have been solved automatically. Redundancy payments would have been limited to the statutory amounts, the pension fund would have been dissolved, the Treasury would have had to pay off the banks whose loans it had guaranteed. The liquidator would have been able to sell off the business as a going concern, free of all obligations, as happened with Rolls Royce Motors. But if we want to keep the existing British Airways in business - and my legal advice is that it would require legislation to alter this position - then we are

From the Secretary of State

at the mercy of those in a position to exert pressure on us - the staff who demand their redundancy payments, and the maintenence of their entrenched pension rights and the unsecured creditors who demand payment of their debts. I doubt whether in political terms legislation to secure the insolvency solution is really a practicable option. If you have a different view I would be glad to know. But unless we do decide to go down that route, it is then a matter of commercial judgement what are the terms which enable you to buy off your problems. I do not always agree with John King but I believe that so far as this is concerned his judgement is broadly right.

18 I hope therefore, in conclusion, that you will now feel able to agree to the comfort letter which BA has asked for. If you can agree to this, I would propose to make the letter subject to the following conditions. First, the assurance should be, as you suggest, limited to one year only - though of course if we have not by next year done anything about a capital reconstruction we must be prepared for BA to ask for a further comfort letter then. Second, I should tell John King that he must make a determined effort to complete the necessary senior management changes at the earliest possible moment. Third, he should be told to press ahead with the planned staff redundancies to 35,000 with the aim of completing these by the March deadline he has set himself. Finally, he should be quite clear that our letter of comfort implies no Government commitment to any particular level of capital reconstruction.

19 We must also consider our public stance when the accounts reach the press. We should first, I suggest, point out that the content of the accounts is entirely a matter for the BA Board and their auditors. We can also point to the fact that, as I have explained at the beginning of this letter, the extraordinary items largely reflect past mismanagement and misfortunes, not present performance, on which we can point to John King's achievements over staff reductions and operating profits. If asked about a capital reconstruction we should say that the Government have not yet accepted any commitment in this regard and we shall take our decision in the light of all relevant factors. As for privatisation, we should maintain our line that we intend to privatise BA as soon as practicable.

CONFIDENTIAL

From the Secretary of State

20 I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours, Arthur

LORD COCKFIELD

CONFIDENTIAL

cc MV Vereker

10 DOWNING STREET

From the Private Secretary

13 September 1982

Dear John,

British Airways Financial Position

The Prime Minister was grateful for your Secretary of State's minute to her of 10 September. She has also seen the Chief Secretary's letter to Lord Cockfield of the same date.

The Prime Minister has commented that she entirely agrees with the Chief Secretary that there is a strong case for a pay cut or at least a pay freeze rather than the pay increase recently negotiated for mid-October. She thinks, too, that rather than a generous voluntary redundancy scheme for the latest tranche of demanning, the Board should now move towards compulsory redundancies at minimum statutory cost. She considers, with the Chief Secretary, that it would be wrong for the Government to provide the kind of assurance of continuing support which Sir John King seeks until satisfactory understandings have been reached on these and any other similar points.

I am sending a copy of this letter to John Gieve (Chief Secretary's Office) and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

John Whitlock Esq
Department of Trade

CONFIDENTIAL

Prime Minister (2)

I entirely agree with X - it corresponds with my previous comments.

X seems to me the minimum we should do, when one thinks of what happened to Laker. The prospect for early privatisation must be very poor (unless there was massive prior Government support).

Would we not be better employed in thinking of what forced staff reductions and asset disposals we wish to impose?

MCS 10/9

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Lord Cockfield
Secretary of State
Department of Trade
1 Victoria Street
London SW1H OET

Please see, too, Lord Cockfield's minute to you (attached)

10 September 1982

Dear Secretary of State,

BRITISH AIRWAYS FINANCIAL POSITION

The situation revealed by British Airways draft accounts is as you rightly say dreadful. The accounts will show British Airways to be massively insolvent. They are expecting the taxpayer to pick up the bill. It would give quite the wrong impression and hopelessly weaken our influence over the nationalised industries generally if we were to appear to be accepting this passively and simply carrying on as before. We must let it be clearly seen that the Government views the situation with maximum seriousness.

I recognise you will be concerned at the implications for early privatisation if we require action to be taken which leads to substantial disruption. But frankly I must say that I see little prospect of achieving early privatisation if things are allowed to continue as at present. On the contrary it seems to me that our best hope lies in persuading Sir John King to take early and radical measures now. The longer these are deferred the more difficult it will be to persuade investors that BA's by now well-publicised problems have been overcome and that the corner has been genuinely turned. Without being able to carry conviction that BA has reasonable prospects of future viability, I do not believe that any amount of capital reconstruction (at the expense of the taxpayer) will do the trick.

You will be in a better position than I to judge what is needed. But it seems to me that recent developments have pointed almost inescapably to certain conclusions.

First, the corporation still lacks an effective and credible management team. Three crucial members of management have now left the company but only one new man, the Finance Director, has so far been found to replace them. The position of the Chief Executive - a vital post in view of the fact that Sir John King

is only part-time and has other major business concerns to occupy him - is in doubt. Publicly the press has been full of rumours and these have given rise to a general impression of internal dissension and lack of decisive direction. The first requirement is surely for the Chairman to lose no further time in rectifying this state of affairs.

Second, I am bound to say that this public impression is not substantially contradicted by anything we have seen from our slightly more privileged viewpoint. It is now two years since the Government received a firm plan endorsed by the Board. The plan we discussed in July remains as I understand it unendorsed, and recent developments have suggested that its realism is still being seriously questioned within the BA organisation. A new fleet and route review is promised by the end of September, but whether that will arrive on time or be satisfactory when it does remains to be seen. Meanwhile BA are threatening once again to exceed their EFL this year. A convincing plan for recovery fully backed by the Board is an urgent necessity.

Third, I do not think it is now adequate for BA to be entering large scale financial commitments such as those recently incurred on pay and proposed on severance, as though it were simply a matter of "business as usual". No private sector concern in the same financial position could get away with this. Once the accounts are published people will rightly ask what the Government is going to do about the situation they reveal. Potential investors may well be put off if they gain the impression that BA's problems of low profitability, overmanning and industrial relations are not now going to be forcefully attacked. There is a strong case for a pay cut or at least a pay freeze rather than the 11 per cent increase recently negotiated for mid-October. Rather than a generous voluntary redundancy scheme for the latest tranche of de-manning should not the Board now get going for compulsory redundancies at minimum statutory cost? There may well be other areas where decisions are continuing to be taken on similarly false premises and with equally or even more damaging results.

In my view it would be wrong for the Government to provide the kind of assurance of continuing support which Sir John King seeks, let alone to commit or half-commit itself to a fresh injection of capital, until satisfactory understandings have been reached on these and any other crucial points. I suggest that such understandings should now be urgently sought. There would also be advantage in letting it be known that the Government is undertaking a radical re-appraisal of the situation, in advance of publication of the accounts which will otherwise come as a substantial shock. This will give us a better negotiating base both to get the things done which need to be done and for taking sensible decisions about any future capital reconstruction.

May I also suggest that Hill Samuel as your merchant bank advisers on BA should be asked to do a thorough and objective appraisal of the prospects for early privatisation? In doing so they could take account of the measures we have taken in response

to the accounts, assess the Board's response and advise on the prospects for a sale in the light of them and any other action which they might recommend ought to be taken. We shall need a sound commercial assessment of the position for E(NI)'s discussion later in the Autumn and for considering the desirability and size of a possible capital reconstruction which I agree would almost certainly require legislation.

The proposal to mention estimates of the unfunded past service liability for pensions in a note to the accounts causes us enormous concern. We are far from convinced of the need for this and my officials are seeking legal advice from Treasury Counsel. The main motive for mentioning it now, when it has been thought unnecessary to do so in the past, seems to be to maximise future claims for capital funding from the Government. Such liabilities in respect of past service are common to most pension funds and are funded by employers' contributions in the normal way. There is no reason to suppose that they cannot be funded in the BA case unless we close the airline down in which case the extent of any deficiency requiring to be met by BA is extremely uncertain. That point will need to be clarified for any prospectus for privatisation but BA and its auditors should be dissuaded from mentioning figures which almost certainly beg the issue.

Finally, if we decide, in the light of understandings on the lines I have suggested, to give some assurance of continuing support, it will be important to make clear to BA that it is only intended to cover obligations arising over the next financial year, and thus to satisfy the auditors for the purpose of the 1981-82 accounts: it does not prejudge the Government's decisions on any capital reconstruction, or in particular the longer term obligations of the BA pension fund, where I agree with you it is very questionable whether the Government has any duty to step in.

I am sending a copy of this letter to the Prime Minister and to Sir Robert Armstrong.

Yours sincerely

for LEON BRITTAN

[Approved by the Chief Secretary and signed in his absence]

CC JV

CONFIDENTIAL

Prime Minister

MCS 10/9

PRIME MINISTER

BRITISH AIRWAYS' FINANCIAL POSITION

I have seen your Private Secretary's letter of 6 September to mine.

As I said in my letter of 1 September to the Chancellor I regard the situation as quite appalling. It is a combination of two things: gross mismanagement over a long period of years with huge undisclosed or potential liabilities which are now coming home to roost; and a determination on Sir John King's part to dress up the accounts to provide the most favourable scenario for privatisation.

The accounts are not our responsibility and if the Board of British Airways can get their Auditors to certify them, however much we dislike them there is nothing we can do. But it does not follow that we accept the accounts as the basis on which we should pay for the reconstruction and this has been and will continue to be forcibly put to British Airways.

I too have serious reservations about the pay settlement, not least because it savours too much of blowing hot and cold - a freeze one year followed by a bonanza next year. Arithmetically it is worth 5½% per annum - the 11% figure in itself is misleading - but of course the real point is whether there should have been any increase at all although, as you know, the biggest loss-makers among the Nationalised Industries tend to have the biggest pay increases. We were not told. And there is nothing we can now do about it.

I am asking the Department to prepare a factual note on British Airways' redundancy payments and pensions liabilities which my Office will send you in a few days, in my absence overseas. On all these matters Sir John King's strategy has been to limit employee benefits to the greatest extent possible without provoking a confrontation. He has shown some skill in this, succeeding, for example, in beating his own ambitious target for the rate of run-down of manpower. The alternative strategy would be to crack down severely, from now on, on all generous-seeming benefits to employees at British Airways, allowing no increases in expenditure beyond what is inescapable. But I have no doubt that Sir John King would take the view that this would lead inevitably to industrial confrontation, which would be costly in itself and would put paid to our target, recently re-affirmed by E(NI), of privatising British Airways as quickly as possible.

The only bright spot in this dismal picture is that British Airways are still on target for a pre-interest profit this year of about £180m. This compares with a pre-interest profit for 1981/82 of £13m, and a pre-interest loss in 1980/81 of £95m.

I am copying this minute to the Chancellor of the Exchequer and to Sir Robert Armstrong

Department of Trade
1 Victoria Street
London, SW1H OET

10 September 1982

John Whitmore

for LORD COCKFIELD

[Approved by the Secretary of State and signed in his absence.]

10 DOWNING STREET

THE PRIME MINISTER

10 September 1982

Dear Mr. Thomson.

Thank you for your letter of 26 August expressing your concern that the Government's desire to proceed as soon as possible with the privatisation of British Airways might overlook the consequences which this change would have for the rest of the civil aviation industry. I can assure you that we are most anxious to see a thriving and healthy airline industry in this country and are very concerned that our airlines should recover as quickly as they can from the problems which have been created for them by the economic recession. Indeed it is because we have confidence in their ability to do so that we believe British Airways will be more successful in the private than in the public sector.

In your letter you speculate about various changes which may be made to pave the way for privatisation. While some re-organisation of British Airways' finances may be necessary, the Government have not yet received nor approved any specific proposals.

You suggest that some re-allocation of routes might be of benefit to British Airways as well as to your own company, and I understand that you have recently given some specific examples to Iain Sproat of route exchanges between your two airlines which you have proposed to Sir John King. I am sure that this is the most constructive and fruitful way for you to proceed, and if you are able to agree on some mutually acceptable proposals to put to the Civil Aviation Authority, I have no

/ doubt

doubt they will respond helpfully. John Biffen in his reply to your letter of August 1981 explained why he did not think the Government should initiate such a redistribution, and I am sure you will appreciate that that would be quite contrary to the change which we brought about in the Civil Aviation Act 1980, which made the Authority, rather than the Secretary of State, responsible for policy on route licensing.

Finally may I thank you for your support for our stance in the Falkland Islands dispute, and I am sorry that those events have made life more difficult for you.

Lively good wish.

Yours sincerely

Margaret Thatcher

Adam Thomson, Esq., C.B.E.

CONFIDENTIAL

JR

bc: Mr. Vereker
Aerospace

10 DOWNING STREET

From the Private Secretary

6 September 1982

Dear John,

BRITISH AIRWAYS' FINANCIAL POSITION

The Prime Minister has seen a copy of your Secretary of State's letter of 1 September to the Chancellor of the Exchequer about British Airways' forthcoming annual report and accounts for 1981/82.

The Prime Minister is most concerned about the situation revealed in Sir John King's letter of ~~8 October~~ 26 Aug. She has commented that we simply cannot agree to every request from British Airways - requests which could certainly not be afforded were British Airways a private sector company. In the light of British Airways' situation, the Prime Minister does not believe that any pay increase for British Airways' staff can be justified. Mrs. Thatcher would, further, be grateful for information about the size of the redundancy payments which are being made to BA staff, and their total financial effect on the Corporation. The Prime Minister would also be grateful for a note on the impact of BA's pension liabilities on their financial position.

I am sending a copy of this letter to Peter Jenkins (HM Treasury) and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

John Whitlock, Esq.,
Department of Trade.

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

MCS (or)

NBPM

From the Secretary of State

CONFIDENTIAL

Miss Jill Rutter
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

3 September 1982

Dear Jill

BRITISH AIRWAYS' FINANCIAL POSITION

in box

I much regret there was an unfortunate typing error in my Secretary of State's letter of 1 September to the Chancellor of the Exchequer on this subject. The figure of £200 million for interest payments shown in the fourth line of the second paragraph should have read £100 million, and I should be grateful if copies of the letter could be altered accordingly.

I am sending copies of this letter to Willie Rickett (Number 10) and Richard Hatfield (Cabinet Office).

Yours sincerely

John Whitlock

JOHN WHITLOCK
Private Secretary

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

(2)

Prime Minister

Appalling.

From the Secretary of State

Does why any increase in pay? We cannot just agree to every request which comes in. We could not afford it. i.e. extra pay by redundancies by pensions.

MCS 1/9

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

1 September 1982

Dear Chancellor,

BRITISH AIRWAYS' FINANCIAL POSITION

I am writing to alert you to the position expected to be shown in BA's forthcoming annual report and accounts for 1981/82 and to seek your agreement on one aspect.

As shown in his attached letter, Sir John King intends to publish these if possible on 8 October. (They are of course strictly confidential at present.) The accounts are likely to show a break-even on their operating position (an improvement after last year's loss) before interest payments of over £200m. In addition, however, BA intend to include about £500m of "extraordinary items" so as to show a total loss of about £600m.

These "extraordinary items" include provision for accelerated depreciation and redundancies and are designed in part to improve BA's profits for later years. However, the inclusion of these items makes BA's loss for 1981/82 even higher than has so far been forecast in the Press and will therefore cause a considerable stir. These items also have implications for the size of the cash injection we may need to give BA as part of any capital reconstruction we decide upon.

How much?

CONFIDENTIAL

From the Secretary of State

CONFIDENTIAL

BA in addition wish to refer in the published accounts to substantial past unfunded liabilities for their pension scheme (of about £300m), which could also give rise to Press comment and, by obliging the Government to fund or guarantee these liabilities, add to the public expenditure cost of privatisation.

In principle, of course, the accounts are a matter for the BA Board and their auditors. But because of the implications of these matters for Government expenditure we cannot disclaim interest. My officials and yours are accordingly in touch with BA on the treatment of these "extraordinary items" with the aim of securing agreement on their presentation.

As a result of BA's inclusion of these items, however, the accounts also show an insolvent capital account, with negative reserves exceeding public dividend capital by about £300m. In addition BA are likely to have difficulty in meeting their redundancy payments under this year's new scheme within the EFL for 1982/83. As a result, and as Sir John King reports in his letter, BA's auditors require an assurance by Government about future funding in order to give a clean audit certificate. Then the redundancy payments may be too large.

Sir John King suggests two alternative forms of assurance. I do not think his first alternative - an undertaking over capital reconstruction - is acceptable, as we have as yet taken no decision about this, and it is likely in any case to require legislation. Nonetheless, I accept the need for some public assurance, in view of the position to be revealed in BA's balance sheet, and I hope you will agree to me writing to Sir John King on the lines of his second sugggestion. The exact form of words I would suggest is:-

"I write to assure you that the Government will enable BA to meet its obligations as they fall due, pending consideration of the capital reconstruction that you are seeking from the Government".

Agreed MT

From the Secretary of State

CONFIDENTIAL

(I understand that wording somewhat on these lines was recently agreed for British Shipbuilders.) I should be glad of your urgent agreement to this in view of the need to finalise BA's already overdue accounts as quickly as possible.

I do not, of course, propose to make any substantive reply to Sir John King's request for a capital reconstruction, before this has been considered in E(NI) later in the autumn.

All this is a dreadful state of affairs. The situation has built up over a period of years due to appalling management. One can argue that the moment of truth has arrived and we must bite on the bullet. If this were a private sector company the right course would be to appoint a receiver and clear the matter up that way. But that course is probably not open to us. But it does not follow that we have to swallow everything the Board of British Airways or their Auditors choose to dish up. In particular, I am very dubious whether the Government have any obligation, moral or otherwise, to bail out the BA pension fund.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours sincerely

John Whitmore

for LORD COCKFIELD

[Approved by the Secretary of State and signed in his absence.]

British airways

PO Box 10
Heathrow Airport (London)
Hounslow TW6 2JA

Telephone: 01-759 5511
Telegrams: Britishair

26 August 1982

Private and Confidential

The Rt. Hon. Lord Cockfield,
Secretary of State for Trade,
1 Victoria Street,
London, SW1H OET

Dear Secretary of State,

Annual Accounts 1981/82

There is one particular aspect of our 1981/82 Accounts that I need to bring to your attention.

It is clear to me from the reports I have had of our discussions with Messrs.Ernst and Whinney, that if we are to be given a clean audit certificate by them, I must be able to say in my Statement that the Government is prepared to undertake a reconstruction of our capital and debt structure in the near future. Alternatively, if this cannot be said at this stage, I need your assurance that the Government will enable British Airways to meet its obligations as they fall due, pending the Government's consideration of such a reconstruction.

I should perhaps add that a response from you along the lines indicated will be necessary not only from the audit point of view, but also in relation to the provisions of a number of our financing agreements.

I would be grateful for an early and sympathetic response to this letter, since I am anxious that the Accounts should be finalised at an early date, and published before 8 October if at all possible.

I would also take this opportunity of asking, formally, for the Government to reconstruct the capital and debt structure of British Airways. Details of our present views are being sent by Dunlop to Clarke separately today.

Yours faithfully,

Gordon Dunlop.

Dictated by Sir John King
and signed in his absence

British Caledonian

Caledonian House
Crawley West Sussex
RH10 2XA England

Telephone: Crawley (0293) 27890
Cables: Scotair Gatwick Telex: 87161

From the Chairman's office

26th August, 1982.

The Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
London, SW1.

Dear Prime Minister,

I wrote to you on the 14th August 1981 expressing concern about the British Air Transport industry and making suggestions which I felt could place it on a sound basis for the future. I received an acknowledgement from your office and then a letter from John Biffen on the 30th September 1981, which stated in the last sentence "I do not think that a major reorganisation of the nation's air transport industry is necessary".

Since that time Iain Sproat and John King have been energetically tackling the longstanding problems within British Airways and, if I may say so, obtaining some promising results. The objective of privatising at least part of that airline is still being promised before the next Election. I have no fundamental objection to this, indeed I would like to see complete privatisation rather than part. However, I am concerned lest the consequences of this action on British Caledonian are not fully understood. A massive change in the financial structure and goals of 75% of the U.K. scheduled industry represented by British Airways must de facto, cause a major reorganisation of U.K. air transport.

1981 was a disastrous year for the airline industry; 1981 was another and in 1982 the hoped for return towards prosperity has not materialised and the industry is in the throes of the worst crisis in its history; no airline is exempt although some, like British Caledonian, are faring better than others. We were estimating a return to profitability this year and, had it not been for the Falklands War, which had a £5M negative effect on our profit, we would still be forecasting a profit

for the 31st October, our financial year end. I hasten to add my full support for the Falklands action and how thankful I am that we had a Prime Minister with the courage and conviction to do what was necessary. However, we are now in a position where we shall be fortunate if we break-even this year.

Latest world airline industry forecasts show significant shortfalls between profits and the amount required to service debts, indeed they indicate a worsening position in 1983.

The British Airways' problem is twofold. The first, created through its inefficiency as a nationalised entity, the second, through an industry crisis that is affecting all airlines.

I can envisage the actions that John King is taking changing British Airways into a leaner, slimmer, more effective airline; I have read that this could be followed by £600M, £700M or £800M worth of Government cash being injected, then an attractive package being offered to the private sector.

Other British private enterprise airlines operate short haul scheduled services and charter flights and may be unaffected by this development, but we shall be. From the British United Airways and Caledonian Airways of the 60s British Caledonian was formed in 1971; by its own efforts it has achieved an acceptable international reputation for quality service. Bit by bit it has fought for route licences and built a network which has made it the biggest privately owned international scheduled airline in Europe. British Caledonian is the only non-U.S. airline, which is completely privately owned, competing on U.S./Europe North Atlantic routes. We now see one of our main competitors about to receive massive Government investment and support, on a scale never before contemplated, without any apparent regard for the effect this will undoubtedly have on the British private enterprise carrier that has kept the flag flying in spite of all opposition for the last twelve years. My suggestion is that, instead of the Government simply endeavouring to find a solution for British Airways, it should be considering what steps should be taken in the interests of the British airline industry as a whole and that means including British Caledonian.

Prime Minister, our business is more complicated than most, it is regulated nationally and internationally, the latter is usually covered by Air Service Agreements between two countries which, on most occasions, restrict the number of flights operated per week, the fares that can be charged and even the type of aircraft that will be permitted on the route. British Government policies have lent one way and then the other since the end of the Second World War and perhaps with greater changes over the past 21 years when I have been involved with Caledonian Airways and British Caledonian. These policies have gradually permitted the development of British Caledonian as the second British flag carrier on international routes, but only after a long, hard fight for every single franchise (licence) that has been won. We have problems with protective policies

.../...

for airlines in emerging countries, which not infrequently break Air Service Agreements; the difficulties with remittance of funds from African countries to cover costs already incurred have recently been raised. Overall we are in a business that is simply more dependent than most on Government policies at home and abroad.

There are a number of actions that can be taken between British Airways and British Caledonian that could result in improvements for both. In the past we have been rebuffed by the British Airways' management when we have put these forward. I have recently put such proposals to Iain Sproat and John King and received much more positive responses and a willingness to give them consideration. I expect serious discussions to take place on this subject during September.

Why then am I writing to you? Simply because the Government's objective appears to be singular - turn British Airways into an efficient, effective operating unit and privatise it. I would like to see British Caledonian's own efforts in creating an international airline, operating to 48 cities in 31 countries, recognised through an objective which is designed to take consideration of our industry crisis. I would suggest that an appropriate strategy would be "encourage the profitable development of the two British international airlines through the privatisation of British Airways and an allocation of routes to both which will allow them to compete effectively in the international market place".

I believe that right now, with the enormous financial difficulties of the U.S. airlines, we have a unique opportunity to lead the world in air transportation and I think it would be ironic indeed if this Government's constructive plans for British Airways excluded consideration of the significant part the existing British wholly private enterprise flag carrier has played in the past and could play in the future. British Caledonian has a good track record and I would suggest deserves better than being excluded from current Government policy.

Certainly I am talking constructively to Iain Sproat and John King and they are being as constructive as they can be under the present policy - but right now it seems to me that they must be severely limited as they are working to a directive which they are determined to fulfil - "Privatise British Airways" - Regardless? Beyond that shouldn't the Government's clear objective be to encourage the development of a strong profitable air transport industry of which the nation can be proud.

Yours sincerely,

Adam Thomson

Adam Thomson

RESTRICTED

Aerospace

Prime Minister (2)

Lord Cockfield must quarrel with any of this!

MCS 27/7

MT

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

26 July 1982

Dear Arthur,

I have seen a copy of E(NI)(82)20, in which you suggest that we should aim for a flotation of British Airways in late 1983, to be preceded by a capital reconstruction of the airline for which powers would be taken, if necessary, in a short bill introduced early next Session.

I must point out that the legislative programme for the 1982/83 Session which has been approved by the Cabinet makes no provision for a bill of this kind, even on a contingent basis. The business managers have all along made it clear that the very tight constraints under which we shall be operating next Session make it essential to avoid net additions to the agreed programme. The possible legislation mentioned in E(NI)(82)20, though short, would clearly be highly controversial, and it is very likely that we should have to drop something else from the programme if it had to be accommodated. Although I do not wish to comment in detail on the substance of your proposals at the moment, I do wonder whether the autumn of 1983 - not more than six months before the next General Election - would be the most propitious time for a flotation of BA, or whether it would not be better to leave it, and the capital reconstruction legislation, until early in the next Parliament.

I am copying this letter to the Prime Minister and other members of E(NI), to the Home Secretary, the Lord Privy Seal, and the Chief Whip, and to Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

The Rt Hon The Lord Cockfield

P.0821

PRIME MINISTER

British Airways
(E(NI)(82)20)

BACKGROUND

The Secretary of State for Trade reports on the current position of British Airways (BA); invites E(NI) to approve the general approach of the airline's Corporate Plan, subject to some modifications which he proposes, and to agree that the Plan should form the basis of BA's financial target for the next three years; and discusses the possibility of privatising BA in late 1983.

2. BA's recent performance (summarised in Annex A to the Secretary of State for Trade's paper) has been marked by an over-optimistic commercial strategy, excessive investment, low productivity and large losses in 1980-81 and 1981-82. Under its new Chairman, Sir John King, BA appears to have begun putting its house in order, although the Corporation expects to do little more than break-even in 1982-83.

3. British Airways' Corporate Plan is summarised in Annex B to E(NI)(82)20. The Plan continues BA's recent strategy of improving profits by reviewing unprofitable routes and contracting manpower and investment. This is particularly the case with 'Option C', the variant of the Corporate Plan which the BA Board favours and which has the least ambitious programme of investment in new aircraft. On this basis BA forecast profits rising from £59 million in 1983-84 to £249 million in 1986-87 and a real rate of return on net assets of 4 per cent or more in each year from 1983-84 which compares well with the average rate of return achieved by British industry in recent years.

4. The BA Board will be considering next month whether there is scope for a more profitable approach than suggested by Option C of the Corporate Plan.

MAIN ISSUES

5. There are two areas for discussion:

i. BA's Corporate Plan and the related question of the financial target;

ii. privatisation.

Corporate Plan

6. I understand that BA's current plan has been prepared on conservative assumptions and takes good account of Price Waterhouse's comments on the airline's past failings: for example the Corporation assume that their share of the world travel market will fall somewhat. The Sub-Committee may well endorse Lord Cockfield's judgement that the strategy is on the right lines, while noting his words of caution that BA do not have a good record in meeting their own targets and that they will need considerable management and industrial relations skills to achieve their plan.

7. The main possible criticims of the Corporate Plan appear to be as follows, (the first three are Lord Cockfield's own):

a. Manpower

BA have reduced staff numbers by 20 per cent since last September. The Corporate Plan assumes a further reduction in manpower from about 42,500 now to 34,000 by 1986-87. Recent comparisons with other airlines however suggest that BA ought to be able to make do now with about 35,000 staff. The Sub-Committee may want to express its support for the Secretary of State for Trade's efforts to encourage BA to get down to about this figure much sooner than the Corporate Plan assumes, perhaps during 1982-83.

b. Routes

The Sub-Committee may also want to endorse the Secretary of State for Trade's efforts to ensure that BA should undertake a radical appraisal of their route structure. The Corporate Plan seems to imply the retention of a good number of routes which do not cover their full costs.

c. Uncommitted investment

The Corporate Plan proposes uncommitted investment of over £600 million. The Sub-Committee may again want to endorse the Secretary of State for Trade's intention to probe whether the Plan should include this item.

d. 'Headroom'

The Plan includes a general contingency element or 'headroom' of £50 million in each year from 1983-84 onwards; the Corporation's bid for external finance in the context of the Nationalised Industries Investment and Financing Review also includes this item. Given their past record, it is perhaps prudent of BA to build a sizeable contingencies element into their plans. On the other hand £50 million a year on top of the £30 or £40 million which the Plans already include for specific contingencies perhaps provides too much leeway for the airline's management. The Chancellor of the Exchequer may want to indicate that the Chief Secretary and he will be unwilling to take full account of the £50 million headroom in setting next year's external financing limit for British Airways and public expenditure provision in the following years.

e. Pay

According to the press British Airways have just agreed to a pay increase of 11 per cent from October for 12,000 engineering maintenance and ground services staff. All BA employees have been subject to a pay freeze since the beginning of this year, and the new settlement will run for 15 months. In effect therefore the 11 per cent is spread over two years and in annual terms is modest compared with the average level of settlements. Nevertheless Ministers may want to be sure that BA is adopting a sufficiently rigorous approach to pay.

Financial target

8. The Sub-Committee will probably be able to agree with the Secretary of State for Trade's proposal that BA should be set a financial target over the next three years consistent with their Corporate Plan; and that his officials should sort out the details with the Treasury and CPRS.

Privatisation

9. The Secretary of State for Trade proposes that the Government should, as BA's Chairman wishes, provisionally plan to sell some 50 per cent of the shares in BA to the private sector late next year. This would require a capital reconstruction of BA so as greatly to improve its present debt : equity ratio of over 90 per cent. The Government would have to take over responsibility for about half of BA's debt of about £1,000 million. The capital reconstruction could cost more than privatisation would raise (depending how the market valued the company). The Secretary of State accordingly proposes that he should arrange for urgent detailed discussions on the arrangements and

timetable for a capital reconstruction and privatisation; and that he should report in the autumn.

10. There are two problems about this timetable:

i. Privatisation in late 1983 may be too ambitious. A prospectus issued in the autumn of next year could not avoid giving prominence to BA's substantial losses in 1980-81 and 1981-82: all it could set against that gloomy record would be a small profit in 1982-83 and the prospect of some improvement in 1983-84. On the face of it the best time to float BA would be when the profits forecast for 1984-85 are within reach and there is a reasonable expectation of further improvement in 1985-86, ie privatisation late in 1984. On the other hand a provisional target of late 1983 might help to sustain the momentum which Sir John King appears to have created towards making BA more profitable.

ii. Legislation, for which there is at present no place in the programme, would be needed in the next session. Powers to turn BA into a Companies Act company and sell its shares already exist; but a capital reconstruction would require legislation. The Bill would be short, and Lord Cockfield suggests that it could be introduced early in the 1982-83 session. It would in effect be making a present of £500 million to BA as a prelude to privatisation and could therefore be contentious.

11. The conclusion may be that the Government should continue to plan for the possibility of privatisation in late 1983, mainly so as to keep up the pressure on BA, and that the Secretary of State should, as he proposes, report back to the Sub-Committee after the Summer Recess; but that in reality it is unlikely that privatisation will be possible next year. Ministers may feel that, even so, the capital reconstruction of BA cannot be deferred for much longer and that time should be found for a short Bill in the next Session if this were to prove possible.

HANDLING

12. The Secretary of State for Trade will want to introduce his proposals. You will want to invite comments from the Chancellor of the Exchequer and Mr Sparrow. Any other member of the Sub-Committee may wish to comment, especially perhaps on the possible privatisation of BA.

CONCLUSIONS

13. You will want to reach conclusions on the following questions:

i. Does the Sub-Committee endorse the general direction proposed in BA's Corporate Plan, subject to the Secretary of State for Trade's impressing on the BA Board that further manpower reductions may be needed, that they should be prepared to take a radical approach to the Corporation's route structure and that the provision for uncommitted investment in the later years of the Plan may be overgenerous? Are there any other comments on BA's Plan and performance (for example 'headroom' and pay)?

ii. Does the Sub-Committee agree that the Plan should form the basis of BA's financial targets for the next three years, and that the Secretary of State should agree detailed arrangements with Treasury Ministers and the CPRS?

iii. Should the Government plan provisionally for a flotation of BA in late 1983? Should the Secretary of State arrange for urgent detailed discussions of the arrangements and timetable for a capital reconstruction and privatisation and report progress to the Sub-Committee in the autumn?

PLG

P L GREGSON

23 July 1982

Prime Minister (2)

Agree

MCS 8/6

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

JFF842

Secretary of State for Industry

7 June 1982

The Rt Hon The Lord Cockfield
Secretary of State for Trade
Department of Trade
1 Victoria Street
LONDON
SW1H OET

MT

Dear Arthur,

BRITISH AIRWAYS : SALE OF INTERNATIONAL AERADIO LIMITED (IAL)

Thank you for copying to me your letter of 27 May to Geoffrey Howe.

2 I agree that we should not rule out a foreign buyer for IAL. Quite apart from the objective of getting the best price for the disposal, foreign ownership can in my experience sometimes prove beneficial. Furthermore, as you yourself recognise, if the Government were seen to restrict the sale to UK buyers we could meet considerable international criticism to the detriment of our efforts to attract inward investment. Because of this latter consideration I should welcome the opportunity to comment if a foreign bid seems likely to be a runner.

3 I agree too that in principle we should oppose the disposal of IAL to a public sector buyer. I have therefore written to Sir George Jefferson asking him to consult me if BT propose to pursue their interest further.

4 I am copying this letter to The Prime Minister, Members of E(NI), John Nott and Sir Robert Amstrong.

Yours ever

Patrick

CONFIDENTIAL

Aerospace

Prime Minister (2)

MCS 3/6

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

3 June 1982

Lord Cockfield
Secretary of State for Trade
1 Victoria Street
LONDON
SW1H OET

Dear Arthur

BRITISH AIRWAYS: SALE OF INTERNATIONAL AERADIO LIMITED

Thank you for your letter of 27 May about the proposal from British Airways to sell IAL.

I am in broad agreement with the line you propose to take. In particular, disposing by means of bids from interested corporate buyers should both maximise the proceeds - which is important - and speed up the disposal. I also agree with you that to dispose of IAL to a public sector buyer would be to make a nonsense of the philosophy underlying our privatisation programme.

I am sending copies of this letter to the other recipients of yours.

Yours

GEOFFREY HOWE

Aerospace

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

MBPM MUS 1/6

cc JN

CONFIDENTIAL

From the Secretary of State

Peter Jenkins Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

28 May 1982

Dear Peter

BRITISH AIRWAYS: SALE OF INTERNATIONAL AERADIO LIMITED

I am sorry that there is a typing error on the last page of my Secretary of State's letter to the Chancellor dated yesterday.

The last sentence in paragraph 2 which begins "I should take a similar line ...." should be the final sentence in paragraph 3. Thus the third paragraph should read:-

> "Subject to any comments by you or other colleagues (which I should be glad to have by Wednesday 2 June), I propose to take the line indicated above with Sir John King. I should take a similar line on the question of a public sector purchase with Norman Payne; and I hope Patrick Jenkin would do the same with Sir George Jefferson."

I am copying this letter to the recipients of my Secretary of State's letter. I should be grateful if it could be amended accordingly.

Yours ever

Patricia A McNulty

MISS P A McNULTY
Private Secretary

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

Prime Minister (4)

MCS 27/5

From the Secretary of State

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

27 May 1982

Dear Chancellor,

BRITISH AIRWAYS: SALE OF INTERNATIONAL AERADIO LIMITED

As you may be aware, British Airways are intending shortly to dispose of their subsidiary, International Aeradio Limited (IAL), which is a profitable company specialising in aviation consultancy, communications and related activities.

Sir John King and his Board consider that the company is not central to British Airways' buisness and that responsibility for its management is better located elsewhere. I entirely agree. IAL is diversifying into many non-aviation fields, and indeed at present is currently supervising the construction of a major hospital in Saudi Arabia. It needs new money for such ventures; I do not think we should provide it and disposal is the only way of allowing this diversification to go ahead. Moreover, the proceeds could be substantial and help BA with its financial problems including the task of living within this year's EFL. For these reasons, they (and I) are keen to move fairly fast on the disposal.

The question of disposal is essentially one for the judgement of the BA Board: under existing legislation, I have no formal powers to prevent BA disposing of IAL, or to direct them as to the method of sale. However, I have already made it clear to Sir John King that I would expect to be consulted about the way

in which he intends to dispose of it. From a political point of view, it is clearly important that there is no avoidable criticism over the handling of the disposal; I am sure that Sir John King has taken this point on board.

The main questions that arise on the method of sale are as follows. First, BA, advised by both Price Waterhouse and Warburgs (BA's own merchant bank adviser), think that disposal of IAL to a single buyer should enable benefits to be obtained if the buyer was in a complementary field of activity; such a disposal could therefore be expected tocommend a significant premium over a flotation. BA therefore favour disposal to a corporate buyer (via an auction among the candidates) rather than a flotation, in order to maximise the proceeds (which could be of the order of £50-£60m). I would not wish to take a different view on this; and I imagine you would not dissent.

Second, there are aspects of the choice of buyer. First, I would be strongly opposed to any question of disposal of IAL to a public sector buyer, even though there has been some interest expressed by British Telecommunications and the British Airports Authority. We are trying to reduce the size of the public sector not helping it to entrench itself even deeper into the national economy. I have already indicated an initial view on this to Sir John. A second aspect relates to whether we should express any view to BA about a disposal to a foreign buyer. I can see that there might be criticism of such a disposal. But there is considerable advantage in not ruling out a foreign buyer at this stage, in order not to depress the price. Moreover, since IAL operates in Saudi Arabia, it would be most tactless to exclude the Saudis should they be tempted to bid. Further, if it became publicly known that we had attempted to limit the sale to a

From the Secretary of State

CONFIDENTIAL

United Kingdom buyer, we could run into international criticism, particularly from our Community partners and from the United States (who had proved sensitive in the last year to cases where they thought we might be departing from our general policy of welcoming inward investment). Nonetheless, I would propose to indicate to Sir John King that while I did not suggest that the Board should narrow the field by excluding foreign bids, I hoped that they would take into account in weighing such bids, whether the bidders' plans might lead to the company making less of a contribution to the British economy.

Finally, although I do not think - for the reasons set out above - that I should make it appear to the Board that my consent is required, I propose to ask Sir John to consult me if the Board is minded to close with a bidder in any unusual circumstances - for example, if the proceeds from the bid fall substantially below the Board's present expectations or if the preferred bidder offered substantially less than the highest bidder. I should take a similar line on the question of a public sector purchase with Norman Payne; and I hope Patrick Jenkin would do the same with Sir George Jefferson.

Subject to any comments by you or other colleagues (which I should be glad to have by Wednesday 2 June), I propose to take the line indicated above with Sir John King.

I am copying this letter to the Prime Minister, other members of E(NI), to John Nott and Sir Robert Armstrong.

Yours sincerely,

LORD COCKFIELD

(Approved by Secretary of State & signed in his absence)

CONFIDENTIAL

Aerospace

CF
pl file
MCS 25/5

Prime Minister

From: IAN GOW

BRITISH AIRWAYS

1. Herewith letter dated 22nd May from John King, together with a copy of his letter of the same date to Arthur Cockfield.

2. Iain Sproat lunched with me today.

3. He is very strongly in support of John King about this.

4. John King wants to pay the new Finance Director, Gordon Dunlop, £55,000 a year. Apparently, both Arthur and the Treasury are arguing that this is too much. John, on the other hand, says that he must have the best man, and that this is the salary which will be required in order to get Dunlop.

5. John King and Iain Sproat are both allies about this. They both want to sell off British Airways if they possibly can, in July 1983.

6. Although I have considerable reservations about this salary (greatly in excess of that paid to the Queen's First Minister) I have the highest regard for John King and think that we ought to let him run British Airways as he thinks best, with the earliest possible prospect of privatisation.

24th May 1982

IAN

CLEVELAND HOUSE
ST. JAMES'S SQUARE
LONDON SW1Y 4LN

01-930 9766

SIR JOHN KING

As from: Achnabourin,
Betty Hill by Thurso
Scotland.
Tel:Betty Hill (0641)
213

By Hand:

Strictly Private Personal and Confidential

Ian Gow Esq., MP.,
10, Downing Street,
London S.W.1.

22nd May 1982

Dear Ian,

It is shameful of me to bother you and the Prime Minister at such a time with this wretched matter. I hope she will forgive me but I am under real pressure to get forward. So if you could show my letter to the Prime Minister, I would be most grateful.

In addition, I hope to come up with a Group Managing Director for the airline quite soon. The prospect that I had has gone away.

Needless to say, I send my best wishes to her and know that she is right in the South Atlantic and will be successful.

Yours ever,

p.p. Sarah Crabb

John

Enclosure:

Dictated by Sir John King and signed in his unavoidable absence:

CLEVELAND HOUSE
ST. JAMES'S SQUARE
LONDON SW1Y 4LN

01-930 9766

SIR JOHN KING

As from: Achnabourin,
Betty Hill by Thurso,
Scotland.
Tel: Betty Hill(06412)213

22nd May 1982

By Hand

Strictly Private Personal and Confidential

Lord Cockfield,
Secretary of State for Trade,
1, Victoria Street,
London S.W.1.

Dear Arthur,

British Airways

I refer to my letter of 14th May, concerning the appointment of Gordon Dunlop to the Board of British Airways as its Finance Director.

You have met Dunlop, you know the terms I have agreed with him and why I must appoint him.

When we met the Prime Minister, it was agreed that I should find the men I wanted and the salary levels I would have to pay were discussed and accepted. I made a commitment on my part to keep the Prime Minister fully informed. She understood what I had to do and said I must be supported.

As a consequence of this policy, I have made a commitment to Dunlop, which I intend to keep. You say that the Treasury is not now in agreement, but I know you will put the case to them and I know our view will prevail.

I have the job of returning this awful British Airways mess to a profit and then selling it to the public, but I must have the proper resources to do so.

Why the reluctance to confirm the five year term of my appointment that I need in order to see the job through? and to convince certain people that I am not just a ship passing in the night? If the Department of Trade thinks I must prove myself and gain airline experience before I qualify and it can be confirmed, where are we then? I must ask you if the experience of those in charge of the airline to date and the efforts of the Department of Trade to monitor and guide them have proved to be other than disastrous. Losses of over £500m in the last two years, and continuing apace?

...2/

By Hand

Strictly Private Personal and
Confidential

22nd May 1982

Lord Cockfield,
Secretary of State for Trade,
1, Victoria Street,
London S.W.1.

There is an urgent need to have a capable and credible executive and non-executive board of directors to run a company properly if we are to move into the private sector (and also to be a more efficient public sector company) and have an airline the nation can be proud of. In the meantime, Rome burns and I, theoretically, am in command.

Yours sincerely,

p.p. Sarah Chalk

John

c.c. Iain Sproat Esq., MP.,
Parliamentary Under-Secretary of State
for Trade.

Dictated by Sir John King and signed in
his unavoidable absence:

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

Prime Minister (4)

MCS 20/5 cc

From the Secretary of State

CONFIDENTIAL

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

20 May 1982

Dear Leon,

BRITISH AIRWAYS

Thank you for your letter of 5 May.

I fully agree with you that the Price Waterhouse analysis of British Airways makes disturbing reading. Although airlines all over the world are continuing to face grave financial difficulties - Braniff's bankruptcy is the most recent reminder - there is no doubt that British Airways' management must bear the prime responsibility for the failure of the growth strategy of 1979. Equally, however, I hope you can agree that there are now encouraging signs that Sir John King is taking the necessary remedial steps to turn British Airways round. The action taken last September to reduce over-manning and to cut costs, and the more recent decision to establish clear lines of profit-centred accountability, are important steps, and I am sure that we should continue to support the further remedial measures, as well as the plans for strengthening British Airways' management which Sir John has in mind. Our aim must remain to launch British Airways as a prosperous, efficient private sector company standing in high repute with its customers, its staff and its shareholders.

To this end, the return to profitability and privatisation are inextricably linked. I therefore very much share, as I am sure you do, Sir John's hopes that it will be possible successfully to float British Airways during the lifetime of this Parliament.

Turning now to the specific points you raise, I of course agree on the importance of constructing an effective framework of sponsorship and financial control. Sir John, too, is seized of this point, and has initiated steps to improve the financial information which his own Board receives. He has also agreed that my Department, and of course the Treasury, will be given prompt, regular, and more importantly reliable, reports enabling us to monitor British Airways' performance. On the details of such improvements, I think your officials are already in touch with mine.

As for the Corporate Plan, Sir John is already well aware of the importance which we attach to receiving this by early June. We have also asked British Airways to ensure that the Plan addresses itself to the strategic options available, and to an analysis of the key sensitivities which might cause it to deviate. Again, your officials have already been involved in discussions on this point. In this context, I am glad to see that you recognise that we cannot realistically determine BA's financial target until after we have received their Corporate Plan.

Finally, I should emphasise that one of the crucial determinants of the success of British Airways' future will be the quality of their top management - which has clearly been deficient in the past. This in turn will require adequate remuneration to attract candidates of the right calibre. I shall be writing separately about this in due course.

From the Secretary of State

CONFIDENTIAL

I am copying this letter to the Prime Minister, John Sparrow and to Sir Robert Armstrong.

Yours,

Arthur

LORD COCKFIELD

Prime Minister (2)

MCS 6/5

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Lord Cockfield
Secretary of State
Department of Trade
1 Victoria Street
London SW1H OET

5 May 1982

MT,

Dear Arthur

BRITISH AIRWAYS

will respond if required
L + PM

John Biffen wrote to me on 5 April about the Price Waterhouse report, and I have now had an opportunity to consider it.

The Price Waterhouse analysis of British Airways deficiencies makes disturbing reading. One must accept that the airline industry as a whole faced a sharp deterioration in their trading situation from 1979 onwards. What emerges clearly from the report is that BA management, secure in the knowledge of Government backing, in no way measured or even tried to measure up to the challenge; through unfounded optimism and other devices, the real problems were glossed over.

I am particularly struck by two conclusions:

(a) That it is inconceivable that an effective management would have allowed the growth strategy of 1979 to proceed unchanged in the way that the BA Board did (paragraph 12 on page 118 of the report);

(b) That BA would not have embarked on and maintained such an ambitious capital expenditure programme had they not been a nationalised industry with the backing of Government guarantees on past and projected bank borrowings (paragraph 39, page 11).

I am worried by the fact that even now, in May 1982, no considered options or proposals have yet been put to Ministers on the key issues of business strategy.

You are I know giving a great deal of thought to this. The return of BA to adequate profitability must be the first priority. Scarcely less important is the need to construct an effective framework of sponsorship and financial control so as to ensure that the recovery measures eventually agreed are implemented and that the impact on BA of any new adverse developments is not allowed to fester, unacted upon, as in the past.

As regards profitability there is the difficulty that no financial target has yet been set for BA for this or future years. I alluded to this in my letter of 16 March to John Biffen but he was inclined to the view that it would not be possible to make a final determination until the Summer when the figures had emerged from BA's Corporate Plan. I am prepared to accept this subject to two stipulations.

First if we are to reach sound decisions on the basis of the Corporate Plan then it must address itself specifically to the implications of achieving alternative rates of return and should set these out fully and realistically, with a firm indication of the relevant timetables involved.

The Corporate Plan will of course need to cover a great deal else. In particular you have no doubt already told Sir John King that you will expect it to set out the BA's proposals for action on the crucial recommendations of Price Waterhouse on capital expenditure, route structure, aircraft utilisation and manning. There is clearly a range of options on some, if not all of these. The Plan should set these out and relate them to different possible overall returns over the next two or three years. It should also include a proper analysis of the vulnerability of the projections to the key factors in the competitive environment to which Price Waterhouse drew attention.

Secondly, BA must be persuaded of the extreme importance which we attach to this work being done quickly now. The present budgetary projections for 1982-83 are far from satisfactory, nor are those for the later years acceptable. Further delay in producing proposals for improving the situation would be intolerable. If E(NI) is to discuss British Airways in June as at present scheduled, then BA's Plan must be ready by the beginning of the month.

Turning to the question of future control, I see from the press and also from elseshere that Sir John King is already addressing some of the recommendations in the report on divisional structure and senior management. Provided that the inevitable disruption caused by organisational and managerial changes does not lead to further delays in the production of the proposals for substantive measures, these changes seem to be generally in the

right direction. But implicitly, (and on occasion explicitly), the report has also revealed deviciencies in our own machinery of sponsorship which I believe must be put right. It may well be, as the report suggests, that it will be sensible to revert to the possibility of privatisation during the first part of 1983, but we cannot be sure. Moreover, there must be adequate monitoring of progress between now and then, if we are to reduce the risk of being once again sprung with a nasty surprise. My officials are discussing with yours a tightening of our arrangements for linking BA's future recourse to external finance to satisfactory reports of progress against plan during the year, drawing on the analogy of those which have been instituted for other nationalised indistries in a similar position. I propose that you and I should receive regular reports based on this monitoring and should take any necessary action with British Airways as the year goes forward. I regard this as being of crucial importance.

I hope you will have no difficulty in agreeing to these points and would be grateful to know how, in the light of your discussions with Sir John King, you now see the prospects for making early progress. If you would find a discussion helpful, I would be happy to arrange one.

I am sending a copy of this letter to the Prime Minister, John Sparrow and Sir Robert Armstrong.

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

(4)

Prime Minister

MCS 20/4

From the Secretary of State

CONFIDENTIAL

Michael Scholar Esq
Private Secretary to the Prime Minister
10 Downing Street
London, SW1

16th April 1982

Dear Michael,

BRITISH AIRWAYS

Thank you for your letter of 8 April recording the outcome of the meeting between Sir John King and the Prime Minister.

The Secretary of State found the meeting an extremely useful introduction to the problems facing BA. He does not doubt the importance of the issue, and will be pursuing the range of questions raised by Sir John King and his colleagues.

In your note you record Mr Dibbs as saying that "no investment appraisal had been made at BA for the purchase of a Boeing 747 freighter which BA had subsequently sold at a large loss after 18 months or so of unprofitable operation". The Secretary of State recognises that Mr Dibbs' point was simply intended as an example of what he saw as BA's shortcomings. But whilst this purchase did in the event prove unnecessary, Mr Dibbs' assertion that there was no investment appraisal is incorrect. Such an appraisal was carried out early in 1979, and was submitted to the Department in the usual way. The Department subsequently communicated approval of the order in May 1979.

For obvious reasons, I am also copying this to Terry Matthews in the Treasury.

Yours Sincerely,

Jonathan Rees

J N REES
Private Secretary

CONFIDENTIAL

Aerospace

CLEVELAND HOUSE
ST. JAMES'S SQUARE
LONDON SW1Y 4LN

01-930 9766

SIR JOHN KING

April 8th 1982

Dear Prime Minister

How very kind of you to see us this afternoon in view of all the major & pressing matters of state that you are dealing with. Your support & understanding is a massive help towards solving the British Airways problem. Again my thanks

Yours sincerely John

PERSONAL AND CONFIDENTIAL

File

cc Master

Subst

10 DOWNING STREET

From the Private Secretary

8 April 1982

Dear Jonathan,

BRITISH AIRWAYS

Your Secretary of State was present this afternoon when Sir John King, accompanied by Mr. Dibbs, and by Mr. Wheatley of Price Waterhouse, called upon the Prime Minister.

Sir John King said that British Airways, as the Price Waterhouse report had made abundantly clear, was in a mess. It lacked a competent and businesslike management. He could deliver a successful airline to the Prime Minister, but it would take more than the two years which remained of his appointment as Chairman. When he recruited new people from outside he needed to be able to say that he would be Chairman for longer than two years; the same point applied so far as the establishment at British Airways was concerned, given that they had seen a succession of Chairmen and Secretaries of State come and go. He also needed freedom of action to recruit, and to pay at an appropriate level, three top managers: a managing director, a deputy managing director and a finance director. He intended to sell International Aeradio (IAL); and it was possible that an overseas potential buyer would come forward. He had already sold the College at Hamble. Finally, he asked that the progress in implementing the changes following the Price Waterhouse report would not be monitored in detail by the Department of Trade. It was for the BA Board to do this, and for the Chairman to report to the Secretary of State. If the Department attempted to monitor in detail, the Board's responsibility would be eroded.

Mr. Wheatley said that he had begun work on his report in October 1981, and concluded in March. His conclusion was that British Airways was in a mess, financially, managerially and operationally. Without a Government guarantee it would not be able to continue trading. Its debt/equity ratio was worse than Laker's. Yet it still had a £2 billion capital expenditure programme. British Airways was the most unproductive and overmanned of all international airlines. There was scarcely a businessman in the organisation. He had enquired of BA what plans they had for renegotiating - as other airlines had - the terms of their purchase of nineteen Boeing 757s. They had none; indeed, the idea had not occurred to them. Mr. Dibbs said that

/he had

he had, similarly, discovered that no investment appraisal had been made at BA for the purchase of a Boeing 747 freighter which BA had subsequently sold at a large loss after eighteen months or so of unprofitable operation. It was true that BA had suffered over the years from the insistence of governments that it should purchase aircraft it did not want; it had also suffered from higher fuel costs, and from the effects of sterling depreciation. But he had been appalled at the amount of management effort which had been expended on devising various very short-term expedients to overcome BA's financial difficulties. He was not recommending, and BA were not requesting, that the Government should now take over £812 million of BA's debts. It was necessary first to rebuild BA's management (and, for example, to bring to an end a situation in which the only person in the airline who was profit-accountable was the Chief Executive). Above all it was necessary to create a viable business. Once this new situation had been created it would be time to consider how to deal with the airline's unsustainable debts.

Your Secretary of State said that British Airways were confronted by a very serious situation and that it would be a major task to turn round the losses of recent years. But he had doubts giving the British Airways Board an entirely free hand in the selection of three top managers. The level of their pay was bound to have repercussions elsewhere in the public sector. As to monitoring, he did not wish to set up a bureaucratic procedure, but some monitoring was inescapable, given that the Government was answerable to Parliament for British Airways' affairs.

The Prime Minister acknowledged the importance of recruiting sufficient new management strength to take on the existing establishment effectively; one man on his own, however able, could find this an impossible task. Sir John should go ahead and look for three people of the kind he had in mind. She believed that it would be very difficult to find people of the right kind; it was possible to pay £90,000 a year (Sir John had mentioned this figure), and still get somebody who was of little use. The repercussive effect elsewhere in the public sector of a high salary was not necessarily a decisive argument; Mr. MacGregor's appointment at BSC was a case in point. She was grateful for Sir John's undertaking to consult Lord Cockfield before coming to final conclusions on this matter. So far as the sale of IAL was concerned, a proposal to sell to an overseas buyer would need to be looked at very carefully, and treated with sensitivity. Present indications were that, given the degree of interest being shown by a number of UK potential purchasers, this question would not arise.

I am sending a copy of this letter to Terry Mathews (Chief Secretary's Office). I would be grateful if both you and he would give it a very narrow circulation within your Department.

Yours sincerely,

Michael Scholar

Jonathan Rees, Esq.,
Department of Trade.

cc JV

Prime Minister (2)

For Thursday's meeting.

MCS 6/4

PRIME MINISTER

BRITISH AIRWAYS: PRICE WATERHOUSE REPORT

I thought it would be helpful to let you have a few preliminary points in advance of our discussion with Sir John King on 8 April.

The Price Waterhouse report (of which you already have a copy and a summary) was of course commissioned by Sir John himself. Sir John has told me that "in essence" the report's recommendations have the British Airways Board's full support.

The report has done a good job in analysing past deficiencies in BA's performance and the over-optimism of their forecasts; it has also stressed that BA's priority must be to return to profitability. To this end it urges the airline to review its capital expenditure commitments, to cut out unprofitable routes and to improve aircraft utilisation and manning. It also makes sensible proposals for increasing the effectiveness of the Board and senior management.

I have already discussed the report on several occasions with Sir John King, and we have agreed that BA's priority must be to improve its operating results. It would be helpful if you could re-inforce this message on Thursday. On the more practical level, BA must now take urgent steps to draw up a detailed and agreed plan to implement the measures necessary to remedy the deficiencies highlighted by the Price Waterhouse report. Such a plan must consider alternative strategies based on lower as well as currently envisaged levels of capital expenditure, and should be ready by the beginning of June.

The Price Waterhouse report also made important recommendations about a capital reconstruction for BA, and the possibilities of privatising the Corporation by autumn 1983. I think we must encourage Sir John King to pursue this goal. However, as indicated above, his immediate priority must be to return to profitability, and we must do all we can to help him, since only then can we successfully seek the partnership of private capital for BA.

To sum up, therefore, I think the line we should take with Sir John at Thursday's meeting should be as follows:-

1 To acknowledge the measures Sir John has already taken (though as he himself will admit, these are not enough);

2 To confirm with Sir John that his priority must still be to improve the airline's operating results;

3 To express our support in principle for further remedial action, and to ask Sir John to let us have a detailed plan on the measures he intends to take by, say, June.

Jonathan Rees

PP WJB (Approved by the SoS and signed in his absence)

Department of Trade
1 Victoria Street
London, SW1H OET

5 April 1982

Atta 2

→ CF pp's pl
[redacted] 5/4

Note
Mr Henderson
will not come
MCS 5/4

10 DOWNING STREET

(1)

Prime Minister

As agreed, we have arranged for Sir J King (with Alex Dibbs, his joint Deputy Chairman, and also Alan Wheatley of Price Waterhouse) to come in on Maundy Thursday to discuss the Price Waterhouse Report on British Airways.

John Biffen has asked if he may bring Ian Sproat and Michael Franklin – and thinks that it would be a good idea if Leon Brittan

OVER

attended, too.

Agree?

We will be letting you have a brief early next week.

MCS 2/4

Please - it is not a mass meeting.

I have already invited John Hoilyoke.

John Bolton can if he comes - but no-one else.

Aerospace

Prime Minister (2)

MCS 31/3

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05877

CONFIDENTIAL

31 March 1982

Dear Secretary of State,

Draft Objectives for British Airways and British Airports

I am afraid that I did not receive until a few days ago a copy of your minute to the Prime Minister requesting comments by 10 March.

Given the size of the losses of the British Airways Board (BAB), and the apparently receding prospects for privatisation, I do not think Ministers would wish to remain satisfied indefinitely with objectives on profitability and privatisation as imprecise as those in your draft, particularly as to timescale. Although I have no special knowledge of BAB I am concerned that even now the Board may not be looking sufficiently radically at the size and structure of the industry, and in particular at the scope for cutting back on loss-making routes. It may be that the Government at present lacks sufficient information to be able to specify precise and demanding targets for profitability and privatisation. Hence the importance of objective 3 which, as your minute says, will lead to an examination of alternative strategies in the context of the Corporate Plan. I believe it important that the Board takes early action along these lines, aimed at developing a corporate strategy; perhaps your discussion with the Chairman about the Price Waterhouse report will provide an opportunity to get this point across.

I have no major comments on your draft objectives for BAA although I wonder whether a pay objective should be included, given

The Rt Hon John Biffen MP
Department of Trade
1 Victoria Street
S W 1

that BAA is in a near monopoly situation. Something on the following lines might suffice:

> 'to negotiate settlements on pay, pensions and other conditions of service at the lowest levels consistent with adequate recruitment and other relevant factors, particularly productivity improvement.'

I am sending copies of this letter to the Prime Minister, other members of E(NI) Committee, and Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

Prime Minister

Mr Biffen is seeing Sir J King today will report before your meeting on 8 April. MCS 17/3

cc Mr. Hoskyns
Mr. Vereker

Aerospace

MR. SCHOLAR

BRITISH AIRWAYS: PRICE WATERHOUSE REPORT

1. This is a most depressing document. The basic suggestion is that the Government should take over £812m of British Airways' debt, which is I think mostly owned by banks. On their reckoning this would mean that the debt equity ratio would then be 83:17. There would be about £300m of debt and £60m of equity.

2. In order for the Government to take over this debt, or write off the small amount that is on the Government's account, we would need to raise the £812m in the markets. It would willy-nilly count as part of our PSBR. So far as I know, no such sum has been included in the public expenditure figures for next year.

Yes - part of PSBR just included in any plans - but spread out over 8-10 years. MCS 17/3

3. In return for this purchase of British Airways debt, the report remarks that we would enjoy a substantial increase of the net worth of the group and the expected proceeds of privatisation. But obviously the proceeds from privatisation depend critically on future expected profits and these in turn depend upon pay levels, manning practices, as well as general management. Similarly it would be affected by the political constraints which are imposed on British Airways - including the requirement that they fly certain routes etc. Price Waterhouse suggest that the capital re-structuring is a necessary requirement to put it into shape. I cannot really see why.

and on debt liability

4. The main thrust of British Airways should be to get it into a form like Delta. The objective is clear, to make profits, and strategy should be drawn up with that in mind. It is difficult to do this when there are enormous political constraints and they do not know how far they can go in dealing with the unions. But I cannot see how transferring capital to Government can help in radical re-structuring of their objectives, strategy and tactics. I suspect that Sir John King needs a few young Turks around him. Perhaps he is gathering them now.

17 March 1982

ALAN WALTERS

Prime Minister (1) Clive - to see.

PA. 16 March 1982

Agree?

MCS 17/3

MR SCHOLAR

I see that Sir John King is spending half an hour with the Prime Minister on 8 April. I would very much like to sit in on that meeting.

I have met King - spent an hour or so discussing his problems (not least with his board!) Our chairman claims to know him well.

JOHN HOSKYNS

It is a private meeting - at his request. I think it had better stay private.

MT.

Told Mr Hoskyns MCS 18/3

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

cc JV

(2)

Prime Minister

As promised: depressing reading. See new, Alan's note (attached)

MCS 16/3

From the Secretary of State

CONFIDENTIAL

COMMERCIAL IN CONFIDENCE

Michael Scholar Esq
Private Secretary
10 Downing Street
London, SW1

16th March 1982

Dear Michael,

BRITISH AIRWAYS: PRICE WATERHOUSE REPORT

... As promised last night, I enclose a summary of the Price Waterhouse Report. I am very sorry that we were unable to get it to you yesterday.

Yours Ever,

Jonathan Rees

J N REES
Private Secretary

(1) No business men in the Co.
(2) Disposed assets
(3) Property non-profitably - it could be a joy for passengers.
(4) Don't want to be monitored in detail.
(5) Pass financially, managerially, operationally.

CONFIDENTIAL

COMMERCIAL IN CONFIDENCE

CONFIDENTIAL &
COMMERCIAL IN CONFIDENCE

SUMMARY OF PRICE WATERHOUSE REPORT

Section I

A 29-page summary of the 85 pages which follow.

Section II - The Group's results 1979/80 to 1981/82

During the 3 years to March 1979 British Airways did quite well: £200M of profits after tax, and a return on assets of 10%. During that period pressure for cheaper fares, US deregulation and IATA reform began to threaten airline yields. BA had ten different aircraft types, which were expensive in logistics, and many of them were heavy fuel burners. McKinsey advised BA to cut manpower by 30% to match competitors' productivity.

302

The 1979 Corporate Plan GP7 set out a strategy for coping with these changes. It assumed that low yield traffic would grow by 38% and revenue by 60% in the next 3 years. Lower fares were introduced, 11 wide bodied aircraft were ordered and manpower was held stable to "grow out of our inefficiency".

!

The 1980 Corporate Plan acknowledged that 1979/80 had not turned out as expected, but continued to forecast traffic growth at more modest rates.

In the event growth in traffic over the 3 years was nil, BA had surplus capacity and was still overmanned. 5 wide-bodied aircraft have been sold at less than book value; 3 more are up for sale. BA have improved their productivity by about 25%, but so have competitors, hence relatively BA have not gained much ground. They will have lost over £400M after tax, against a predicted profit of about £180M for the triennium.

The reasons for the shortfall in revenue and profit, are analysed: pressure on fares; political events (Iran); higher fuel prices; exchange rate fluctuations and the ATC strike are the most important. Other airlines have suffered similarly.

The Action Plan of September 1981 is a belated, and hence very costly attempt to deal with the overmanning.

Section III - Forecast results for 1982/83 to 1985/86

A detailed analysis of BA's latest forecasts for the next 4 years, and the assumptions underlying them. After interest and tax Price Waterhouse predict a loss of £15M in 1982/83 and small profits in the ensuing 3 years. Over the 4 year period only

£5M would be available for retention. This does not allow for dividend to Government on PDC, nor for the Government's share of forecast Concorde surpluses. The figures are however struck after charging about £35M provisions each year in the airline's profit and loss accounts, and slightly smaller amounts in those of the subsidiaries, for "sensitivities" - the probability that unplanned factors will affect the results. These provisions total £263M over the 4 years. They are explained on pp 54-58, and represent PW's view of the extent to which BA's forecasts, even on their "low growth" assumptions may be optimistic.

Five groups of routes will provide half the expected 1982/83 operating profit. BA's position on them is at some risk in various ways, political, competition and CAA licensing.

The forecasts show an unacceptable position which would not be greatly improved by higher assumptions of traffic growth, because interest charges would also increase. So a capital reconstruction should take place when the Board have reduced manpower further; improved fleet utilisation considerably; and reviewed BA's route strategy and capital expenditure plans.

Section IV - Capital expenditure and cash flows 1979/80 to 1985/86

This section starts with an account of BA's investment over the last three years; the assumption that a lower proportion than in the past would be financed from BA's own resources - a private sector company without Treasury guarantees would have hesitated to act this way; internal funds in the event were much less than forecast, so BA had to borrow more, worsening the debt/equity ratio further, and also had to adopt expedients to keep within the authorised limits of this borrowing, which were inadequate.

BA's aircraft fleet is then discussed, compared with those of other operators and the plans to replace older thirsty aircraft with new ones consuming less fuel examined. The rationale for the major purchase in prospect - 19 Boeing 757 aircraft is summarised. However BA's fleet utilisation is still lower than many other major airlines, it will still have more aircraft types, including some which are no longer produced, for which spares will be costly.

Part III showed that retained earnings will contribute only £5M. A £705M contribution from internal funds is forecast (mainly from depreciation provisions) towards capital expenditure over the 4 year period of £1400M. This includes £100M contingency and £160M progress payments on aircraft wanted in 1986 and 1987, for which £800M more will be needed in those years.

With these commitments and no capital restructuring the Group could not substantially improve its present gearing, although the measures suggested in Section III would help a little. To keep within the EFL of £-9m for 1982/83, the Board should consider selling IAL and other non-airline assets; deferring, cancelling or renegotiating terms for 757s; restructuring non-aircraft capital expenditure and other measures to improve profitability.

Section V - Capital restructuring

On the forecasts of future profits and cash flow PW have made BA will be unable to generate enough cash to service its existing debt, and pay for new capital expenditure. Its equity will be reduced to £60m by 31/3/83. Loans will total over £1.1b, and the debt/equity ratio will be 95:5. In this state the auditors would have difficulty, unless the Government gave them "comfort", in certifying the accounts on a "going concern" basis.

812m

The debt/equity ratio BA needs is 25:75 (Hill Samuel thought no more than 50:50). To achieve this PW recommend the Government take over responsibility for up to £812m of BA's debt. In the best interests of the airline this should be done as soon as possible, but PW suggest not later than 31/3/83. This allows time for:

(a) discussion with Government over a politically difficult proposal;

(b) self-help measures by BA to increase cash flow and reduce demands on cash, viz

(i) improvements in fleet utilisation
(ii) disposal of assets, notably IAL
(iii) improvement in use of manpower, and negotiation of 1983/84 pay;

(c) the other fundamental changes referred to in section VII.

Conversion of debt into Public Dividend Capital would not help because the PDC would still have to be serviced at much the same costs as debt.

Since only £41m of the Group's debt is due to the Government, most of the debt could not be written off: the Government over the years would have to pay interest and principal. PW do not forecast the cost of this as they do not precisely identify the debt to be transferred, commenting only on which kinds should preferably be retained by BA.

The transfer of debt would substantially increase the net worth of the Group, and hence the expected proceeds of privatisation. This would compensate the Government to a degree for the burden it has assumed.

Section VI - Privatisation

This summarises Government statements about privatisation of British Airways, and the relevant legislation (not entirely correctly). It lists 14 topics where the Government at present controls or affects BA's activities - borrowing, guarantees, licensing, noise regulations (~~which BA apparently intend to ignore~~), airport policy, support for Concorde, on which clarificatory statements will be needed in the prospectus.

The earliest practicable date for privatisation would be autumn 1983; it would require audited half-year accounts to September 1983. BA do not produce these now, and should do a dry run this year. Investors might be put off by the impending election, and fears of re-nationalisation if a Labour Government won.

A classical form of privatisation would be difficult or impossible to achieve before the next General Election. However, placing of convertible preferred securities with institutions might be possible in the late autumn of 1983, and should be investigated further. At worst, sale of BA's (99%) stake in International Aeradio (IAL) could be presented as a step towards privatisation.

Section VII - the future of the Group

BA, if it makes the necessary changes, could be on of the world's best airlines. The Action Plan of September 1981 is just a first step; the Board needs to give much clearer responsibility for profit to individual managers, and to broaden their career experience to equip them better for top posts. The structure of the Board should be reviewed; a financial director appointed to it; the non-executive directors given a clearer and fuller role; and the relationship with the Executive Board clarified. Board members ought to be paid more, otherwise no-one will want to succeed them.

The airline's strategy in recent years had relied on continuing growth, and been upset by recession. The positive returns arise from too few of the routes, and BA needs to review not just its strategy but its mission "what kind and size of airline it aims to be in the medium to long term" - which is not now clear. BA should not, PW say, be drawing up future plans and strategy on the basis of a capital expenditure programme of at least £2 billion over the next six years: a strategy of lower capital expenditure and fewer routes could well improve profitability.

Tactically BA needs to keep up the momentum in staff reduction and productivity gained from the Action Programme; to use its bargaining power to get better terms from suppliers; to give greater attention to customer service; and to disposing of tasks which can be sub-contracted, or of activities which do not contribute to profit or cash flow or strengthen and secure BA's market position, and their supplies or sales.

Aerospace

British airways

Cleveland House, St. James's Square, London SW1Y 4LN
Telephone: 01-930 9766

Prime Minister

No need to read this tonight. I am having a summary done for you.

But you might look at pp. 1-4: a ghastly catalogue - esp recommendation 4 (given that the loans are from banks as I understand it).

MCS 15/3

Sir John King

Chairman

12th March 1982

By Hand

The Prime Minister,
The Rt. Hon. Mrs. Margaret Thatcher, MP.,
10, Downing Street,
London S.W.1.

Dear Prime Minister

I enclose a copy of the Price Waterhouse report concerning British Airways, the contents of which I shall be discussing with the Secretary of State for Trade and his colleagues on Wednesday of next week.

I hope you will have time to read some of it as it will give you a glimpse of the inside of a nationalised industry!!!

It would be helpful to me if I could see you sometime on Thursday, 18th March. I would like to bring along Mr. Alex Dibbs and introduce Mr. Alan Wheatley to you. He led the PW team which is responsible for the Report. If John Biffen could be there also, that would be most helpful and what I am seeking is a very informal thirty minutes or so. If you are free on Thursday, a meeting could be any time after 5.30 p.m.

Yours sincerely

John King

Enclosure:

P.S. Since writing this letter I believe a meeting has been arranged for 2.30 p.m. on Thursday, 8th April. I am most grateful to you.

10 DOWNING STREET

Note for file.

Price Waterhouse report concerning British Airways is filed in the folder at the back of this part.

Duty Clerk

BRITISH AIRWAYS

REPORT BY PRICE WATERHOUSE

STRICTLY PRIVATE AND CONFIDENTIAL

This report, which is the property of British Airways, has been issued for the information and personal use of:

The Prime Minister
The Rt Hon Mrs Margaret Thatcher MP

copy attached to this file has been removed and destroyed.
C Wayland
23 July 2013

Copy Number: 1

(1)

PRIME MINISTER

Sir John King has been in touch with us to ask whether he could come to see you towards the end of next week, for a general discussion* about the financial position of British Airways: in particular the report of the Price Waterhouse team, and privatisation plans.

* about 1/2 hour

John Biffen is happy with this proposal, and would himself be ready to come.
Sir John King would like to bring with him his Joint Deputy Chairman, Mr Alex Dibbs, and would like to introduce Mr. Alan Wheatley who led the Price Waterhouse team.

Agree to a meeting on these lines?

MCS Yes MT.

11 March 1982

cc Mr Gow
Mr Vereker

1.00
Rang today no good next week.
CJ. 12/3.

Michael Scholar

PRIVATE AND PERSONAL

11th March 1982

Many thanks for your letter of 10th March, which you had written following our talk on the telephone.

We will be in touch with you very shortly about this.

I much appreciate your courtesy in having written as you did.

IAN GOW

Sir John King

British airways
Cleveland House, St. James's Square, London SW1Y 4LN
Telephone: 01-930 9766

Sir John King
Chairman

10th March 1982

Private and Personal

Ian Gow Esq., MP.,
10, Downing Street,
London S.W.1.

Dear Ian

In writing to the Prime Minister as follows:

"I enclose a copy of the Price Waterhouse report concerning British Airways, the contents of which I shall be discussing with the Secretary of State for Trade and his colleagues on Wednesday of next week. *

I hope you will have time to read some of it as it will give you a glimpse of the inside of a nationalised industry!!!

It would be helpful to me if I could see you sometime on Thursday, 18th March. I would like to bring along Mr. Alex Dibbs and introduce Mr. Alan Wheatley to you. He led the PW team which is responsible for the Report. If John Biffen could be there also, that would be most helpful and what I am seeking is a very informal thirty minutes or so. If you are free on Thursday, a meeting could be any time after 5.30 p.m."

* The letter to the Prime Minister will be dated and sent round by hand on Friday 12th March.

I am anxious to explain to you the reason for suggesting 5.30 p.m. on Thursday 18th March and I hope she will not think me presumptious in doing so. Friday morning is all right up to 12.30 midday. Otherwise I am stuck. I go to Scotland that afternoon for the annual Babcock Power Dinner at the Renfrew Works, to London early Monday morning to New York and San Francisco. Otherwise I would never have dreamt of attempting to impose a time.

Yours ever

John King

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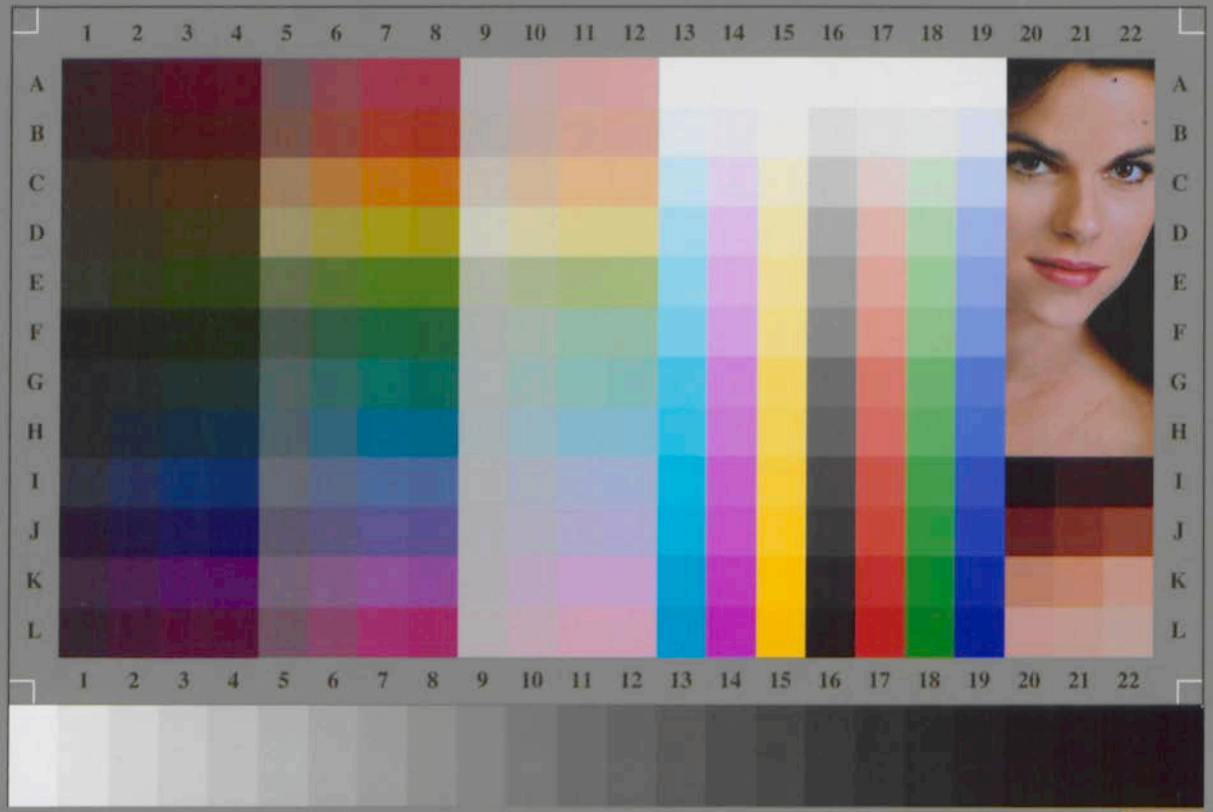

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